House of Commons

Treasury Committee

Financial Regulation: a preliminary consideration of the Government's proposals

Seventh Report of Session 2010–11

Volume II

Oral and written evidence

Additional written evidence is contained in Volume III, available on the Committee website at www.parliament.uk/treascom

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The Treasury Committee

The Treasury Committee is appointed by the House of Commons to examine the expenditure, administration, and policy of HM Treasury, HM Revenue and Customs and associated public bodies.

Current membership

Mr Andrew Tyrie MP *(Conservative, Chichester)* (Chairman)
John Cryer MP (*Labour, Leyton and Wanstead*)
Michael Fallon MP *(Conservative, Sevenoaks)*
Mark Garnier MP *(Conservative, Wyre Forest)*
Stewart Hosie MP *(Scottish National Party, Dundee East)*
Andrea Leadsom MP *(Conservative, South Northamptonshire)*
Mr Andy Love MP (*Labour, Edmonton*)
John Mann MP *(Labour, Bassetlaw)*
Mr George Mudie MP *(Labour, Leeds East)*
Jesse Norman MP *(Conservative, Hereford and South Herefordshire)*
David Ruffley MP, *(Conservative, Bury St Edmunds)*
John Thurso MP *(Liberal Democrat, Caithness, Sutherland, and Easter Ross)*
Mr Chuka Umunna MP (*Labour, Streatham*)

Mr David Rutley MP *(Conservative, Macclesfield)* was also a member of the Committee during the inquiry.

Powers

The committee is one of the departmental select committees, the powers of which are set out in House of Commons Standing Orders, principally in SO No 152. These are available on the Internet via www.parliament.uk.

Publication

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The Reports of the Committee, the formal minutes relating to that report, oral evidence taken and some or all written evidence are available in printed volume(s). Additional written evidence may be published on the internet only.

Committee staff

The current staff of the Committee are Eve Samson (Clerk), David Slater (Second Clerk), Adam Wales, Jay Sheth, Jonathan Tang, Daniel Fairhead (Committee Specialists), Phil Jones (Senior Committee Assistant), Caroline McElwee (Committee Assistant), Gabrielle Henderson (Committee Support Assistant) and Laura Humble (Media Officer).

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Taken before the Treasury Committee

on Wednesday 28 July 2010

Members present

Mr Andrew Tyrie, in the Chair

Mr Michael Fallon
Mark Garnier
Stewart Hosie
Andrew Leadsom
Mr Andrew Love
John Mann
Mr George Mudie
Jesse Norman
Mr David Rutley
John Thurso
Chuka Umunna

Witnesses: **Mr Mervyn King**, Governor, **Mr Paul Tucker**, Deputy Governor (Financial Stability), and **Mr Andrew Bailey**, Executive Director, Banking, and Chief Cashier, Bank of England, gave evidence.

Q1 Chair: We will try and keep this session brief. It will be the first of many opportunities, I am sure, for exchanges on this new subject of the new financial regulatory architecture. Can I begin by asking you, Governor, in order that I can understand better how this new system is going to work, if the Bank tells the Treasury today that we need to rescue a major bank before the markets open tomorrow, who is in charge?
Mr King: The Chancellor is in charge of all decisions relating to the use of public funds. I would very much hope that, short of extraordinary calamities such as pretty well hit RBS and HBOS, we would never get into a position where I will be saying to the Chancellor, "I'm sorry, I forgot to tell you before, but you need to do something before the markets open tomorrow". Part of the new framework is a very clear statutory obligation on the Governor to keep the Chancellor informed about any developments that might have implications for the use of public funds precisely so that we should avoid the position, which I gather distant memories can recall, but none of us can, when there were situations when a chancellor felt he was asked to commit public funds, but had no opportunity to influence the course of events that led to that.

Q2 Chair: What are going to be the practical mechanics for the Chancellor being in charge? Is he going to chair the relevant meetings?
Mr King: No, I think that is exactly what he wants to avoid because chairing meetings is process, not substance. I had a long discussion with the Chancellor about this and I said to him, "What's the real substance of concern here?" and what became very clear was that the substance of concern was to ensure that the Chancellor did not want to get sucked into individual decisions, but did want to make sure that he would never be put in a position where the Bank could say to the Chancellor, "You need to take this action by five o'clock this afternoon or by eight o'clock tomorrow morning". We then devised this process in which there will be a six-month meeting between the Governor and the Chancellor, and other people, I am sure, will be present, but Governor-Chancellor meetings with a written record where I would be saying, "Of all the range of activities which come under the Bank from the PRA to the FPC to the resolution activity, including the MPC", if it had any request for actions that required an indemnity or indeed executive decisions in the Bank, "what implications could there be for public funds down the road?" and this record will be made public, but, over and above that, an overriding strategy obligation on the Governor to inform the Chancellor so that ex post this Committee could say to me, "When did you talk to the Chancellor and what did you say?" and there would be a private written record which ex post could be examined which would make it absolutely clear what the communications were so that no chancellor would be put in a position where he would be asked to make a decision without notice, unless of course circumstances meant that that indeed was inevitable.

Q3 Chair: I am sure these issues will need to be explored further, but that is a very helpful initial clarification. You are going to be unprecedentedly powerful now as a consequence of the accretion of these responsibilities to the Bank. What reassurance can you give us and the public that the necessary level of accountability is going to flow in a democracy?
Mr King: Well, this is clearly an absolutely fundamental point to these new arrangements. I do not think that I personally will be powerful in that all of the decisions will be taken by committees or groups of people, so the MPC, FPC, PRA, so it will not be vested in me, but it will be vested in those bodies, but the institution will indeed be powerful and have a range of responsibilities. It is crucial, therefore, that there be proper accountability. What I mean by 'accountability' is accountability to Parliament, to the Government and to the public. I would differentiate that from accountability to the industry itself which is often an excuse that we are meant to give in to lobbying as to how effective the system should be, so it is fundamental that the accountability is to Parliament, to Government and to the public. This Committee is clearly a crucial part of that, but so are the commitments and obligations which the Governor or the Bank would have to the Government and to the public in wider accountability that we would speak, that all members of the committees would speak, about their responsibilities and the work. I think we

have a track record here. I think the Monetary Policy Committee, and you have just met some members of it, over more than ten years now has been highly accountable in public, and I think I can also personally say that it has not been a body which anyone could say has been a centralisation of power in any one individual. I have been in a minority on the MPC 15 times now since it was set up in 1997, two as Governor.[1] I do not think that has affected adversely the effectiveness of the MPC, but I think in many ways it has enhanced the credibility of the MPC and it has certainly enhanced its accountability where each individual stands up and is counted. We have a track record in doing that and I would like to argue that we could deliver that with respect to the other bodies as well.

Q4 Michael Fallon: But, Governor, you are to chair the new Financial Policy Committee.
Mr King: Yes.

Q5 Michael Fallon: Can you explain to us what happens when the Financial Policy Committee, chaired by Mervyn King, decides to loosen credit controls and the Monetary Policy Committee, chaired by Mervyn King, decides to tighten credit?
Mr King: Well, of course we do not loosen or tighten the same instruments, and I think that what we would argue is that in the run-up to the recent crisis what we saw was the failure of having only one instrument, namely the Bank Rate, because the Bank Rate, in my judgment, was set appropriately to ensure that there was a balance between supply and demand in the economy as a whole and we did see an unsustainable expansion of demand or output and we did not see inflation rising too high or too low. What we saw in fact was a wholly unsustainable expansion of leverage and credit expansion within the financial sector. Two-thirds of the credit created in the five years before the crisis hit was not to companies or to households or the real economy in total, it was to other parts of the financial sector. The FPC will be focusing very much on that, but that is not an instrument available to the MPC, so I think that the actions taken by the FPC under this assumption that they will be tightening, say, within the financial sector would actually make it easier for the MPC to take its decisions on monetary policy. I see the two as complementary, not as competitive.

Q6 Michael Fallon: But you do not see circumstances in which, for perfectly justifiable reasons, the two could be working or rubbing against each other, both of them chaired by you?
Mr King: No, I do not think so because I believe that, to the extent that the FPC takes actions about its judgments that are needed to improve the resilience of the financial system, that may well make it possible for the Monetary Policy Committee to take a different decision on the Bank Rate, but I think it would be removing the awkwardness of a trade-off which, in the new regime, the Monetary Policy Committee will not have to contend with, so the idea that the two committees will be unhappy with each other's decisions is not one that I think I am particularly concerned about, no.

Q7 Michael Fallon: Do you think it is right that you should chair both?
Mr King: Well, I think that, if they are going to be Bank of England committees, it is fair that I should chair them, but only that I should chair them. I repeat, I will not be making the decisions, they will be taken collectively by these different bodies, and we have a track record of that, but I think that, if you want the Bank of England to be responsible for these different instruments, and I think you can form views on that, if you think they should be within the Bank of England, then I think only the Governor could chair them, but it is only chairing.
Chair: We will return to these issues, I am sure.

Q8 Stewart Hosie: Governor, in addition to these new UK bodies and new structure, we also have a European framework. We were talking earlier about the Basel III discussions, so having the European Banking Authority with the possibility of it stepping up further, and you touched on that earlier, these structures are very different and the regulations within them may be very different. How will we negotiate and liaise through the UK to these other bodies? How will that function?
Mr King: Well, that is a very interesting question and can I divide it into two parts. I think foreign bodies, like the European Systemic Risk Board where, as a Governor of a central bank, I would expect to be on that and will be on it, that body will be debating and discussing the risks, it will be in many ways similar to the discussions that we will be having nationally on the Financial Policy Committee and it will be able to issue warnings and suggestive actions on a 'comply or explain' basis, but it will not have any statutory authority. I think, when it comes to regulation and the new Prudential Regulatory Authority, the prudential regulation of banks in the UK, clearly the new Basel III standard will be embraced in a European Directive and will become binding on the UK as a minimum. Now, I have no concerns about that as a minimum standard, indeed my only concerns about the way the debate is going is that it is not tough enough, but where I would be concerned would be if, at the European level, there was an attempt to make this complete harmonisation because at that point there would be almost no discretion for the Prudential Regulatory Authority to adopt the sort of judgmental approach to regulation which it is the purpose of these reforms to introduce, and I do think that the benefit of splitting the consumer protection and market conduct regulation from the prudential regulation is that the two styles of regulation are naturally very different. One is naturally a compliance-driven style and the other is inevitably, or should be, in my view, a very close and careful look at the balance sheet risks of those institutions and judgments made by the regulator, which can result, for example, in decisions of the kind of telling a bank that it needs more capital, more liquidity because the risks on its balance sheet

[1] *Note by witness:* Mr King has been in a minority on the vote on Bank Rate twice as Governor, but also once on the vote on the quantity of asset purchases.

are too great. It has to be possible, in our view, that the European framework enables regulators to make those judgments. And I would be worried if we got to a point where the degree of harmonisation was so great that the national regulator had effective discretion removed.

Q9 Stewart Hosie: That is a very detailed answer. In terms of the process and where we are now, are you happy that the Bank and others are involved in all these negotiations with partners to the extent they need to be to make sure we get the outcome that would be best?
Mr King: 'Happy' can never be a word used at the moment in all of these discussions.

Q10 Stewart Hosie: Content?
Mr King: I am content that we are involved and able to express our views, but the sheer number of meetings and frequency of them means that there is a massive programme for debate and reform, not just at the European level, but also at the international level, with the Financial Stability Board that Paul Tucker sits on and all the working groups and so on. I think, if anything, my concern would be that people are trying to get to an end point too quickly. Many of these decisions would be better made in a slightly more relaxed timeframe, but trying to get it right. I understand there is political pressure to get on with it and we do not want to lose the momentum for change, but I would be happy if we could maintain the pressure of momentum for change, but actually take our time to implement it over a slightly longer period.

Q11 Jesse Norman: Governor, the ramp-up in inter-bank lending was no secret during the last few years, but the Bank did not really blow the whistle on it. Why do you think you could do better than that now with this new regulator?
Mr King: Let me ask Mr Tucker to take that question.
Mr Tucker: Well, I think it is fair to say we did not blow the whistle on it in some decisive sense, but we absolutely did flag, from about 2002 onwards in our twice-yearly Financial Stability Reports, the increase in leverage both within the banking system and in the shadow banking system. And, whether in this country or globally, there were essentially two problems. There was a lack of a system-wide perspective that fed through to tools, to instruments; and I do not think there was a lack of analysis, but there was a lack of action. Now, I have described this before as a problem of 'underlap' in the UK, but this problem was replicated to a greater or lesser degree around the world. You started with the Financial Policy Committee and, in many respects, I do think that is the decisive change that is being contemplated by the Government and it is saying, "We will establish a body that won't just work bottom-up, at the level of individual banks or insurance companies, but will look across the piece and look forward over time and ask the question: is this becoming stretched, is it becoming vulnerable and should something be done to lean against that?" The Government's consultative paper sets out two elements to that: one, policies and rules that would make the system more resilient and less vulnerable, whatever the circumstances; and, two, leaning against over-exuberant credit booms. Those tools were lacking in the past. I do not doubt that, had the tools been there, we and others would have done a better job of analysis, but I think that the basic problem was one of a lack of instruments rather than a lack of an awareness that problems were brewing.

Q12 Jesse Norman: Just as an observation on the previous question that was raised, of course there was one recent occasion on which some central bank governor was told that a bank could go bust, and that was SOFGEN in France, at very short notice, and I think the solution was not to tell the markets for a week while they sorted out the bail-out, so whether that would be our approach is an interesting further question. This is a question possibly again for you, Mr Tucker, or for Mr King. Obviously, the Bank has not got any bankers in it at the moment, it is really full of economists and other people who are thinking about debt and the market side of things from the Government financing office. Will you be taking on a lot of bankers or experts?
Mr King: I think that is a misunderstanding about the nature of the Bank. One of the things I did when I was appointed Governor all those years ago was to ask Paul Tucker, I said to Paul, "The day I become Governor is the day you start to build a market intelligence function in the markets area". I had looked very carefully at the way the New York Fed had operated and I think they have been very successful, and Paul built up what is a very successful market intelligence function in the markets area, now handed on to Paul Fisher; it informs both the financial stability work of the Bank and the monetary policy side of the Bank. We have people who have a great deal of knowledge and expertise about all aspects of banking. If you look at our financial stability reports, I do not think you could believe that they were written by people whose expertise was only in macroeconomics. What we want to build up now in the area of regulation is not a team of, what I would call, 'bankers', but a team of people who clearly understand banking, but who have a professional commitment to a lifetime of public service as a regulator. I think we need to move away from the idea that having people who are taking two or three years out from the City to be a regulator for a bit and then go back is not the model, but we need public service in the area of regulation, people who understand banks, who are not going to focus their efforts on, what I will call, the 'compliance-driven style' of making a detailed point here or a detailed point there, but someone who can look the chief executive and the finance director in the eye and say, "I don't believe you understand the risks you are taking and, therefore, you have a higher capital requirement", people with the self-confidence and judgment to make that stick.
Mr Tucker: I would add one thing to that. Central banks have two natural endowments, every central bank has. One is that they have a macroeconomic role that equips them with extraordinary analytical talent, which we and many others have. But we also have balance sheets. The difference between a central bank and every other significant government economic

agency is that we have a balance sheet. We are in the markets every day and two central banks, in particular ourselves and the New York Fed, are in the markets in the biggest capital markets in the world. This endeavour is, in part, about reconnecting that second endowment to the stability policy process. Now, there will be lots of things that we have to improve, as the Governor describes, but I do not think anybody should be concerned that we start off in some ivory tower miles away from what goes on in the markets. No central bank can afford to do that and run its balance sheet at all safely.

Q13 Jesse Norman: That is two very helpful clarifications, and thank you for that. Do you think your ability to attract and retain talent will go up with these current changes, and obviously you are inheriting a lot of people from the FSA, will it go down or will it stay the same?
Mr King: I think in the long run it will enhance our ability to attract staff by offering wider careers and opportunity to move around. We have unbelievably talented people now. The younger you look in the Bank, the greater the talent.

Q14 Andrea Leadsom: Just following up, Mr Tucker, from what Jesse was saying, there is US$1.4 quadrillion of derivatives exposure outstanding in the world. Is that something that keeps you awake at night, or is it something that you feel the Bank has fully got its arms around?
Mr Tucker: There is a big initiative in the States and in Europe, which we are fully behind, to put much more of this activity through central counterparties, and one of the things that we will do—

Q15 Andrea Leadsom: As in exchanges?
Mr Tucker: Possibly through exchanges or trading platforms with greater transparency, but also through a process that effectively nets this down to a smaller number so that it is possible to see more clearly where the exposures are. The complexity of those so-called 'over-the-counter' derivative markets has gone far beyond anything that was sensible, and it could have been avoided. Frankly, it could have been avoided if the industry and the authorities had stepped in half a decade or more ago with the initiatives that are now under way. But, there will be something equivalent in five years' time or ten years' time, I do not know what it will be, and I think the authorities have to be much more alert and determined about saying, "We are going to ensure that there is adequate infrastructure around these capital markets". That is not a challenge that will ever go away.

Q16 Andrea Leadsom: Secondly, Governor, a long time ago, 15 years ago, I had the dubious privilege of working with your predecessor over a weekend to stop a run on the banking system when Barings went bust due to derivatives trading at the time during the post mortem period afterwards. It was largely agreed that directors of banks and the Governor did not know enough about derivatives, hence my question, and I am not sure that we are still quite there as yet, but my question is very specifically one of accountability. When I had that pleasure, I was running the investment team at Barclays and we were the main bankers of Barings and that was why I was involved, and it was very apparent to me that Eddie George felt very personally that it was down to him and him alone to prevent a run on the banks on the Monday morning, and indeed he achieved that. You said yourself, when the Chairman asked you, that you considered that it would be the Chancellor who would be the accountable person in the event that there was a Barings or perhaps a Northern Rock in the future. Could you just expand on that slightly because certainly my experience was that Eddie George really did feel it was only down to him, as the Governor of the Bank of England, and there was nobody else that should be looked to.
Mr King: No, I do not think that is an accurate description of what I said applied to your example. What I said was that, if there were any suggestion of public money being used, the Chancellor would decide. In the case of that Barings weekend, that was discussed and on Saturday the Chancellor decided that no public money would be made available. From then on, it clearly was a matter for the Bank to sort out and the Governor, Eddie George, was completely committed to sorting it out, as indeed I would be with a team of people around me. I think we would have a better infrastructure involved with the Prudential Regulatory Authority and a board and I think that, unlike then, it would be much easier now for the Treasury Committee to say after the event, "Tell us what happened. When did the PRA meet? What discussions did they have? Was it agreed within the PRA?" and you could have the PRA here at this table to ask them. That is a better infrastructure, I think, but, I can assure you, I will be just as committed as Eddie to doing the things which would be my responsibility, but not to take upon myself things which are clearly the Chancellor's prerogative.

Q17 Andrea Leadsom: Thank you, that is very comforting. Do you think that the Dodd-Frank legislation in the States is an opportunity for London in terms of rebuilding our financial services much as the Sarbanes-Oxley legislation was for the London Stock Exchange? Do you think it is an opportunity for us? Do you think we should emulate it?
Mr King: I do not think we should see legislation being introduced in other countries as an opportunity for us somehow to have lower standards and get a bigger financial services sector. That was one of the views, I think, that led to the predicament we are now in. What we should do is to ask ourselves, as I am sure the Americans will: what is the right framework to have? Now, their legislative outcome is a morass of different provisions which is massively long and, to be perfectly honest, reflects a very large amount of lobbying which has been successful. I very much hope, and absolutely believe, that this Committee will be able to lead Parliament in resisting some of the excessive lobbying which, no doubt, will rain down upon your heads when all this is being debated, and we look to you to ensure that we actually have a simpler, very clear, tough but fair regulatory framework that we can then implement.

Chair: We will do our best!

Q18 Andrea Leadsom: Would you agree that part of our problem has been that regulation has trumped competition and that is why we have had these 'too big to fail' and no new entrants? Would you agree?
Mr King: No, I think the 'too big to fail' problem is a big and very complex problem which has grown up over many years where banks have become large and, for very good reasons, governments feel that they have to support those banks when they get into trouble. To get out of it will not be easy and cannot be the subject just of one or two simple measures, but it will require a whole complex set of measures which, in my judgment, will mean that over 20 to 30 years we need to see a change in the whole liability structure of banking so that it will then be possible to put in place measures of the kind of resolution and recovery plans, bail-ins, and all the other things will work, but only if we have a restructuring of the liability side. We should not believe that we can do that quickly, but we must believe that we can do better than we were able to do in the recent crisis.

Q19 Chair: We will do our best, Governor, on the point you raised earlier, but it is also extremely important that the Bank of England helps us hold the ring, and you need to put up the amber light early if you see, what you consider to be, successful lobbying.
Mr King: Indeed.

Q20 Chuka Umunna: I want to probe a bit more into the Financial Policy Committee, but can I just ask you a couple of general things, Governor. There is a bit of a scurrilous rumour doing the rounds that you did not particularly want to expand your empire so that you would take charge of financial regulation, and I think a former member of the MPC, Sushil Wadhwani, said that in his time at the Bank he was surprised by the lack of interest in issues relating to the financial markets and that indeed there seemed to be a deliberate policy to run down resource in the financial stability wing. Would you like to perhaps take the opportunity now to set the record straight as to whether you did actually want to take on oversight of financial regulation with your Committee?
Mr King: I am very happy, and I do not want to get involved in arguments about who said what when, but I was very clear that after 1997 I supported the changes that were made then. I felt it would be good to avoid the reputational contamination that can come from merging banking supervision with monetary policy. I changed my mind after the crisis when I saw that, first of all, despite the fact that we had absolutely no responsibility for banking supervision, it seemed to make absolutely no difference to the degree of reputational contamination and that, more importantly, when big banks did get into trouble, as a lender of last resort, the central bank was inextricably drawn into the minutiae of dealing with the regulation of liquidity and capital of those banks. What I came to form as a different view than I had before was the view that, if we were going to have to play such a deep role in a crisis period, it actually would have been sensible for us to have been closer to the system of regulation in peacetime, and we were not. Therefore, I think, for me, the lessons of the crisis were, first, that monetary policy alone was not sufficient to ensure a stable financial sector because, as Paul said, we needed these additional instruments through the Financial Policy Committee, secondly, that the people running the FSA were under constant pressure to deal with consumer protection and market conduct issues and did not have the time to devote to prudential regulation at a time when there appeared to be no obvious problems in the banking sector and, therefore, that the 'twin peaks' approach, I think, was the right way to go and, thirdly, that, if there is to be a Prudential Regulatory Authority, I have come to the view, somewhat reluctantly because I have absolutely no interest in expanding my empire and I have done everything I can when I have been at the Bank to do the opposite, it is probably sensible to have prudential regulation inside the central bank, and I have tried very hard to ensure that all aspects of regulation that are not to do with prudential regulation are indeed well away from the central bank.

Q21 Chuka Umunna: Do you think, had you been charged with oversight of banking supervision since you took up your post in 2003, that the impact of the financial crisis on our banks in the UK could have been averted?
Mr King: I do not think we would have been able to prevent a crisis because I think it was global in nature and I think the underlying causes, namely the imbalances in the world economy and the massive capital flows into the banking systems of the US, UK and Western Europe, that would still have been the case and we could not have stopped that nationally, and I think the massive expansion of the financial sector would probably have taken place, but maybe to a lesser extent, but I think, as Paul said, the Financial Policy Committee is the key instrument that would have enabled us to focus on that.

Q22 Chuka Umunna: Then I suppose that kind of begs the question: well, what is the point? I suppose your answer to that is that reputationally the Bank of England could not really separate itself from the regulation, the oversight that there had been, so it seems to be more a reputational thing than actually there being a massive point to this reorganisation.
Mr King: No, having a Financial Policy Committee with instruments, it is having the instruments of the Financial Policy Committee and that is a group of people who can say that capital requirements, as a whole, must now be higher, that more banks put aside more capital. That is not a judgment about an individual bank and it is very hard for the regulator, whose instruments are to make judgments about individual institutions, suddenly to say that all capital requirements should go up or down because that is not a judgment about the risks which an individual institution is putting on the system, it is a judgment about the risks in the system as a whole. I think it is appropriate to have a separate committee make that judgment, and it will rightly.

Q23 Mr Rutley: We have talked about how there is a view that the banks have become 'too big to fail', but, given your reluctance to take on some of these responsibilities, has the Bank of England become too big for its own good?
Mr King: Well, I think you will have to form that judgment. As I said, I have been reluctant all along—

Q24 Mr Rutley: We are asking you for your judgment.
Mr King: Well, my judgment is that in the end, against my wishes not to create an empire for the sake of it, which I have never done, I think it is sensible to have in the Bank of England the Prudential Authority, but not market conduct or consumer protection, I think it is sensible to have a Financial Policy Committee and for that to be in the Bank of England and I certainly think it is sensible for us to retain the Monetary Policy Committee, so I do think these add up to a sensible package of responsibilities, but I completely accept that this means we will be creating a powerful institution and it is very important, and it is the heart of these reforms, that that powerful institution must be accountable, but accountability means to Parliament, to you, to Government and to the public.

Q25 Mr Rutley: Just following on that theme, given the powers that will be coming to the Bank of England and indeed to you, the balance of responsibility, the balance of power swings very heavily in favour of the Bank of England, surely, versus the Treasury. Are you comfortable with that balance?
Mr King: Well, I do not think it does. We are not fighting a competition in which each year we are struggling to see who is more important. I think one of the great lessons of the 1997 reforms was that having clarity of responsibilities was the key to having successful policy. The Treasury withdrew from monetary policy in 1997, and that was a very successful step, and I think it is now appropriate to put these responsibilities in the Bank. We have quite deliberately not put consumer protection or market conduct in and the responsibilities are limited to prudential because that is what a central bank can do, so I think it is clarity of responsibility, it is accountability of those bodies, but it is asking the central bank to do what the central bank can do and not going beyond that.

Q26 Mr Rutley: That is a good point and I think accountability it is important to have clarity on. As you look at the proposals which are being set out, are there any areas where you are concerned, where there are accountabilities that need to be further examined to get the clarity that you are talking about?
Mr King: Well, this is something which we will be able to discuss at greater length in the future. I think the system of accountability is very clear. You will hold us accountable, the Government will hold us accountable and there will be a great deal of transparency, so I think the mechanism that is there is adequate, but I think nothing can work unless it is absolutely clear who is responsible for what. Otherwise, you cannot have accountability. The virtue of this consultative document is, I think, that it does make clear who is responsible for what. Now, you may disagree with it, you may prefer a different style or approach to regulation and a different allocation of responsibilities, but I think it is clear who is responsible for what here.
Mr Tucker: And it is important, as part of that accountability, that these stability issues and prudential issues are discussed not just in the wake of a crisis, but when things are calmer as well. One of the great failures of all of us in the past is that it only ever gets discussed after a bank has failed or, this time, after lots of banks have failed. You ask whether this could have been avoided and, in a way, it could have been avoided if there had been a discussion, a public discussion, about the stability of the system year in, year out, a quarter in, a quarter out, rather than just when it was too late.

Q27 John Thurso: Governor, you said that clarity of responsibility is the key to all of this. In *A New Approach to Financial Regulation*, there is table 6A which sets out the authority, tasks in peacetime, tasks in emerging risks and tasks in crisis. Do you think the division of responsibility between the Treasury and the Bank and the various bits within the Bank have sufficient clarity, or does that need more work?
Mr King: Well, I think they are clear, in our view. I think the FPC's role is clear, the PRA's role is clear, the resolution unit's role is clear, and the Chancellor and I, when we discussed it, were absolutely clear that any decisions which involve the use of public funds are for the Chancellor and it is very important that we know in advance his attitude towards the use of public money. You cannot carry out a resolution or worry about a course of action that you might want to recommend unless you know what the implications are for public funding, but, where public funding is not concerned, then the responsibilities lie fair and square with the Bank.

Q28 John Thurso: Within the different components, and, funnily enough, I think the responsibility between the Bank and the Treasury is probably the easiest one because you have just defined it and it is pretty straightforward, but there might be more worry between the different components within the Bank and, Paul Tucker, your comment about the underlap which we all know was there, do you think you got into the point where you were at the least joined or possibly had a little overlap within those components?
Mr King: Well, I think the composition of the boards and committees, it will surely prevent any underlap because the Bank executive will be present on the MPC, the FPC and indeed the PRA, so I think there is enough there, but it is very important that, in addition to the Bank executive, each of those bodies has independent members on it, some of whom may be members of court, some of whom not, and no doubt those appointments will be made in due course. Remember, neither the FPC nor the PRA will actually exist in statutory form until two years or so from now and I think it is sensible that we make sure we get this right, and we have time to get it right, that their statutory responsibilities begin only after Royal

Assent of whatever legislation will appear here, so we are talking about 2012 at some point, and we must get it very clear and right, but we have time to do that.

Q29 John Thurso: Can I ask one quick 'for instance' question. I am still quite interested in the events surrounding the failure of Bradford & Bingley which of course had the misfortune of coming in the middle of a developing crisis and, therefore, possibly got treated differently from how it might otherwise have been done. When you have a bank like that, which is not going to be a threat to the financial system, who is kind of monitoring it because it seemed to bubble up very quickly over 48 hours, so how will we have that kind of failure spotted and dealt with in a more appropriate way? Who has got the responsibilities there now?
Mr King: Well, that is clearly for the Bank, but, let me assure you, in the case to which you refer, it did not bubble up over 48 hours, it was a longer-running saga than that. The PRA will be responsible for monitoring individual institutions and that information will be conveyed to the FPC to the extent that there was a suggestion that it might have wider systemic consequences. Now, one of the problems that we faced in the period to which you refer was that almost any individual institution at that point could be said to be one whose failure might have systemic consequences, such was the fragility of sentiment. In principle, that is true, but one would expect generally that small institutions would not have that importance, and in that kind of crisis they can, but the PRA would spot it initially and the executive on the PRA board would know that they had a responsibility to refer it to the FPC and I imagine that at FPC meetings there would be a report from the PRA, either as an institution or through its representatives on the FPC, which would say, "In our judgment, these are the things that you might be wanting to consider".

Q30 Mr Mudie: Governor, I hear your protestations about the gathering of fresh powers, but I think you would have to accept that you came in this room as a king, but you left as an emperor!
Mr King: I am afraid, reluctantly, I must return that to you; I cannot possibly accept that!

Q31 Mr Mudie: I think you have to accept it. I want to just touch on the CP/MA division. On the consumer protection area, we have never been persuaded that the FSA took it very seriously, and the lumping together of this with the Markets Authority, I am slightly uncomfortable about it; I think it gives a sense of, "We've got CP. What the hell do we do with it? It's not big enough to run separately. Put it with the Markets Authority". I think it might be unfair on the CP part of the business and also unfair on the Markets Authority part of the business which can clearly either go as a subsidiary of the Bank or into the PRA. Would you care to comment?
Mr King: Well, you make a very good point and I think you can perfectly reasonably argue for having separate bodies doing market conduct and consumer protection. I think where I would disagree is that I do not think that market conduct should be in the Bank of England. I think the style of regulation of market conduct is a natural enforcement style, a compliance style, which is not what I think is appropriate to a central bank; it is not what we are good at. Our expertise is in judging the riskiness on a balance sheet, understanding what is going on in the financial markets, and I do not think we should be drawn into the market conduct. There are obviously links, but there are ways of handling that. I think the actual regulation of market conduct should not be in the Bank of England. Now, you could argue that it should be a stand-alone business, as in the US, or it should be part of an overall body, the CPMA, with two branches, if you like, one doing market conduct and one doing consumer protection, and I certainly think, when it comes to holding them accountable or finding out what is going on, it will be sensible to consider having almost separate sessions with the two parts because they are, as you say, very different kinds of regulation and they should be considered separately, but that really is a matter for those who will be running it and for you, but it is not for us because we will not be involved in that.

Q32 Mr Mudie: Can I just touch on something, and I do not want to take one of my colleague's questions, but one of the things that again was noticeable with the FSA, particularly in the crisis, was the way they unilaterally went out and hired a tremendous number of fresh people. Now, they financed themselves with a levy on the industry, but what is the prospect for the costs to the industry, not the transition costs which someone else will ask you about, but the running costs in the future? Are you intending to see this as slimmed-down with less charge to the industry, or more? Perhaps you could just tell the Committee as a matter of course, when you set a levy on the industry, is that with ministerial approval? In the way the BBC asks the Minister on the licence fee, is the Minister or is the Chancellor asked, "We are intending, we wish to put this levy on", or is it unilaterally agreed with yourselves?
Mr King: I do not know the answer to that latter question. I would have no objection to ministerial approval.

Q33 Mr Mudie: No, but I have asked you a question that you have said you do not know the answer to—
Mr King: You done it!

Q34 Mr Mudie: You see, your empire has got too big!
Mr King: I would be perfectly happy with ministerial agreement and I have no problem with that. From our point of view on the prudential side, I would very much hope that we could produce cost savings because I do think that focusing on the judgments that are needed does not require vast numbers of people, and my instinct would be true in the Bank of England too, that you do not need vast numbers of people, but you need the right people with the right focus and commitment, and that is going to be a challenge to us and it will take time to get there. I think it would be wrong for me to pretend that we can guarantee today any particular figure on the budget, I cannot, and I do

not know at all how CPMA will be run or the costs of it, but I do hope that, at least from our side, we will be able to make a reduction in the overall cost, but it would not be a reduction in the toughness of regulation because we will be looking absolutely at the risks being taken prudentially by the institutions whom we would regulate.

Q35 Mark Garnier: Following on from this structure question and also following on from Andrea's question about the derivatives markets and your answer to that, and this is a question for the Governor or Paul Tucker, the current proposal is that the Government plans to transfer regulation and supervision of settlement systems and central counterparty clearing houses to the Bank of England and actually also good practitioners in terms of investment banks to the Bank, while the CPMA is going to be responsible for regulating exchanges and the trading platform providers. There is quite a sort of rift, if you like, between who is regulating one side of this and who is regulating the other. Do you think this is a sensible way of approaching regulation, particularly when you get back to Andrea's question which is about this sort of global, colossal derivatives market and, if you look back at what has happened, say, to the government credit defaults swap market, which grew out of, I think it was, No 1 Curzon Street, if I remember rightly, and took over the world from there without seeming to have any sort of central settlement system or regulation to it?
Mr King: I think it is sensible and Paul will explain why.
Mr Tucker: The settlement systems and central counterparties are mechanisms for distributing financial risk. Settlement systems involve huge, mind-boggling amounts of intra-day credit just in order to ensure that the transactions go through each day. Central counterparties, as we were discussing earlier, bring all the risks together and centralise them in one place and then disperse them again to their clearing members. If either of these parts of the infrastructure gets into real difficulty, it will be curtains, frankly. The fact that those parts of the financial infrastructure worked well almost everywhere in the world throughout the financial crisis is something to be deeply, deeply thankful for. Unimaginable though it is, this crisis could have been horribly worse if the infrastructure had failed. I think on exchanges, we will have an interest in how securities are traded, but the business of regulating and overseeing exchanges shades into market conduct and so to insider trading. The data that the securities regulators monitor on exchange trading are used not just for ensuring the integrity of the system in a soundness sense, but also the integrity of the system in an honesty sense, and that is something for the other body. Now, there will have to be co-operation in this, some exchanges own clearing houses, so we are not going to approach this in kind of parallel universes and we will have to talk to each other. But I think it would be very odd to leave clearing houses and settlement systems outside the central bank. Indeed, I would go further and say, personally, I think it was very odd to leave them outside the central bank over the past 13 years and I think there is an even greater case for that being in the central bank than for the micro-supervision of banks. But I think it would be very hard indeed to take exchanges away from the market regulator; I think we would have a completely impoverished market regulator if we did that.

Q36 Mark Garnier: So, essentially, what you are saying is that the technical nuts and bolts side of this whole system have got to be regulated by the Bank?
Mr Tucker: Yes.

Q37 Mark Garnier: And the market practice, the conduct, is micro—
Mr Tucker: Yes.

Q38 Mark Garnier: That is incredibly clear. There is just one other question slightly outside this about the process of moving away from the FSA into this new system. The FSA has a body of corporate knowledge which has grown up from the experience of the last two years and the crisis, which is quite a useful body of knowledge. We have seen a number of people resign from it when they knew the FSA had a limited life. Do you think there is a risk that we could lose that sort of corporate intelligence by going to this new system?
Mr King: Well, I very much hope not, and I think that having Hector Sants as someone who will bridge between the FSA and the new Prudential Regulatory Authority is of enormous importance. I spent a lot of time talking to Hector to try to persuade him that he might change his mind and stay on and oversee this enormous new challenge and I am delighted that he, in the end, agreed to accept that and stay on. We will have to work very carefully over the next two years to ensure that the best of the FSA and the best of the Bank come together. Hector Sants is working very closely with Andrew Bailey from the Bank and we have transition teams in place already in both organisations. Quite a lot of resource is devoted to this and they are working closely together day by day to ensure that this transition will be as smooth as possible.

Q39 Mr Love: Following on from that, three of the managing directors at the FSA have left and there is some concern about the transitional issues and the change and unknown quantity of what is coming in the future. Is that a concern to you at all?
Mr King: No, and I spoke to Hector Sants about this. We have a very strong team of people, the FSA and the Bank together. We have put that together and we will be recruiting more people before the PRA is finally set up, and it is our task to ensure that we retain a strong and motivated team of people to make this work and we will have to work very hard on that, but I do not think that what I have seen so far makes me worry that we cannot do this; I am sure we can.

Q40 Mr Love: There are issues raised about the differences between the FSA and the new PRA. One of those will be in relation to remuneration, which is going to be very much an issue because of very different structures in the Bank from in the FSA. How

do you seek to deal with that as a tricky issue, and good salaries are one of the attractive features of coming to work in the FSA presently, so is that going to be a problem into the future?
Mr King: Well, it is clearly a challenge in the long run. The PRA will be an integral part of the Bank of England and it is not imaginable that they would have vastly different terms and conditions in the long run, but I want to be absolutely clear that no individual transferring from the FSA to the Bank will be required to accept a deterioration of their terms and conditions and they will be on the same terms and conditions as they are on now. In the long run, we will have to work towards a harmonisation of the terms and conditions in the PRA and the rest of the Bank, and I think this goes along with my view that what we really want to do is to create a cadre of people who see their professional motivation in life as being regulators working in public service and that, I think, is the absolutely key thing. It has worked perfectly successfully in other countries and I am sure we can do it here.

Q41 Mr Love: Taking that question, perhaps I might ask Mr Bailey, you mentioned earlier on about the central bank style and you were talking really about the culture. There will be a different culture between the FSA and the Bank, so do you see that as a difficult transitional issue, Mr Bailey?
Mr Bailey: Well, it is an important transitional issue. We have talked a lot about introducing, what I might call, 'judgment' into the system and the Governor has talked about this in the past. That will involve a change of culture and I think it involves some changes in the makeup of the staff, frankly. I think it does involve infusing it with some people who have greater experience of the industry and who do that, as the Governor has said, with the sort of culture of why they are doing it and the public interest. It will be a challenge and it is particularly important and, when you look back at the cases of banks that have failed and got into trouble in this country, it is very important that we do have a culture where the PRA is in a position, frankly, well before we ever get to that point, to challenge senior management appropriately on the practices because there is no doubt, as we have said, that there was a global origin to this crisis and there were elements of it in particular UK banks which were a function of the way those banks were being run.

Q42 Mr Love: Do you agree with the Governor that there is overlap between the Bank and the FSA at present and there may be room for redundancies in terms of staff and, the Governor's point, that what you need is the quality of staff rather than perhaps a particular quantity?
Mr Bailey: Well, I am not interested in redundancies, I think there is a sufficient level of turnover, and the Governor made the point that this is a transition period over a number of years, so let us be clear, I am not interested in redundancies. There is a degree of overlap in the sense of how we have had to respond to the crisis. It goes back to Paul's point about underlap originally, and you sense that the response to that has been overlap, and the reason is that, when a bank gets into trouble on funding and turns up at our door and says, "We need assistance", we have to understand that bank. You cannot have someone who comes to see me and says, as happened, "I need £25 billion tomorrow". We do not just shell out money without knowing what is going on and we have to have a very deep level of understanding of that institution and that, as the Governor has said, is one of the very big lessons from the last three years, going right back to Northern Rock. We cannot be ignorant of the circumstances. It is exactly the same point about Barings, and I think you and I were probably on the other side of Barings dealing with it, that you have to understand the institution you are dealing with.

Q43 Chair: Has it crossed your mind at all, Governor, that Hector Sants will be your deputy and earning twice as much?
Mr King: Quite frankly, I have not the slightest interest in whether my deputies earn twice as much or half as much. As a rational economic man, I am more concerned with what I am earning than what other people are, but I do not think this is a relevant consideration at all. What matters is the quality of the job that people do, and I have often said in the Bank that, if we need to get an expert in and pay a lot more than I am earning, then we should pay that person more. There is no reason at all why the Governor of the Bank should necessarily earn more than the staff he employs.

Q44 John Mann: Mr Bailey, considering this cadre of new young civil servants who are going to be recruited will all, doubtless, be rational economic men and women when it comes to their own pay, how are you going to stop the poaching of such people in future years at a time when their value to the people that they are overseeing becomes incrementally greater by the year when perhaps some of the financial institutions might want to use inside knowledge to push the boundaries a little further than they have been pushed previously?
Mr Bailey: Well, you will always lose some people, but we have learnt in the Bank of England that what you have to offer, I think, is a combination, and clearly there needs to be a level of remuneration that means people want to work for you, but that is not the end of the story. If that were the end of the story, we would be a very different institution from the one we are. Going with that is a desire to want to deal with the challenges, and to enjoy dealing with the challenges, that come with public service in this field. I can tell you, we could all tell you, that this is hugely difficult work that we do, but it is hugely enjoyable, frankly, and we need people who have got that enjoyment of that combined with clearly a level of remuneration which says, "That is a reasonable combination for me". It is not easy to find, but we have had a good record, I think, in the Bank of England over the years of finding those people and keeping enough of them, but it is going to be a bigger challenge because clearly we are now going to expand.

Q45 John Mann: The question to you, Governor, about this strengthened remit is that you have used the word 'accountability', I think, three or four times in the last hour, but we have not asked about transparency. What are the limits to transparency and how great are those limits, particularly historically? To ask my follow-up at the same time, if we take the two examples of Bradford & Bingley and Northern Rock, it would be very interesting to see the internal discussions, let us say, on Northern Rock in the few weeks after the Northern Rock crisis hit you, what the discussions were, what the different people in the Bank thought and how you, therefore, reached judgments and what the discussions between Mr Tucker and yourself were, whether you had different views. When it comes to the MPC, we can see that because there are minutes and there are obviously votes as well, but there are minutes and we then have the chance to explore the nuances from the minutes. There is not that with other issues. What is the role for increased transparency so that we can learn, and the wider public can learn, some of the lessons to assist in the debate that Mr Tucker rightly, I think, flagged up as having been absent in the past?

Mr King: Let me take the MPC and the PRA separately. On the MPC, there will be a published record of the discussion that will set out the balance of arguments that was discussed and the arguments for and the arguments against the decision that was made, so you will know what were the arguments that we were discussing and debating and you will be able to ask us to explain those after the event at hearings before you. On the PRA, what we cannot do is put into the public domain, if you like, information about a bank which almost failed and then did not because that might be undermining the ability of that bank to survive, but, where there are events where we have to provide money with the Chancellor's approval or where there are regulatory decisions, again you will be able to quiz us on what the arguments were for and against those regulatory judgments, so I think there will be transparency insofar as it is possible to be transparent when dealing with individual cases. There is a real difference here between the PRA and, say, the MPC. The MPC is never discussing or dealing with information that is in the private domain of the MPC, but all the information that we have in the MPC is available to you, so it is then a judgment and a debate about what you make of it, what your judgment is about where policy should go.

Q46 John Mann: But, in informing policy debate and in assisting Parliament and Government, clearly there are huge commercial sensitivities and any FOI request would immediately be knocked down and fail in its appeal because of that, but there comes a time when the production of historic information, and not necessarily 75 years, 50 years or 25 years, but perhaps five, perhaps ten years, does not have that sensitivity and would inform current debate, including, to be fair, whether the Bank, as an institution, was up to the job and whether that is a personality issue or a structural issue or an empowerment issue, and it does seem to me that that is rather vital and rather lacking. Should consideration be given as to what stage such confidential information should be made public to allow that historical perspective to be considered?

Mr King: Yes, and it is for you and Parliament to discuss the balance between the arguments toward protecting confidential advice and the confidentiality of individual people and institutions versus the public benefit from having the ability to look at the past, as you suggested. That, I think, is pretty close to the sort of debate which was had on the 30-year rule and, if you think that needs to be altered, then that has to be a decision for Parliament and it cannot just be unilaterally imposed by us. One of the things which I did in the Bank was to put in our annual report very clearly, when I became Governor, a statement that was not noticed very much at the time, but made very clear that on any 'lender of last resort' operation, when it became possible to reveal the details of that without jeopardising the actual operation, then it would be made, and that is in fact exactly what we did with the operation on RBS and HBOS. That has now been formalised appropriately, in my view, with a private briefing to the Chairman of this Committee and the Chairman of the PAC when an operation like that takes place, but it is backed up by a very clear undertaking from the Bank that, when we feel it is possible then to reveal this information without undermining the purposes for which it was put in place, then we would indeed publish the details of the operation, and we have made clear what we actually did with RBS and HBOS.

John Mann: I do think, Chairman, it is something that we should consider and give some thought to in the near future.

Q47 Chair: Thank you very much for coming today, Governor. We have managed to get pretty much back on schedule. We will be publishing later today the terms of reference for our inquiry into this whole huge subject, and I am sure you will understand if many of us will want to see you again before we come to our conclusions. I note that you said we have time to think this through and I strongly agree with that, but I also note the very tight deadline on the paper produced by the Government which was 18 October, and I think we all need to send the message to the Government, and I hope they are listening to you, that we have time to sort this out, and I am sending the same message, that we may take longer to finalise our views on this subject. You have arrived as a Governor and you are leaving as a Governor, but you do have a larger province, and we will be keeping a close eye on how you administer that new province.

Mr King: That is very appropriate, and I look forward to coming to your future sessions.

Tuesday 14 September 2010

Members present:

Mr Andrew Tyrie (Chair)

Michael Fallon
Mark Garnier
Stewart Hosie
Andrea Leadsom
Mr Andrew Love
Mr George Mudie
Jesse Norman
David Rutley
Mr Chuka Umunna

Witnesses: **Professor Charles Goodhart CBE**, Programme Director, Regulation & Financial Stability, Financial Markets Group and London School of Economics Professor Emeritus of Banking and Finance, and **Lord Myners of Truro CBE**, former Financial Services Secretary.

Q48 Chair: Thank you very much for coming, Lord Myners and Professor Goodhart. We have an interesting session ahead of us which we hope to run for about an hour, and I hope it is acceptable if we go straight into questions. I have first of all a question for you, Lord Myners. You have had a careful look, I am sure, at the proposals that the Government have come forward with. What do you think would be different, or would have been handled differently, in the crisis if that new structure were already in place?
Lord Myners: I start from the premise, Chairman, that there is no one form of financial regulation or architecture of financial regulation which is assured to be superior to all others. There were undoubtedly shortcomings in the way in which the Tripartite arrangement operated. These proposals seek to address some of those shortcomings, but they in turn have some risks within them: a great deal of concentration of authority in the hands of the Governor, as Mr Fallon raised in the previous session; a lot of need for colleges and memoranda of understanding between different bodies; and a lot of use of the term "have regard to" in dealing with subordinate responsibilities of the PRA and the CPMA.
I think the major issue I have with this document, Chairman, is that it is about architecture. My view is that the answer to effective regulation is largely about behaviour and about competencies. It matters less where you sit than what you do when you're sitting there. This document is relatively light on those areas.

Q49 Chair: Have you got specific proposals for improvement?
Lord Myners: I think, if I may go back again to Mr Fallon's question to the Governor, the Governor is clearly central to this structure. Indeed we have now reached a situation where we talk in banking about banks being too big to fail. The Governor is now going to be too important to fail. He will be the principal person in the Court. He will chair the Financial Policy Committee. He will chair the Monetary Policy Committee. He will chair the PRA and he will represent the UK on the ESRB. So we are putting a considerable burden of expectation on the holder of the office of Governor of the Bank of England.
I think also from the perspective, Chairman, that I had of being a member of the Court of the Bank of England—I was a member of the Court for four years before I became a Minister in the last Government—I think the Bank is going to need to make some quite important changes to take on executive responsibilities for regulation: the number of people; the number of entities it will be responsible for overseeing through the PRA; and the wide range of activities. It is easy to think that we are returning to a pre-1997 structure but the Bank, through the PRA, will now have responsibility for banking, for the insurance industry, for investment management, for hedge funds and for a number of other activities. I think there are some major resourcing and competency challenges for the Bank and the PRA under this proposal.

Q50 Chair: Professor Goodhart, following on from that do you think there is a risk that we have the Governor chairing the FPC, which may have a policy to lean against the wind in order, for example, to deal with an asset price bubble by making greater demands of banks on capital ratios, which simultaneously is being offset by a policy of the MPC, who, because inflationary conditions may be mild at that time, may want to keep interest rates low or even lower them further?
Professor Goodhart: No, I don't. There are some who do. I think Andrew Large raised that particular point.

Q51 Chair: I have Professor Wadhwani's rather interesting paper on this subject in front of me, which I am sure you have also seen.
Professor Goodhart: I don't actually agree with that. After all, there are very close inter-relationships between fiscal policy and monetary policy. The Monetary Policy Committee can take into account what the Government does in its fiscal policy measures and adjust for that. When the Government is thinking of what it is going to do on fiscal policy, it knows how the MPC might react. I don't see any reason why the Financial Policy Committee and the Monetary Policy Committee cannot work in exactly the same way, but financially.

Q52 Chair: Isn't that exactly the analogy? Haven't we learnt that deflationary policy and monetary policy need to be co-ordinated much more closely together in a crisis; and that the separation that we thought was good for inflationary conditions might not be the right arrangement when dealing with deflationary conditions?

Professor Goodhart: That is absolutely correct in a crisis. Indeed in a crisis it is not quite clear whether quantitative easing is necessarily part of financial policy or monetary policy, so in a crisis things do alter. Indeed, in a crisis the inter-relationships between the Government, who may have to play a part in crisis resolution, and the monetary authorities have to be considerably closer. So in a crisis things change, but unavoidably so.

Q53 Chair: So when the FPC has decided that it wants to tighten bank balance sheets because it fears an asset price bubble, you are relaxed about the fact that the Governor walks down the corridor and agrees a cut in short-term interest rates to deal with the then current inflationary conditions?
Professor Goodhart: Yes; and indeed we can even conceive of situations in which the two move in opposite directions. You could have, for example, an inflationary scare which requires interest rates to be raised because of the concern about the longer term effects on inflation—for example, say if the exchange rate collapsed—at the same time when the banking system is under severe strain, and you might actually need to undertake measures such as, perhaps, a continuation or extension of QE or an easing of certain regulatory measures to maintain the stability of a financial system.

Q54 Chair: Do you want to add anything to what you have heard, Lord Myners?
Lord Myners: I think it is perfectly reasonable to ask questions about situations which could arise where the monetary policy, expressed in pursuit of the 2% objective, would take one in the direction of lowering interest rates, whilst the FPC would be talking about tightening credit availability by changing loan-to-value requirements and increasing capital requirements. I think that they are manageable but, again, we already see in this document the need to create cross-membership between these bodies and to have memoranda of understanding. This phrase "to have regard to" recognises that what was meant to be a rather simpler structure which answered the question "Who's in charge?" shows that it is actually far more complicated in practice to deliver that particular outcome. Can I also add that I think this document, produced by the Treasury, is very light on how the Financial Policy Committee is going to lean against the wind. For instance, it ignores the fact that we have open capital markets. It assumes that all lending takes place by institutions regulated here in the UK. It says nothing about commercial paper or corporate bonds. It overly simplifies the mechanisms that the FPC will have available to it to manage credit availability and the macro-prudential environment.
Chair: Those are very interesting remarks. Rather than hold up the Committee now, if you have more developed thoughts on that that you are prepared to put on paper I know they would be very welcome. I am not going to demand it of you because I am very grateful to you for coming to give evidence at all. Michael Fallon?

Q55 Michael Fallon: Lord Myners, you said the Tripartite had shortcomings. What were they?
Lord Myners: It did not meet for a number of years at principals' level, as I understand it. I became a Minister in October 2008. It met at deputy level but not at principal level: I think that was an oversight. My own experience, Mr Fallon, of the Tripartite working, as from October 2008, is something about which I can speak very positively. The three elements—the Treasury, the Bank of England and the FSA—worked together extremely well, with great clarity as to who was responsible for what and how they interlinked. But I think there were some failures of not exercising the machinery frequently enough and developing a close enough dialogue. Indeed the Council for Financial Stability that was proposed under the 2009 Act was designed to force more contact between the agencies within the Tripartite.

Q56 Michael Fallon: It is the period up to your arrival in October 2008 that is probably of more interest to us, before you saved the world. You said the issues of behaviour and competence were as important as architecture. Were there weaknesses in the way the Tripartite operated in terms of behaviour and competence, after this point of the principals not meeting?
Lord Myners: I can only talk, Mr Fallon, of what I observed. As I said, from October 2008 I observed the Tripartite working together very effectively, particularly in October 2008 and then again in January 2009 when we were making critical decisions about the banks. I would just be repeating what I heard about what happened before, and I think there are better sources than me.
Professor Goodhart: Could I add that I think the main failing was not really one of architecture but what instruments they had? They didn't really have any instruments at all for crisis prevention. You will recall the Governor's phrase, which I love, which was that the only thing they could do was "compose sermons and conduct burials". They could not even conduct burials very well because the only mechanism for burial we had before the special resolution regime was straight bankruptcy, and bankruptcy for financial institutions—particularly large ones like Lehman Brothers—in the standard mechanism is a recipe for disaster. There were no instruments. I feel very strongly that the credible issue, as I think Lord Myners was indicating, was what the institutions do rather than the precise architecture.

Q57 Mark Garnier: Professor Goodhart, what do you think are the pros and cons of the twin peak model of financial regulation versus the former FSA single overall regulation?
Professor Goodhart: I have always been a great fan of twin peaks. I think there is really no alternative, as I think we have seen, but to put macro-prudential with the Central Bank. It is notable that even in the United States, where the Fed has been criticised very severely, at the end of the day the macro-prudential control, the mechanism, has actually been put with the Federal Reserve. I think that will become the standard and norm. The question is how far you actually put

some of the other micro-prudential issues with the Central Bank because there is a danger that there is too much power within one institution. I wouldn't personalise it as far as to say that it is within the Governor himself, or herself, because the Governor will have committees and they will have some externals, and there will be a range of views which can be accessed. There should be transparency and accountability. Nevertheless, I think there is a need to restrict the Central Bank from doing things which it doesn't have to do. I think it has to do macro-prudential, but in my view it does not have to, for example, look after the sort of details of some of the supervision of the insurance companies or the smaller banks. To do macro-prudential supervision, you actually have to have the ability to supervise directly and get information directly from the big systemically important financial intermediaries; but you don't have to look after the vast long range of things like bureaux de change and all of the rest of them.

Q58 Mark Garnier: One of the big problems in the banking crisis, of course, was you had the so-called casino investment banks who were contaminating the high street banks, which of course is what we like to have in order to get the economy running. One of the things I want to be reassured about, Professor Goodhart, is that this twin peaks model of regulation will not allow that to happen again. Having drawn an organogram of how this would work, you have the Bank of England with the PRA, which is looking at the investment banks. Then you have the CPMA which is looking at the high street banks and the investment banks. Do you think this system of regulation is going to ensure that we don't have a situation like we've had before, where the more speculative side of banking is going to contaminate the more traditionally secure—and important—side of banking?

Professor Goodhart: I would make two comments. The first one is that I'm not sure it was certainly always the more speculative. Northern Rock wasn't speculating: it was just doing bad mortgages. Also, regarding the likelihood that we are never going to have financial crises again—we are always going to have financial crises. The kind of people we all are means that we actually shift between greed and fear. Greed can involve tulips or investing in South Sea bubbles; whatever it is that looks like making a quick buck, we'll all pile into it. One of the problems is that that's enormously popular when a bubble is occurring. It's very difficult for a central banker, or anyone else in power, to stand against the pressure of the market. They need to be very strong-minded indeed. What you need are strong-minded central bankers, because if a bubble—a boom—starts it will be enormously popular, as sub-prime mortgages were. If you had tried to stop sub-prime mortgages in 2005–06, you would have been told by the politicians, and the media, and the lenders and the borrowers that you were stopping the most wonderful financial instrument that was providing housing to the disadvantaged. A central banker has to be prepared to take away the punchbowl just when the party is going, and that is not something that is enjoyable to do.

Q59 Mark Garnier: No, it is not, but with the benefit of hindsight—and of course we can all go back to the South Sea bubble, the black tulip bubble and all this kind of stuff—we get a body of knowledge that can then be taken forward. I think the important point is that given what we've learnt over all of these things—and I do agree with these bubbles going back a long way; they are just as relevant as the sub-prime mortgage bubble—do you think that we are learning the lessons and that they are going to be incorporated into this model?

Professor Goodhart: One of the dangers is to focus unduly on the immediate past. I think that there is a danger—I hope that we won't fall into it—that we will focus on a set of banks and a set of activities and regulate them very tightly. The regulation may be right, but the danger is that if you regulate some group very tightly it will lead to an incentive to shift business into the non-regulated, maybe even to the markets, and they can be just as dangerous on their own. If you are a regulator you always have to be worrying about "What is happening where I'm not looking?"

Q60 Mark Garnier: Lord Myners, there is a certain amount of speculation that some of the bigger banks are going to be a bit grumpy if the banks are asked to divide their one activity from the other and they may go offshore. Do you think this twin peaks approach to financial regulation may prove to be sufficient in terms of dividing the two parts of these banks such that we don't need to follow through the structural division between investment banks and retail banks?

Lord Myners: I think they are rather different issues. I don't think there is anything in the Treasury's White Paper, "A New Approach to Financial Regulation", which in itself will disadvantage UK banks or make the UK a less attractive place to base a bank. I think it would be wrong to assume that the new Prudential Regulation Authority and the Consumer Protection and Markets Authority represented something which linked into the observations about casino banking versus retail banking. There is nothing in this paper which would require banks to cease to do one or the other of those activities; nor do I believe that the cohabitation of those activities within a single organisation was in itself a significant factor in the international banking crisis.

In some ways we are doing this the wrong way around. In parallel to this we've got Sir John Vickers' Independent Commission on Banking, which is also asking questions about regulation and some of the questions that you are asking. In a perfect world we would have something similar to the Wallis Committee in Australia, which started off from first principles about what we expected from our banking system. We would then go on to banking structure and banking regulation. There is a danger, or a probability I think, that the Vickers recommendations will require some of the Government's current thinking on regulatory structures to be revisited. But I don't think there is anything in this document which will drive banks away from the UK, although I don't underestimate the risk that one or two of our major banks will consider relocating if they believe that the

UK is not a good place to be based for their business in the future.

Q61 Mark Garnier: One very quick question, Lord Myners. Much was made of the FSMA in 2000, and of the fact that the regulation was very much a light-touch regulation. With the benefit of hindsight—I appreciate obviously you are not here to comment about the previous Government's record—do you feel that light-touch regulation perhaps was an error of judgment?
Lord Myners: I think "light touch" can mean many things, but certainly the FSA was overly rules based. It was overly focused on collecting data, didn't ask enough questions about business strategies and wasn't thinking enough about the broader context and the way the shape of regulated activities was developing, particularly the securitisation and the move to wholesale funding as opposed to retail funding. So the FSA fell short there, but the Bank of England did as well. Remember the Bank of England did not have a good 2007. The Bank of England could have done things in the second and third quarter of 2007 which, with the benefit of hindsight, would have ameliorated many of the pressures.

Q62 Chair: Do you think they should have spotted them in time?
Lord Myners: As I said, I sat on the Court and studied with great care the financial stability reports that the Bank produced, Chairman. I think the Bank did flag that there were problems but it did it in a rather sotto voce way. The Bank was struggling with whether it wanted to have a financial stability role. I remember this being discussed at a Court offsite, which was held at the Hampshire Country cricket ground just outside Southampton, in which the Governor was very clear that there was a mismatch between the Bank's responsibilities for financial stability and the information on powers that it had available to it. The Governor had been downsizing the financial stability side, whilst registering with the Treasury that he wanted more powers; and the Treasury were very slow in responding to those requests.
Professor Goodhart: We were not alone, of course. Exactly the same kind of mindset was really in existence everywhere else, particularly and especially in the United States. There was a general view that as long as you kept the macro system stable by hitting your inflation target and that you had enough capital, which was supposed to be provided by Basel II, then efficient markets would generate financial stability. If the market thought that a particular line was appropriate, who were the regulators to say no? I think that it was a general unwillingness to say that the regulators, under certain circumstances, knew better than the markets. Alan Greenspan, for example, argued that it was very rare for the regulators to know better than the markets. I think that mindset has changed.

Q63 Chair: Just to be clear, Lord Myners, although with the advantage of hindsight the Bank might have done better, at the time they were right to ask the Treasury for more powers, and the Treasury weren't providing them.
Lord Myners: The process of response from the Treasury was slower than the Bank would have wanted.

Q64 Andrea Leadsom: I have to say I still feel so angry about this financial crisis. In fact what you have both just said has cheered me up slightly, but I would like to return to what you said earlier because it actually just enraged me further, I have to say. I have been in banking 20 years, including when Barings went bust, and seeing an absolute master-class in how to deal with a financial crisis. To my mind, absolutely, the key is accountability. When you start by saying it is all too much power invested in one person, and so on, the way I see it, actually accountability is key. Everything that you have said so far: you said, Lord Myners, that when you came into your ministerial position it was all working very well and everyone worked very well together. Professor Goodhart, you said that the problem is they didn't have the instruments. But this, surely, is the point about accountability, isn't it? They were in the position to see the weaknesses and the shortcomings of their situation. They may have been working well together as administrators, but when the rubber hit the road nobody was willing to stand up, be accountable and actually do something about it. In the case of Northern Rock we had a run on a bank simply because nobody was willing to say, "This is my problem and I need to resolve this." So this issue of accountability is incredibly important. Going on to what Professor Goodhart said about a quote that we can only do burials: well, we didn't even do burials, did we, because effectively all those implicated walked away scot-free with large pensions, to the absolute rage of the public. I had a bank in yesterday talking about how appalling it is that we are proposing to raise their capital requirements. I've had mutual funds in talking about how it will destroy their profitability. But at the end of the day, surely, this is all about accountability.
Lord Myners: There are many interesting observations there. I remember your involvement in the rescue of Barings when you were at Barclays, I believe. My own perception from October 2008 was that people did know what they had to do. The FSA knew that it was responsible for the regulation of individual entities; the Bank of England for the supply of liquidity; the Treasury for the availability of public funds. I was very, very new to this job and to working within the Treasury and I was impressed by how it worked. It clearly did not work as well before. You talk about Northern Rock. There were clearly shortcomings in the oversight of Northern Rock by the regulator. The FSA admitted that. I think it is worthwhile recognising and acknowledging that the FSA has made significant changes and improvements in its performance, in its conduct and in its skill set over the last two years. The primary issue with Northern Rock in July and August 2007 was liquidity, and that responsibility lay clearly under the Tripartite structure with the Bank of England.
Professor Goodhart: Could I make a comment?
Andrea Leadsom: Please do.

Professor Goodhart: First of all, Barings was a great deal easier to resolve.
Andrea Leadsom: Agreed.
Professor Goodhart: Barings was an occasion of a rogue trader. It was idiosyncratic. There were no major implications for contagion, though at the time the Bank of England was worried that there might be reputational effects on the other merchant banks' accepting houses and actively took measures which weren't needed to support them in case of need; but it was in fact a great deal easier. You emphasised accountability. There are two aspects of accountability. There is the question of the accountability of the regulators, and that is very much an issue which I hope that you will pursue, which is how should you make the FPC in particular accountable to Parliament and to yourselves. How can you make it accountable when financial stability is extraordinarily difficult to measure? How do you do it? Then there is the second one, which you were also talking about, which in a sense is accountability of the banks for what they do. One of the interesting issues here is why did those to whom the banks were accountable—for example, the shareholders and the bondholders—not themselves object to the kind of compensation levels which presumably were part of what caused rage in yourself?

Q65 Andrea Leadsom: Yes; and that takes me on to my second point. I have long felt that regulation has increasingly trumped competition over the last 15 years. Regulation has become such a mantra—a tightly regulated industry and so on—that competition, going back to Adam Smith's principles of free entry and free exit of market players, just has not happened. As a result, when I get banks in to lobby me, they say "Well it was all the regulator's fault. They should have done something about it." Yet the chairman of Marks and Spencer wouldn't say such a thing: he would feel it was for him to manage the risk. Is there not an issue here where regulation has overtaken competition and we have ended up in a position where we have artificially created firms that can charge oligopoly pricing; and yet we are not allowing, we are not permitting, the market to find its own level?
Lord Myners: I think in retail banking we have an overly concentrated industry. Sir John Vickers and his Commission will be looking at that.
Chair: As will we.
Lord Myners: The Herfindahl Index of industry concentration takes retail banking into an area where competition authorities will begin to ask questions. The SME market, for instance, has been dominated by two banks, so there are some issues which need to be addressed there. I don't think the role of regulation per se is to facilitate competition. It is, as far as prudential regulation is concerned, to ensure that organisations are resilient and that failures can be managed. Again, we have heard from Professor Goodhart, and I have touched on it as well, that we simply did not have adequate recovery and resolution arrangements, although that was addressed by legislation which was passed in 2009. I think, Ms Leadsom, you raise a very important point which is about ownership of the banks. The banks did not fail because of shortcomings at the FSA, the Bank of England or the Treasury. The banks failed because of mistakes made by their own management and their own boards of directors. The regulatory infrastructure didn't spot that failing emerging and didn't handle the failure as well as it should have done at first when it appeared. We cannot build a safer, stronger banking system without a combination of more competition and stronger management and ownership by the institutions who own the banks on our behalf.

Q66 Andrea Leadsom: May I just press you, Lord Myners? Why then did you allow, for example, the chief executive of RBS to walk away with his pension rather than face a law court? There needs to be some level of sanction that effectively acts as a deterrent to other banks who feel that it is all down to the regulator.
Lord Myners: I feel rather like an Oxfordshire village with a sign outside saying that it is twinned with another town elsewhere in Europe. I am now forever twinned with Sir Fred Goodwin and his pension. Mr Fallon is an even greater expert, and Mr Tyrie, on these issues. I don't think we need to go there in great depth, but I would continue to argue that the decision that was taken on Sir Fred Goodwin's pension was taken by the board of directors of Royal Bank of Scotland.

Q67 Chair: Endorsed by you.
Lord Myners: I think I plead guilty to the charge which this Committee placed on me, in that I exhibited some naivety. I was very new into my job and I look back on that particular evening of Saturday 11 October at 5.45, when I discussed Fred Goodwin's pension, and realise that it was not my finest hour.

Q68 Chair: So a less naïve Lord Myners would have done things differently?
Lord Myners: I have been in Government for 18 months, Mr Tyrie. I think that rubs some of the naivety off.

Q69 Mr Love: Taking the point that you have been in Government for 18 months and have therefore gained quite a lot of experience, I want to take you back to the structure issue. Taking on board your initial comments that there are advantages and disadvantages from any structure, can you say whether you think moving to the twin peaks variety is a step forward, based on your experience?
Lord Myners: First, I don't regard the bank crisis as being over. I still think we are in a very, very difficult situation in respect of funding, liquidity and asset quality. I am personally disappointed with the outcome in Basel. I don't think that the capital requirements are high enough. I think the phasing is too long and I think there is still too much disagreement around issues to do with the calibration of risk-weighted assets, etc., but I may write to the Committee rather than digress on that particular point.

Q70 Chair: While you are at it, could you tell us whether Basel has ever achieved anything?

Professor Goodhart: Yes, it did.

Q71 Chair: Put that in writing as well, Professor Goodhart.
Lord Myners: I think, Mr Love, my answer to your question is that a slightly inferior structure brilliantly executed will win against a slightly superior structure poorly executed. Therefore I would place some reservations around believing that architecture was the answer alone. What we have to do is to talk about the way in which these different entities will be staffed; how they perceive their function; the competencies that they develop; the cultures they require; and how they work together. This is not a simple structure. This is a very complicated structure, but so was the Tripartite.

Q72 Mr Love: You've obviously learned something in your period as a politician.
Finally, can I ask just Professor Goodhart something? You were suggesting that you were in favour of twin peaks but a slightly different variant, if I may put it that way. Can I put to you what Lord Myners has said? Wouldn't that make it even more complicated than the structure that is being suggested here?
Professor Goodhart: Regulation is always rather complicated by definition, because there are so many different kinds of objectives. The degree of complication in this country is nothing compared with the degree of complication in the United States. You have all the countries in the world with largely differing structures, so you try and get international agreement. So far all the discussion has been in the UK alone, whereas regulation has to have an entirely international focus. The international complexities are even greater. I think that the present structure, given how difficult the whole exercise is, is not a very difficult one.

Q73 Jesse Norman: I am very pleased to hear Lord Myners' comments about the importance of corporate governance. I think it is absolutely central to the diagnosis of the failure of the financial institutions. I think the emphasis on behaviour rather than architecture is also very welcome. Can I come to that issue? It is not clear that many of our banks have actually been run in the interests of the shareholders at all; rather, it looks like they are being run, in many cases, in the interests of the employees. Do you think there is a concern about how bank compensation links into financial regulation? How would you think about structuring or incentivising banks differently in order to create the right kind of behaviour?
Lord Myners: I think it is an observable fact that levels of compensation in banking at the highest levels have risen at an extraordinary rate compared with remuneration for folk working in branches and call centres. That has been mirrored to some extent in other aspects of commerce and industry here and elsewhere in the world, but in the financial sector it has been much more pronounced. I can't account for that by logic of supply or demand, so I am driven to the conclusion that there may well be an agency failure at work here and that the shareholders are not exercising sufficient oversight. I think, in turn, it is because they have become too dependent on benefit consultants, which has led to the ratcheting-up. I think they have lost sight of internal relativities and the strains that an organisation can experience when their pay differentials widen as much as they have. But this responsibility rests primarily with the shareholders. The ultimate shareholder is the pension fund or the pension fund trustees. They must require their agents, the fund managers, to exhibit much more involvement and engagement in these issues than they have.
I think there is one core failing in the FSA's approach to remuneration. That is the insistence on remuneration being paid in equity to increase alignment. I think that many directors of banks have enough equity already to ensure alignment, but there must come a point where the marginal utility of an extra unit of equity diminishes quite rapidly. But actually equity is risk-taking capital. What we need to do is to give the senior executives of banks subordinated debt—as their deferred consideration—so their interests align with the stability of the organisation and the stability of the system. There is a lacuna in our thinking which has driven us towards the belief that equity is the right currency for banker remuneration where, in respect of long-term incentive, it should primarily be debt. I would also hope that the Committee might support pressure to encourage the Treasury to ensure that disclosure of remuneration for banks takes place with effect from calendar 2010. The *Financial Times* has reported that it may be delayed. I think it would be regrettable if we didn't give the institutions the necessary information to perform the function, Mr Norman, you and I appear to believe they should be conducting.

Q74 Jesse Norman: Thank you very much indeed for that. The second question also goes to the issue of crisis prevention and behaviour change. It is really for Professor Goodhart. Can you just expand on the instruments that you think are necessary, either not in a crisis to prevent one happening or additional instruments for crisis management?
Professor Goodhart: Let us take crisis prevention first. One of the problems is that the majority of the instruments are decided internationally—for example, in Basel III—and there is only a limited range essentially of add-ons that the national regulator can apply, but there are some. There is, for example, the ability to raise the capital requirements on a counter-cyclical basis if you think the credit expansion is going too fast. Again, there may be the ability to introduce a degree of counter-cyclicality into the liquidity requirements. It may also be possible to change the overall leverage requirements a little bit.
Finally, as a fourth measure, it would be possible to change some of the marginal requirements, particularly in housing markets—the loan-to-value ratio. One of the problems is that the housing cycle, which was very much at the heart of the credit and leverage cycle that we have all suffered, had massive easing in the down-payment requirements: easing in the loan-to-value ratios and easing in the loan-to-income ratios in the upturn. Then of course when everything went wrong, the banks went tremendously in the other direction, tightening up throughout. What

you need are the authorities to prevent the excessive easing in these ratios in the upturn.
A nice example is that the Swedes have just increased the loan-to-value ratio in Sweden at this moment. They were one of the few countries which has not suffered a major downturn in housing. In fact, they have a minor housing bubble. They have done that off their own bat. That is exactly the sort of thing that I think the Financial Policy Committee should be considering in every meeting. It is vital that the Financial Policy Committee actually takes decisions on instruments; otherwise it is a talking shop.

Q75 Jesse Norman: Just to develop that for a second, your view is that there should essentially be a series of questions and that every FPC meeting should be, as it were, the standard agenda to be considered over and above anything that happens to arise?
Professor Goodhart: Absolutely. That is why the Monetary Policy Committee worked so very well, because at the end of every meeting you actually had a decision to take on interest rates. That was a decision which was published, for which you were accountable. You need to have that kind of decision on questions such as "Do we need to change capital adequacy ratios?" and "Do we need to change liquidity ratios, leverage ratios or margins?" There should actually be specifically set a question at the end of each meeting. Even if the answer is normally "no change", it is still important that a specific decision on a specific set of instruments is made at each meeting of the MPC.

Q76 Jesse Norman: That is extremely helpful. Craving the Committee's indulgence for a second, could you just talk about when you are in a crisis, which is the other half of the question, and the instruments you need at that point?
Professor Goodhart: That is much more difficult because you don't have that many instruments that you, as a central bank, can wield other than liquidity. You can raise liquidity in the way that has been done throughout this recent crisis, but you can't inject capital, at any rate to anything like the same degree. The injection of capital has either got to be done by the Government or you have to consider ways in which new equity capital is injected by the other bondholders and creditors to the bank. One of the issues that I am sure you will be discussing at some stage in your debate is the role of bail-ins and also these convertible contingent capital—or "CoCos" as they are known. I actually happen to think that they are not quite as wonderful as some of their advocates would think.

Q77 Chair: In fact, I would value you setting out your reasons why CoCos are not as valuable.
Professor Goodhart: I have done that.

Q78 Chair: Good. Perhaps you could supply that to us. I should have already read it, but I haven't.
Professor Goodhart: I will.

Q79 David Rutley: We have talked a lot about the FPC. We have talked about the PRA, the CPMA and the Government's framework here. I would be very keen to find out the views of both of you on the role of the Treasury going forward; and also to hear your thoughts on how it is better equipped to face, as you said, any forthcoming financial crisis. Let us hope it is a long way off.
Lord Myners: The Treasury's primary role is to make decisions about the deployment of public funds which, as Professor Goodhart says, may well be the only source of equity when you're in wartime crisis. The Treasury, of course, also has important responsibilities in respect of the appointment of people to these various agencies. It is envisaged that the Treasury would run the appointment process for the Court of the Bank of England, for the Financial Policy Committee, for the Monetary Policy Committee and, jointly with the Department for Business, Innovation and Skills, for the CPMA. So the Treasury has important responsibilities there.
Can I say in parenthesis on the Governor that when I talked earlier on about the burden of expectation placed on the governorship, I made it very clear it was the office of the Governor rather than this specific Governor. I happen to believe this particular Governor is up for all these tasks and more, but I do think we need to recognise that the office of the Governor will have extraordinary powers as a result of this structure.
On the twice-annual meetings with the Governor and the Chancellor, I thought the frequency was probably a bit on the low side. I would like to see them quarterly. I am afraid that my experience of working in Government tells me that something which refers to "high-level minutes" is coded language for minutes which tell you nothing. I think that those meetings should be properly detailed in their minuting. Transparency should be something which we pursue at every possible opportunity in this structure, as long as it is not counterproductive to the achievement of financial stability.
David Rutley: Professor Goodhart?
Professor Goodhart: During normal times and under the requirement to try and prevent crisis, the leadership of what should be done should be left with the Financial Policy Committee under the chairmanship of the Governor. When you get a real crisis of the kind we've had, then the Government and the Treasury have to be very much more involved. I have, at any rate, toyed with the idea that when you get a real crisis and you are dealing with crisis resolution issues, the chairmanship of the Financial Policy Committee should then pass to a member of the Government. Governments are very closely involved in crisis resolution and you have to distinguish, I think, between crisis prevention, when the Government and the Treasury can essentially leave it to the leadership of the Bank, and crisis resolution, where the two—the Government and the Bank—have to work very, very closely together.

Q80 Stewart Hosie: On the structure between the EU and the UK, they are very different. The negotiations to set up the European structure will be done by Government but the expertise will be held by the Bank and by the CPMA. Do you think there are any difficulties there? Are you confident that the people

negotiating on the UK's behalf in terms of the new EU framework will have all of the information they require in the right way?
Professor Goodhart: I am actually slightly concerned that the European Systemic Risk Board, or ESRB, which is going to be the overriding body within the European context, is almost entirely dominated by the central banks—by the ECB and the other national and central banks in the European Union. I think that you would have been wiser to have a slightly wider range of involvement, including more of the consumer protection and more of the other supervisory bodies involved. There are flaws in the way that the European system is set up. I think having these three separate bodies for insurance markets, capital markets and banking is nowadays, with so much integration of the three, a waste and a mistake. I think that there should be an oversight body which, as I say I think is too dominated by central banks, and then the supervisory body below should essentially have responsibility for all the macro and micro-prudential issues, but with a separate consumer protection establishment.

Q81 Stewart Hosie: Given what you have just said about the division within the EU model, plus the UK structure sitting alongside it, do you see a danger of gold-plating, particularly to UK financial institutions; or do you see a danger that there are gaps between the various pillars, particularly on the EU side, through which the financial institutions may fall?
Lord Myners: I think there will be a considerable amount of duplication between the work in Europe and the work in the UK, but that probably recognises the reality of global financial institutions. Our major banks, insurance companies, hedge funds and investment managers operate on a global basis, and I think we have to create regulatory frameworks with that in mind and ensure common acceptable minimum standards. There is one area where I believe this document is profoundly wrong, and there is one other issue I would like to raise in connection with Lloyd's, if I could have a moment, Chairman. This document suggests that the UK Listing Authority should go to the FRC. I think that would be profoundly wrong. I think it misunderstands the role of the FRC. The obvious place for the UK Listing Authority, which is a very important entity and of some national significance in ensuring that London remains an important market, is in the CPMA, and it would then allow the CPMA to speak for issues relating to listing on behalf of the UK in the ESMA. I hope very much that the Committee will look carefully at that. That and Lloyd's, Mr Hosie, come right at the end of the document. My experience of working in the Treasury is that there is a point when exhaustion sets in and people say, "Oh goodness me, we've got to say something about the UKLA and Lloyd's" and it comes in the very last page. The document is wrong in respect of the UKLA, and underestimates the importance of ensuring that we have a regulatory structure which protects and promotes the existence of Lloyd's as the world's leading reinsurance centre.

Q82 Stewart Hosie: I am sure the Chairman has picked up the Lloyd's point and we will all re-read the last two or three pages after the session. Without exhausting you, can I take you back to the split between the EU and the UK, and its possible dangers? You said earlier, Professor Goodhart, that it wasn't necessarily a problem if fiscal policy went in one way and monetary policy went in another: sometimes that was necessary. But if we are looking at the EU and UK structures, could we not have a situation either in fiscal policy or in monetary policy, the way that these operate, in which one would be operating in a pro-cyclical manner while another would be operating in a counter-cyclical manner? Given that they are fundamentally looking at the same things, would that not be more of a problem?
Professor Goodhart: I am not sure that I follow what example you have in mind.

Q83 Stewart Hosie: The European Banking Authority, if it proposes its stability fund, which seeks to take more capital while on a counter-cyclical basis to allow more money into the system, will reduce the capital ratios in this country. I am thinking of how they could work against each other.
Professor Goodhart: That is always a possibility. Following Basel III we have a concern that, at the same time, the long transitional period may not allow for the banks to get sufficiently strong quick enough to prevent stability difficulties in future. At the same time there is a concern that if you made the transitional period much shorter then the banks, in order to meet the tougher requirements, would have to cut back on their lending and this would have adverse economic effects. You always have a range of objectives and, as always, it is the art of trying to achieve the best mix of out-turns. I don't actually see anything particular in the structure of the EU-UK arrangements which would make this more difficult than it always is.

Q84 Mr Umunna: I want to ask a couple of follow-up points on issues that have been raised before, and just probe a bit on the growing row about whether the universal banks should be broken up. I should just say that I practised for several years as a City employment lawyer, and I think the point that Lord Myners made about remuneration being given in a subordinated debt as opposed to equity is a very, very good idea. In the many years that I spent in the City, I never once came across remuneration arrangements that included that. I think that is a terribly good idea, as much as many of the bankers and people that I used to act for will probably not appreciate me saying that, but never mind.
There is one question I am not totally clear on that I would like to put to both of you. It arises from the point that you, Lord Myners, were making about your not being so concerned about the architecture, because it is the behaviour that is key. I think for people out there watching this hearing in my constituency and beyond, the key question they are going to have in their minds is: do you think that the new architecture is going to make the behaviours that precipitated the financial crisis more or less likely?
Lord Myners: I don't think it will have a great influence on those behaviours at all. I think we have

failed to grasp the issue of global imbalances which lie at the heart of much of the financial crisis. I think that the new structure is "subserviated" to Basel and the European directives on capital and liquidity. We have mentioned very little about liquidity, though liquidity management is terribly important. It is a great shame that Basel backed off on promoting a net stable funding ratio for banks. I don't think there is anything in this structure which will help institutions manage risk in a more informed way and to price risk more appropriately, and there is nothing in this document which will strengthen and empower boards of directors and shareholders in holding directors to account. That in my view covers many of the areas where the problems arose, Mr Umunna, but I wouldn't actually expect the regulatory architecture to be tackling those issues. They are being addressed through Basel; through Europe; through the FRC and the new stewardship code; through the implementation hopefully of Sir David Walker's recommendations, and many other steps. We would be misleading ourselves if we believe that this structure would, in itself, mean that such events could never occur again.

Q85 Mr Umunna: Professor Goodhart, do you agree with that?
Professor Goodhart: No; I think that the structural change, moving towards the twin peaks approach, will actually make the kind of crisis that we've had marginally or somewhat less likely. The reason for that is that the Bank of England's forte is looking at market relationships, looking at interconnections, looking at the system as a whole and looking at how everything interacts together. The problem with the FSA, who under the previous approach had more of the responsibility, was that they were focused on the individual institution and how it operated. In particular, the FSA's ethos, and its bread and butter operations of work, was primarily to deal with criticisms about unfair behaviour. That meant that the FSA was essentially staffed by lawyers and accountants, and they were looking at the kind of legal and accountancy issues that relate to specific individual behaviour. I am not saying that it is wrong to do that—these are very important issues—but the key issues and the ones that really matter for the economy as a whole and the kind of crisis that we have just been seeing are the interrelationships, the big issues, the market issues, the systemic issues. I think that giving more of the accountable responsibility and the authority to an institution which is primarily concerned with markets, interrelations and the system as a whole will be a step in the right direction. It will mean that the kind of mindsets that are being used will be different and will become much more appropriate.
Lord Myners: If I may have 10 seconds, I don't think there is a great deal of difference between my view and Professor Goodhart's. I was answering as to the structure. I think what Professor Goodhart said, particularly about macro-prudential, is terribly important but, as I said earlier, we should not underestimate the fact that the macro-prudential regime that is being envisaged would require, for instance, the Financial Policy Committee to form a view on house prices and to ration availability of access to housing. It is not clear to me, for instance, if the FPC existed at the moment, whether it would conclude that house prices were too high or too low, and how it would live with the consequences of reporting its decision—and those on corporate valuations and on domestic credit to support consumption. These are the issues which this document really says are macro-prudential and will come through the FPC. It says, "These are some of the instruments", but it rather skates over the practical issues of how this would work in practice. We are going to see mortgage rationing under this proposal, which is something we haven't seen for 30 years: it may be necessary.

Q86 Mr Umunna: I am conscious of the time, and I can hear the Chairman getting restless next to me. Mark Garnier has already touched on this debate. I see it as a kind of war, if you like, that is going on in some respects between the Bank of England and the big banks on the potential break-up, and their concerns about what the Banking Commission is going to suggest in that regard. My first question in that respect is: do you think it is healthy for the big universal banks and their various heads to, in essence, be sounding off in the media and holding a gun to the Government of this country and the people of this country in respect of how they wish to run their banking system? Do you think that is a healthy situation? Do you think it is healthy for them to be making these types of threats alluding to them having to move and domicile elsewhere?
Lord Myners: I think they no doubt feel that they have to speak on behalf of the institutions for which they are responsible, but the right forum to have this debate is through the Independent Banking Commission under Sir John Vickers. But I think we would be misleading ourselves if we didn't recognise that some of our major banks could relocate and may conclude, in certain circumstances, that it was in their shareholders' interest that they did so. I think that would be a great shame and I think it is entirely avoidable. The language from Government about banking also needs to be more moderated than it has been. I think this term "casino", for instance, is used altogether too lightly, and has pejorative connotations which do not promote a healthy debate and discussion.

Q87 Mr Umunna: But that is partly, I suppose, due to a lack of transparency on the part of the sector vis-à-vis the people. Do you think they are credible though? Do you think they are bluffing? Do you think their sounding off is something that we should take seriously?
Lord Myners: I don't think they are bluffing at all. I think it is perfectly possible for a major bank to relocate. You have to ask yourself, Mr Umunna, if you were starting from scratch where would you choose to base a bank? Some of these banks have very, very substantial activities outside the UK, particularly in south-east Asia and in Africa, which they may see as an increasingly growing part of their business. I think it is a perfectly viable option for them. We have to

ensure that the UK is a good place for these banks to be based, but also ensure that the banks are strong, robust and resilient. Part of the process out of the Vickers report will be increased emphasis on subsidiarisation. Rather as HSBC is built on a structure of subsidiaries, that would seem to me to be a very sensible thing for banks to do, together with restrictions on placement of liquidity with affiliated parties. I think a structure along those lines would make the UK continue to be a very attractive place for a bank to be based, but I would not dismiss this as being hot air.

Q88 Mr Mudie: I was cheered up when I read your article that we have in our papers. I got the impression, though you have moved away from it, that this proposed legislation falls into the "something must be done" category; that "people expect it, we are moving and here's our activity". To me it seems like building a more sophisticated Maginot Line, and just as useful. It is marginal because all the countries went down with different regulation systems. So we change ours and can say "Oh, we've done it, we're OK, we're set for the next one." Your answer to Jesse was about behaviour. I am not persuaded. There was a response in the *Evening Standard* yesterday to Basel III: "Banks are jubilant". Do you think these banks have learned anything? How can I and my constituents be assured that they have learned something and their behaviour is going to change? Aren't the forces within that financial industry such that they don't have to change: they just have to survive and let time pass and we are back in business? I get the impression that is their view now.
Professor Goodhart: You have to remember that survival means that they are inclined to cut back. They are inclined not to make loans rather than to make loans in order to strengthen their balance sheet. The danger is that everyone goes into their shell immediately after a crisis, and lending is cut back and not extended. The recovery becomes very slow, and slowly we get out of this particular mess, but as we do memories shorten. One of the problems is that people tend to forget, and we are very myopic in that sense. What normally happens is that the regulations tighten immediately after a crisis. That actually means that the recovery is slowed in some part because it forces the banks to be even more defensive. Then as the recovery continues and you pass into the future, everybody says this regulation or that regulation simply stands in the way of innovation and you don't really need it. "We haven't had a crisis, we'll be all right and the central banks or whoever is in charge will handle it." So you reduce your regulation increasingly until the next crisis occurs. It is an absolutely standard cycle and it is what we are all prone to do.

Q89 Mr Mudie: Do you think that our inability to take steps on securitisation, on regulation of hedge funds, on shadow banking, on strengthening the auditors, and the fact that those issues are not first on the table, shows that the seeds of that bad behaviour are still there, growing and ready to flower whenever the economic situation changes a wee bit more?
Professor Goodhart: My view of the crisis is that it was a question of an excessive cycle in credit expansion and leverage: up in the boom, down in the bust.

Q90 Mr Mudie: But Professor Goodhart, what good are Basel arrangements when you do a lot of your lending, etc. out of sight, on an off balance sheet SIV, and nothing is happening to that?
Professor Goodhart: The point I am trying to make is that wherever credit expansion and leverage occurs, the authorities ought to be in control of it and ensure that it does not get out of hand. It does not matter whether the credit expansion is on balance sheet, off balance sheet or in some other intermediary like a hedge fund. As the leverage and credit expansion increases too much, it needs to be subject to oversight, control and transparency. You need to know where it is.

Q91 Mr Mudie: Are we going to get transparency on derivatives?
Professor Goodhart: Yes, much more so.

Q92 Mr Mudie: Much more? Are we going to get total transparency so people will know what they are buying or what they are selling?
Professor Goodhart: The standardised derivative markets will be put through centralised clearing parties, or CCPs. They will provide the information to the authorities. One of the problems in the future is that there will be so much information that it will be quite difficult for the authorities to see the dangerous needle in the haystack of ordinary market transactions.

Q93 Chair: What about the OTC market?
Professor Goodhart: You have to have some of it because of new methods of doing things. There are lots and lots of perfectly ordinary corporates of various kinds out in the open who have rather specialised needs which they need to hedge. You can't put everything through a CCP. You can put all the major standardised products, i.e. CDS, various kinds of interest rate swaps and so on, through the centralised clearing parties and that is going to be done. The question I suppose is, what is the dividing line when something becomes sufficiently standardised and you can put it through the CCP, and when it is sufficiently innovative, small, new and bespoke that it actually can't be done otherwise except on a bilateral OTC basis.

Q94 Mr Mudie: Can I just ask Lord Myners: you said that it would be a great shame if the two threatening banks—Barclays and HSBC—moved. Define "great shame". I mean, we are facing huge public sector cuts and huge job losses. People cannot buy a house, etc., etc., because of the antics of these people. They have gained by us bailing them out one way or another. *[Interruption.]* That will be the HSBC ringing me, I suppose. It would have a budgetary effect in terms of taxation—we accept that—but would that not be a price worth paying to have a more settled, better behaved banking system?

Lord Myners: If you are saying to me, would it be in the national interest for us to be the domicile of weak and vulnerable banks, clearly not. My argument would be that HSBC, which of course owns the old Midland Bank, is a major provider of credit and financial services in the UK, and Standard Chartered has significant consumer finance activities in the UK. They are beneficial to the UK economy, and as long as they are well managed, profitable, pay tax on their profits in the UK and create employment in the UK, then that must be a plus. I think the other issues to which you refer, such as the public sector cuts, are a valid observation but they don't seem to me to be directly connected to the observation of whether we would like HSBC, Barclays or Standard Chartered to be based in the UK.

I would say, however, that the argument that the financial services sector pays high taxes in the UK is capable, like an onion, of being peeled back. To some extent they make high profits as a result of making high charges on customers. That means that those customers in turn pay less tax themselves. So the argument that the taxes which come from the banking sector could be lost seems to me to miss the point that if the economic value of banking was less profitable it would appear in fiscal contributions from individuals and from companies. It is not quite as simple as the banking industry or the British Bankers' Association would sometimes suggest.

Chair: Thank you very much.

Lord Myners: Can I just say one point on Lloyd's, Chairman, very briefly?

Chair: Very quickly. By all means supplement anything that you haven't said.

Lord Myners: It really does appear right at the end of this document. Lloyd's is a significant market. It has been very well regulated, very well run and has produced large tax revenues and large employment in the UK. It is almost an afterthought in this document. We need to make sure that this structure does not in any way disadvantage the UK as a centre for insurance and reinsurance.

Chair: We've got that noted as well now and on the record. Thank you both very much indeed. It has been a fascinating evidence session, and certainly I have learnt a lot: I think everybody has. One of the most interesting remarks was from Professor Goodhart, who said that this new structure will make the crisis we've had "marginally less likely", which would suggest that we might just have closed the stable door after the horse has bolted but, of course, tells us nothing at all about the next crisis, which is what we are supposed to be regulating for. Thank you very much.

Lord Myners: Thank you, Chairman.

Professor Goodhart: Thank you.

Tuesday, 12 October 2010

Members present:

Mr Andrew Tyrie (Chair)

John Cryer
Michael Fallon
Mark Garnier
Stewart Hosie
Andrea Leadsom
Mr Andrew Love
John Mann
Mr George Mudie
Jesse Norman
David Rutley
John Thurso
Mr Chuka Umunna

Witnesses: **Ms Angela Knight**, Chief Executive, British Bankers' Association, **Mr Adrian Coles**, Director-General, Building Societies Association and **Mr Peter Beales**, Head of Policy and Advocacy, Association for Financial Markets in Europe

Q95 Chair: Welcome to the first session in October of the Treasury Select Committee and our inquiry into banking regulation and financial regulation. I would like to begin by asking you, Angela Knight, whether you feel entirely comfortable justifying £7 billion worth of bonuses this year?
Ms Knight: At the moment I have no knowledge of what the bonuses are going to be frankly. I have read the reports in the newspaper of surveys. As to what is going to happen, I do not know. Do I believe that the members of the BBA that are, shall I say, headquartered in the UK are taking the question of bonuses very seriously? The answer is yes. I also know that as far as other countries are concerned, they do not take the same view as we do here in the UK. So I am expecting that we will see a considerable degree of variability around the world. I am anticipating that we will see some countries which, whether they signed up to the G-20 or not, do not implement type of constraints and have the type of concern that we see here but what I can't do, at this moment, is prejudge an outcome. All I can say to you is that our members do consider this matter very seriously indeed, are well aware of the concern in the UK and of UK people and, at the same time, are mindful of the need to keep relevant staff.

Q96 Chair: When people hear you and others talking about banks taking bonuses seriously, what they hear is "banks deciding to pay themselves a serious bonus." What do you really mean by taking bonuses seriously? Are we talking about realising that very large payments now are going away from shareholders to employees without reasonable justification?
Ms Knight: No, that is not what I mean. I am sorry, I do not agree. I do not think people should be paid without reasonable justification. I think that any pay has to be against proper criteria and well-understood performance for the long term. Variable remuneration there, it has to be subject to understood long-term performance and clawback. So that's what I mean. I think one of the biggest concerns people have is simply that some of these numbers are very large indeed and, I say again, that is entirely correct but it was in the past.

Q97 Chair: But you are not worried about this?
Ms Knight: Of course I am worried about it. Why do you think I would not be worried about it? I'm a human being like everybody else. I live in this country like everybody else and I worry very much about this matter. I also worry about the UK. It is an international centre. I worry about the UK continuing to have a very plural banking sector. The BBA has 230 member banks. The majority are in no way British in the sense that is often meant by that word. There are 60 nationalities around the table. The majority are headquartered overseas. They will pay their people according to the standards that apply in their home jurisdiction and yet we sometimes report that as if it was paid here. Neither you nor I can do anything about that. What I can say to you is that those UK banks—the ones that are fully within the jurisdiction, if you like, and the understanding of what happens here—are, yes, very mindful of the view and concern of the UK people. They have to do two things. They have to run their business, and that means keeping their staff in an international marketplace. They also have to satisfy the home audience. I do not quite know at this stage how that is going to be put together but what I am certainly not going to do is prejudge something that hasn't yet happened based on a report of a non-UK bank.

Q98 Chair: Do you think that very large bonuses have any connection at all to increased concentration in the investment banking industry?
Ms Knight: Well, I'm not sure, frankly. I would have said that the greatest reason why we have increased concentration has been as a result of the consequence of the banking crisis, where banks have been put together for the purpose of effecting stability. That is why we have increased concentration. If you are saying to me, "Before the crisis was pay a function of either forming a large or forming a lot of small, focused, niche-market investment banks?", frankly, I am not sure. I think underneath that is the question that I suspect and if you have not yet asked it, you are going to ask me next; how big is remuneration a driver and a motivator? I think remuneration has a part to play in all of us. I do not think that I would pretend otherwise. Is remuneration the fundamental cause why we have had the problems we have? The answer is, as others have said, no. But I do not think we should pretend either that it does not have any reaction—any action—

Q99 Chair: My question was do you think that increased levels of concentration in the investment banking industry are connected to the high level of bonuses that are going to be paid out?
Ms Knight: Now or before? Either which way? I do not know, is the answer.

Q100 Chair: You do not know?
Ms Knight: Well, I gave you that answer; that I do not know.
Chair: A quick question from Andrea and then Jesse Norman.

Q101 Andrea Leadsom: Yes. In fact, consolidation in the banking sector has been going on for the last 20 years and now I just wanted to take you on slightly to the fate of SMEs, where 83% of lending to SMEs comes from four banks—four extremely large banks with huge market shares—and there is a real crisis in SME lending in this country. What do the BBA propose to do and what are you doing to try to encourage banks to lend to SMEs?
Ms Knight: Okay. So now we are off investment banks and we are on to universal banks. Well, as far as lending to SMEs are concerned, as you are well aware, there are very mixed surveys on that particular topic. The BBA is putting out more statistics today as part of a series that we undertake with the Bank of England that show that the lending to SMEs remains up. But, at the same time, it shows that the payback by SMEs of existing loans and the increase in deposits by SMEs is also up. Now, that in no way means that there are not some areas in which viable SMEs may not be getting all of the finance that they need. That is the reason why, in conjunction with the chief executives of the six major UK banks, a taskforce was announced in July. You will recall it was in the Green Paper. You will also, no doubt, have picked up that that taskforce will be reporting this week with a series of recommendations, many of which have focused precisely on the SME issue. But if you—

Q102 Andrea Leadsom: But, if I may, what I am asking you is do you think that the consolidation that has taken place in the banking sector has lead to this problem, where 83% of all loans to SMEs are being carried out by four banks? There is no doubt that there have been extortionately high rates charged. There have been very unpleasant terms for SMEs. It is hampering the recovery in this country. Is it something that concerns the BBA? I am very much aware of all of the commission that is going on right now.
Ms Knight: Yes, and that is why I am not, at this moment, going to announce what the taskforce is going to announce tomorrow, if you don't mind. Of course we are concerned about the issue. Consolidation in the way that you describe it and has happened in this area is as much caused by many factors. The serious barriers to entry should not be overlooked. The actual cost of operating in the banking sector from the regulatory requirements is high. We favour, as the BBA, new entrants into the market, very much so, and I am glad to say that some of those that we've seen come into the UK, such as Metrobank and indeed Tesco—which is, as you know, proposing to operate as a bank—are also members of the BBA. We are a very broad church and that is useful from our perspective, because it gives us a much wider ability to see what is happening and to understand it than would otherwise be the case. Overwhelmingly, if you have a marketplace which is interesting and where there is business to be done, then it attracts new entrants. If you are not attracting new entrants into the market or it is difficult for new entrants to get into that market, then you have to look at the reasons why. We do think that some of those reasons why relate to a number of the regulatory issues and, as part of the general reviews that are taking place, that will come into focus and be properly examined. We welcome that and we are part of the contributors to that.
Chair: Jesse Norman?

Q103 Jesse Norman: Thank you, Chairman. Banking would be the only industry in living memory in which consolidation was not linked to increase in compensation at senior levels. That's been very much a feature over the last few years of every industry, regardless of the causes of the recent consolidation in finance. Going back to the question of bonuses, do you think that there is in fact any genuine likelihood that the industry will be able to self-regulate on the bonus front, given international competition?
Ms Knight: Well, the industry does not self-regulate because as you know, remuneration has been put into regulation in this country. It hasn't necessarily in other countries but it has in this country and this country will ultimately decide what it does in that area and the consequences will be whatever the consequences will be. It is always said, "Well, the banking industry talks about it being an international industry and you pay on international scales" and somehow that is trying to cover up the issue. It's not. It is entirely correct. That part of the industry where the high bonuses are awarded is a very small part in terms of the numbers of people that are employed.

Q104 Jesse Norman: But it is not small?
Ms Knight: It is a very international part and it is a very vital part, both to this economy and other economies.

Q105 Jesse Norman: But it isn't small in terms of its impact. It's very interesting to read your written—
Ms Knight: That's correct.
Jesse Norman:—written evidence, because when you come to the diagnosis on the fundamental causes of the crisis, you identify glocal economic imbalances, misunderstood risk, unsustainable funding models, excessive build up of debt and shadow banking. You never talk about incentives and yet there is lots of evidence now that incentives created a focus on the short-term, an unattractive bias in favour of more risk and, in fact, oddly enough, rather than enabling creativity, may have stultified it. So are those not factors that would underlie many of the issues that you have identified as the proximate causes of the crisis?
Ms Knight: Well, perhaps I could say we did not identify those issues. We used the identification that has been done by others. So as you will know—

Q106 Jesse Norman: All right. Is the BBA's position not that there is a serious issue here of incentives and that it needs to be looked at?
Ms Knight: Well, of course.

Q107 Jesse Norman: I mean you have to take a position on this. Is your position that the incentives were somehow fundamentally distorted and were part of the cause of the crisis or is it not?
Ms Knight: Well, first of all, can I say thank you very much indeed for inviting me here to talk about the Treasury consultation paper on regulatory structure. I look forward to us getting to those questions at some point. If you had wanted to talk to me about remuneration, I would have come with pleasure, but I would have expected, if I may say, the courtesy of the Select Committee to have let me know in advance. In answer to your—
Jesse Norman: But you have told us already that the bonuses—
Ms Knight: In answer to your—
Jesse Norman:—are regulated and, therefore, fall perfectly well within the regulation of the City of London.
Ms Knight: In answer to your question, I think I am, if I may say, entitled to ask for some courtesy from the Committee. I'm sorry that you have not seen fit to let me know in advance. Now, let me come to your question. Do I think that remuneration has a part to play? The answer is yes and we've never rowed away from that. Do we think that it is the one on which maximum focus should be paid? The answer is no, because the fundamental causes are elsewhere and they lie not just with what happened in the banking industry. They also lie with economies which were run poorly, with excessive spending by governments by too much credit, by individuals, and by monetary policy that was inappropriate. The global imbalances have sadly not been properly addressed and, as we see now, the G-20 is not, unfortunately, converging in the way that we had all hoped but it is diverging. What might be a very good outcome for this Committee on this particular aspect is to do something—and maybe you can think of some recommendations, Chairman— to get the G-20 to come together, particularly on the question which you are particularly interested in at the moment, which is remuneration. We would be happy to see an international agreement on remuneration. There is not one there.

Q108 Jesse Norman: A final question; would you be happy to publish a paper from the BBA to try to lead that debate?
Ms Knight: I think you will find that we have put out some quite useful information on that, as we have on a number of other subjects. I am not sure whether you have seen, for example, our work on bail-ins, the "too big to fail" question nor our work on macro-prudential. That is all available and it is on our website. I'll make sure that what we've done in the remuneration area gets sent to you.
Jesse Norman: Thank you very much.
Chair: Chuka Umunna?

Q109 Mr Umunna: Let me just say, following on from what Jesse Norman has just said, I found it quite extraordinary that you should come here to answer questions about financial regulation and then express surprise that we should ask you about remuneration. I think it is entirely in order for this Committee to be asking you about that. I'll move on. Let me just ask you a general question about the Government's proposals for financial regulation. This is a question for all three of you because, after all, we want to hear from all three of you. Do you think that the proposals are going to make a future crisis less or maybe more likely? What are your views on that matter?
Ms Knight: Well, perhaps I could just answer your first point; that you are surprised that we should come and not expect to be asked questions on remuneration. We had in fact contacted the Committee to find out whether you wanted to go wider than the questions in the consultation paper or not. The answer was that you wanted to do the questions in the consultation paper, so if I may say—
Mr Umunna: Well, it is a general inquiry on financial regulation.
Ms Knight: If I may say, I am quite happy to answer the questions. I just think that the Committee should have had the courtesy to let us know that you wanted to ask the questions. Now, turning to your second one, which is about financial regulatory structure—

Q110 Chair: Just on that, do you think the regulatory structure has nothing to do with the bonuses?
Ms Knight: No. I think that bonuses—

Q111 Chair: You look tired or exhausted or you are sighing as if you are surprised I have even made the point. Clearly there is a connection between the two and, therefore, you would expect the Committee to raise such points with you, particularly given the news over the last 48 hours.
Ms Knight: I think that bonuses—

Q112 Chair: Are you really surprised that we have raised this?
Ms Knight: In some respects I am, yes, because I would have thought that if you wanted to raise these questions—and you are perfectly entitled to raise any question that you like—then you might well have thought it also only reasonable to let me know. I am allowed to have my opinion, even if it disagrees with yours, and that is my opinion and if I had been on the other side of this table, I would have done that.
Now, shall I answer the second part of your question; do I think that the changes to financial regulatory structure will make a big difference? I think they can make some difference but they do have to be seen in the light of other changes that have been made, because this is not just the one question that we should be asking or answering as to who has got which powers. Clearly there is a need for each and every authority, however they are constructed, to be well co-ordinated with the others and, indeed, with the Treasury as well. In the time at which the Financial Services Authority was formed in the late 1990s, consideration was given then to the "twin peaks" model, which is fundamental to the document that we

have in front of us, and I can argue that both have merit.

Mr Umunna: Have merit?

Ms Knight: Yes, so I do not see that there is a particular issue about putting the whole of prudential supervision together, and I think that it does certainly fill up some gaps. But in so doing it raises another set of questions and those other set of questions do need to be considered.

Q113 Mr Umunna: But do you think it will make future crises less likely?

Ms Knight: I think what makes future crises less likely is more than just that. I think it is greater capital and liquidity in the system and by the institutions. It is better management and risk control by the separate and individual major institutions. It is better co-ordination across borders. Many of these are cross-border firms. You do need proper operating colleges of regulators. And it also requires better supervision. Supervision isn't just a set of rules, whether they are right or wrong. It is a far more holistic approach which needs to be taken.

Q114 Mr Umunna: Mr Coles and Mr Beales, do you have anything to add to that?

Mr Coles: Yes, absolutely. Good morning. I think the final point that Angela has made there about the quality of supervision is very important. It doesn't matter what labels you put on the individual institutions. It doesn't matter what powers you give to the individual institutions. In a system in which we are putting much more emphasis on judgement, as the title of the Treasury's consultation paper emphasises, the quality of the people within that system will be as important as the structure of the system. Going to a much wider issue, if you go back to the 17th century—indeed, if you go back to Biblical times—we've always had economic cycles. There were always periods of optimism and pessimism and there were always periods of irrational exuberance and irrational pessimism. This new structure, by calling for higher levels of better quality liquidity and capital, may address some of those issues, but there will undoubtedly be peaks and troughs in economic activity and financial markets activity in the future, almost whatever the structure.

Q115 Mr Umunna: Do you have anything to add to the subject?

Mr Beales: Yes, one or two things. Could I just say a few words about my association, because we only formed a year ago and we were created really to provide a voice for firms specialising in capital markets business throughout Europe and I mention that because it helps you understand the focus that we have had in looking at the Treasury consultation. Our members believe that the structure proposed should be helpful in preventing a future crisis. As well as the context which my colleagues have mentioned, I think the key elements are the creation of the Financial Policy Committee within the Bank of England, which will focus on macro-prudential issues. It seemed that a major deficiency in the previous arrangement was that there wasn't that focus. And I think we believe also that creating a prudential authority which can focus on prudential matters is another strength with the proposals, although one must acknowledge that other questions arise as a result of the new structures that we are creating.

Q116 Mr Umunna: One thing that Lord Myners said when he appeared before this Committee was that there is a danger of being obsessed and over-focused with architecture, and that, for him, behaviours and competencies throughout the system were an absolutely key issue. Do you share that concern that we can get over-obsessed with structures? My colleague next to me was trying to draw a map, which he has here, of the new structure. It's wide and it's complex, but does it really go to these behaviour and competence issues that Lord Myners raised?

Mr Coles: I think that extends the point that I was making. Not only are we reliant on the qualities of judgement of the supervisors, we are reliant on the behaviours of individuals, especially, as has already been mentioned, in a very concentrated banking system where one large bank now has 25% of the mortgage market and 30% of the current account market. If that one bank exercises inappropriate behaviour or qualities of judgement, and if the supervisors of that bank don't correct it, then the behaviour of that one institution can have huge implications irrespective of the nature of the regulatory system. One of the points I'd like to develop later is the complexity of the system.

Q117 Mr Umunna: Who do you think should be responsible for ethics and culture in the city? I suppose I address that to all of you, but if you'd like to go ahead.

Ms Knight: Well, fundamentally, ethics and responsibility have to be vested in individuals, frankly. I don't think you can force that but should there be an ethics and responsibility structure—which I suspect is what you mean?

Mr Umunna: Yes.

Ms Knight: Well, we have been moving there in a kind of divergent way for some time. As you're probably aware, the various institutes which award qualifications all have something there which is about ethics and something there which is about responsibility and standards and that is a good movement forward. I think that that is quite right and it is shared by others, the various institutes. So that begs the next question and that is how much should one codify it?

Mr Umunna: Yes.

Ms Knight: There I am slightly uncertain on the codification, because sometimes you can codify something and you end up with beneficial consequences or you can codify something and you don't. So it is a question that hangs there; one that requires an answer. But the answer is not necessarily as obvious, once you start to think it through, as putting it into formal codification or not. In essence, it is a very vital and very important question and it is very important that ethics and responsibility are fundamentally top to bottom within an organisation. Some of that already starts to come to the fore in the

closer supervisory techniques operated by the FSA and I anticipate that that will develop much further as we form the PRA. Indeed, some of the focuses there will be helpful in that respect, though I quite agree with what Adrian has just said; if you have good people in charge of regulators, however bad the structure may be, they will make the right decisions. But however good your regulatory structure may be, if you do not have the right people in charge then you are not going to get the right outcome.
Mr Umunna: Thank you.
Chair: Mark Garnier?

Q118 Mark Garnier: Thank you. Speaking more to the PRA, in my previous life I used to be in investment banking and investment management and have acted as the compliance officer both under the old Securities and Futures Authority as well as the FSA. I look back to the days when I was dealing with the SFA and we had a very good and constructive relationship with the regulator. With the FSA, when we had a problem and you phoned up the regulator, it was rather like a sort of nightmare skit from *Little Britain* where the computer says no and it was quite depressing how bad it was in that respect. The new system, I suspect, is aiming to get back to a kind of relationship-based thing, which we had under the old SFA; more risk-based and judgement-focused. I think that is a good thing but do you think that this type of relationship between the regulated and the regulator might lead to either a cosy relationship or, alternatively, conflicts between the two banks or the two organisations? Do you think this is a good or bad thing?
Ms Knight: Well, again, there is not a true answer to that but I believe that if you have higher calibre people, higher quality supervision, you will get a better outcome. Judgements, I think, do have to be exercised and that means that you need people who can exercise those judgements. So that means in turn that, first of all, whatever regulatory structure you have has to be attractive to people as part of their career; attractive to people of a seniority and of a type that may have not been attracted certainly in sufficient numbers to the FSA.
So will a PRA as part of the Bank of England have that attraction? There is a view that it might have. Just as there is a view that separating out conduct of business, whether it is retail or whether it's market conduct of business, from the prudential side will also be beneficial in attracting people of the competence and capability to make a judgement. However—there is always an however—the first is that we live now in a much more litigious environment than we lived in 10 or 12 years ago and you are dealing with an international industry. You are a bank quartered in some country overseas. A judgement is made by a regulator here, which then has a consequence. You may find yourself in a litigious situation then in a way that was not the case when the Bank of England previously had responsibility for regulation. We may find that what people look back to fondly, as you have done with the SFA, may well not be the world that we are going forward to. But that does not mean that there won't be the ability to have more judgement.
I think the second thing which is important in this is going to be the relationship between the PRA and the CPMA because you may be primarily prudentially regulated, but your activities are market activities or retail activities or some mixture. So how those two organisations operate together—one seeking to exercise more judgement and one that will be far more rule-based—has to be very clearly thought through. On the face of it, these changes have considerable merit. As to how they pan out, there is a lot of detail and a lot of interactions that are yet to be worked through.
Mr Coles: There will always be a conflict between regulatory capture by firms of the regulator and conflict at the other end. You need a balance between those two and one of the keys to getting the right balance that has not existed in the FSA is consistency of supervision. I know that a number of my large members complain all the time because they have a new supervisor every 10 or 11 months. Now, mutual organisations have a particular form and a particular way of doing things. It is going to take six months for the supervisor to get into the way the organisation works. If the supervisor only has five more months with you, you are constantly re-educating and constantly asking the supervisor, "What is your approach to this, that and the other?" One of the secrets of the success of the new structure is to have supervisors who are able to put three or four years into an organisation and really understand it while adopting the same approach of the accountancy profession of proper movement of individuals so that they don't become too familiar to the organisation, too well known and too understanding of perhaps inappropriate concerns.
Ms Knight: I think we see mobility from the industry into regulation and back out again as quite important.

Q119 Mark Garnier: That has always been the case though. You have had people who have worked in investment banks or whatever who have gone into the FSA and have come back again, but quite often that is seen as a value-enhancing sabbatical from the frontline. I am quite interested in what you said about this litigious thing; it sounds like you see that as potentially quite a risk to the financial industry.
Ms Knight: Yes. I think it can be and the threat of litigation, of course, means that one seeks certainty in rules.

Q120 Mark Garnier: There is another problem with this—in fact, I am going slightly off on a tangent. I need to come back to what we are talking about. But that implies that you will then have higher insurance costs against this type of stuff, which then implies that it is going to be increased costs for the consumer, which cannot be a good thing, can it?
Ms Knight: I think that we are seeing increased costs right across the board anyway; increased costs from increased capital and increased liquidity, as you rightly say, and from a more litigious environment. Yes, there is a significant increase. Is an increase being put in simply as a result of regulatory structural change? Not necessarily the case. I do think we are looking at a more costly structure in the future than

we have at the moment; certainly that looks to underpin much of what is within the consultation.

Q121 Mark Garnier: I just want to draw it back.
Ms Knight: Yes, of course.
Mark Garnier: This is very interesting, but it is not quite where I wanted to go. A number of people—deposit takers, insurance, investment banks—are going to be supervised by two regulators. Do you see this as a problem? Do you see it as difficult for the compliance departments of these banks? Do you think there should be an answer whereby there is one point of contact that maybe is working with these two regulators? How do you see that?
Mr Coles: First, going back to the cost point, you cannot have better regulation, higher levels of capital and higher levels of liquidity without consumers and firms facing greater costs. Regulation is not a free good. Regulation costs and there will be dis-benefits from regulation as well as benefits from regulation and one of the great issues is how you sort out the costs and benefits. But more regulation is not cost-free. As far as the concern that you have just expressed, the regulation discussion document from the Treasury makes it absolutely clear that there will be significant increased running costs for smaller institutions; for smaller building societies, credit unions and friendly societies.

Q122 Mark Garnier: That is going to be anti-competitive, though, isn't it?
Mr Coles: It is. It conflicts with the commitment towards fostering diversity and promoting mutuals that is part of the Coalition agreement, for example. It will make it more difficult for institutions if they have to read consultation papers and understand those papers and act on those papers from the FPC, from the PRA and the CPMA. We can envisage a situation in which there will be three regulators plus Europe all issuing consultation papers on the mortgage market, for example. This will not be an easy system to navigate through for many firms.

Q123 Mark Garnier: It is not. In a funny sort of way, we are getting back to Andrea's point which is that we are going to end up with one socking great bank that can afford to do all this sort of stuff and the small competitors are going to be pushed out.
Mr Coles: We are moving heavily and rapidly towards that situation.

Q124 Mark Garnier: I think we need to avoid it. One last point is you have the Government view that prudential regulation is more important than consumer protection. When the regulators are in conflict do you agree that the PRA's word is final?
Ms Knight: Well, somebody's has to be final, frankly.

Q125 Mark Garnier: But you agree that it should be the PRA?
Ms Knight: Somebody's has to be final; so the PRA, fine. It has to be somewhere. What you cannot have is a system where there is no ability to come to finality because then all you end up with is something that is going backwards and forwards between the two. And the way that this document is written and the proposals in front of it undoubtedly give a hierarchical approach of which the PRA, in the scheme of things, is that final arbiter. If you are a large institution, a predominantly prudential institution, I suspect that is the right way to go. The smaller ones—I agree with Adrian on this—are quite significantly affected by the current environment, let alone a new environment that is ratcheting up costs and so limiting their ability to be able to perform without themselves getting larger in some way. If you are a smaller institution I am not quite sure how that will be received, seeing as you could be quite distant from that decision because you are much farther down in terms of size, in terms of who you interact with and so in terms of the final decision-making process.
Mr Coles: This whole document is written on the basis of promoting financial stability. If that is the number one outcome that we want, then the PRA must be more important than the CPMA.

Q126 Chair: Before we move off this area, Mr Coles, you talked about the risk of increased cost of regulation. Have you, on behalf of your members or with your members, tried to establish what the full compliance cost is for your members? That is not only the cost of running their compliance departments, but the cost of staff time taken up elsewhere in their organisations as a consequence of the existing level of regulation so that that can be broken down in a form and explained as a cost to the customer.
Mr Coles: We have tried to do that but we have not come out with a satisfactory answer. It is very difficult to go through a whole range of different organisations and assess how much managerial time is devoted to compliance, how much board time is devoted to thinking up new products and so on. But I would say we are—

Q127 Chair: I understand that. But don't you think it would be a good idea to have another go, bearing in mind that so much of this is up for grabs?
Mr Coles: I was going to go on to say that we are having another go. We have a questionnaire out with our members at the moment covering precisely this at board level, "What are directors of organisations thinking about most now? Do they devote their time to the prudential side of the business, to the customer side of the business, to the compliance assessment side of the business?" We will report back to you on those findings. It goes to the heart of your point.

Q128 Chair: Thank you. Peter Beales, you have been sitting very quietly listening to quite a wide range of exchanges. I just wondered if there was anything you wanted to add at this point before I bring in Michael Fallon?
Mr Beales: Yes, two points please, Mr Chairman. In relation to the question about how one assesses how costs will fall, there is an important issue that I think all the trade associations have been exploring, which is the degree to which services can be shared and provided in a common place by the different regulatory bodies, which should help to reduce duplication and so on. I think we are all going to press

for that kind of arrangement to be introduced in our responses to the Treasury. The outcome of that discussion will be helpful in determining the cost result.

The other point I was going to make, which goes back to the earlier question about the relationship between the PRA and the CPMA, is that clearly creating two new organisations gives rise to a series of issues about how they will relate together, who will take priority and so on. We have been thinking about whether, in some sense, that relationship could be formalised through a principle under which each regulator is bound to recognise the terms of reference and decisions of the other one, provided that they do not conflict with their own terms of reference. You would then have to deal with a precise case when there was indeed a conflict. But, day to day, we think that kind of principle—we are still considering the implications of it—should help to ensure that the two organisations proceed in a sort of dovetailed manner.

Chair: Michael Fallon?

Q129 Michael Fallon: Mr Coles, Lord Turner has suggested that the new Financial Policy Committee may have to have quite detailed extensive powers capping maximum loan-to-value ratios and regulating different types of lending in different ways. Do you think those powers should be as extensive as that?

Mr Coles: I think there are concerns about that. I think there are major differances about the causes of house price inflation. Is it a result of irrational exuberance in the housing market, is it a result of cyclical economic growth in real personal disposable incomes or it is it just facilitated by the lending that takes place? Or were the banks and building societies forcing loans into the market and themselves creating the house price inflation that I think has been pretty disastrous for the UK economy?

If we did go in the system of controlling loan-to-value ratios and loan-to-income ratios, I think there is an assumption there that there are no other sources of finance. I think what is likely to happen if we have loan-to-value ratio limits is that some families and individual purchasers will find alternative sources of finance: by not repaying their credit card, or by getting loans from parents and relatives. I think we'll have a big debate on the nature of valuations between individual firms that will not make loan-to-value ratio limits particularly effective, although the message that the FPC gives may have an impact on sentiment. But I don't see detailed regulation in the housing market in that way in an open economy as providing the full answer.

Q130 Michael Fallon: Right. So you think people will simply find ways around the credit controls?

Mr Coles: I think that is likely in an open market. I think people will be able to get additional lending. Unless you control additional lending and say, "The loan that I don't repay on my credit card this month cannot be used to support my house purchase lending"—I don't see how you hypothecate lending—I don't see how this can have the watertight impact that some imagine.

Q131 Michael Fallon: That is the difficulty, is it not, to see where you draw the line with that kind of detailed powers?

Mr Coles: I think you would need to have detailed powers and, as I say, I would expect a detailed debate on the nature of valuations of property if the value became a key determinant of the amount of money you could lend into the mortgage market.

Q132 Michael Fallon: If the FPC does get into this area—it is obviously going to have quite an impact on individual firms and stock markets and so on—how do you think it should be accountable?

Mr Coles: I think one of the concerns about the FPC is the extent of its accountability. For example, would it be able to consult on a proposal to introduce a 70% loan-to-value ratio limit? As soon as it consults, that will have a huge impact on the market. Yet it would need to consult and fully understand the nature of valuation, the nature of loans that have been given and the extent to which other loans can be hypothecated from the unsecured market into house purchase. There is a real conundrum there that I don't see my way through to an answer at the moment.

Q133 Michael Fallon: All right. Do you also see anything of a conundrum in the relationship between the FPC and the MPC? Do you see any potential conflict there arising as to the movement of rates and the control of credit?

Mr Coles: There could easily be a conflict if the wider economy needs much lower rates of interest and yet it is determined that the housing market needs slowing down. I think one of the reasons for the somewhat surprising recovery of the housing market in the past year, although it is slowing down again now, is very low levels of interest rates. What messages are being given to the housing market if simultaneously we have very low rates of interest and yet limits on mortgage lending?

Q134 Michael Fallon: So who should reconcile a difference of view like that?

Mr Coles: The Governor of the Bank of England, of course, is going to have a very packed agenda under the new proposals. He is going to be Chairman of the MPC, the FPC and the PRA. So presumably it is his job to reconcile the different interests in this whole debate.

Michael Fallon: Thank you.

Chair: George Mudie?

Q135 Mr George Mudie: Angela, I do understand your concern at the start of the meeting, but in this House we have now introduced topical questions at question time where we can ask Ministers anything that is topical and not have to put it on the agenda. I think it would be impossible for the Treasury Committee to be the voice of the bankers and not raise the topical question of bonuses. But I understand your surprise, because I have come back to this Committee and when we are dealing with financial regulation I have felt constrained just asking questions about the architecture. I think that is a minor part of financial regulation because, as you say in your evidence, every

country had a different architecture but they all had the problem.

But I congratulate you on your evidence and congratulate whoever wrote it. I think you have raised issues that are very, very important. One that is important to politicians is the deficiency in democratic accountability. I think you put a very powerful case. You are making the point that the input from the Treasury is that, once every six months, it will have a meeting with the Governor to discuss this. you make other points in terms of the FPC. Would you like to just put them on record?

Ms Knight: Yes, I would indeed, thank you. In effect, two of the major economic levers of power will be passed to the Bank of England. One is monetary policy, which has been there for some time. I think we would all recognise that it has done well, though of course it has not had to address monetary policy in times of high inflation. Now it is proposed to pass the macro-prudential economic tool to the Bank of England, which will then allow it, in some form and however imperfectly—Adrian has explained what would be some of the issues around loan-to-value exercise constraints on lending, on the availability of credit and so on.

That, therefore, raises the question of what should its accountability be because you, as Members of Parliament, could potentially find yourselves very easily in a situation where you have constituents coming in to see you saying they can't get their mortgage or they can't get the loan to buy a car because the Bank of England has made a decision, via the Financial Policy Committee. Considering this stability means that either the cost of borrowing has to go up or it is simply not going to be available. So that brings it, I think, into the heart of the democratic process. That is socio-economic decisions being made by the Financial Policy Committee.

As such, we think, at the very least, there needs to be more representation on that Committee from the Treasury in some form; at the moment, it only has one representative and does not have voting rights. It seems that there needs to be a little bit more, I think, than appearing before the Committee on a periodic basis and producing a report on a periodic basis, however important that might be. Maybe when you get to a point at which—or you are approaching a point at which—the FPC is going to make a decision that has an economic effect it has, at that point, to be in consultation with the Chancellor of the Exchequer. And also perhaps, before these powers are passed across, you need, as parliamentarians, to be sure what you are handing across, the circumstances in which the powers can be used and the sort of pre-consultation that is required before they can be used and who ultimately has the say so.

Q136 Mr George Mudie: I notice your unhappiness, or the paper's unhappiness, with the secondary objectives and the relationship in terms of accountability. When we have discussed the inflation target, there has been the argument as to whether the inflation target alone is acceptable or whether we should, as the United States does, put employment in?

Ms Knight: Yes.

Mr George Mudie: You have put in the need to maintain economic growth as well as stability or stability with the need to maintain economic growth.

Ms Knight: We have indeed. At the moment financial stability looks like the great God; it is the thing that we all want. Time will pass and we'll come to a point where financial stability is not the thing that is in front of our eyes. One can very well envisage a circumstance where a decision is subsequently taken on financial stability grounds alone that can then have a significant damper on the economy or can result in a sector becoming not competitive on an international scene. For those reasons, we believe that some of these criteria needed to be included more fully in the sorts of issues which have to considered. We are not keen on this list called "have regards". I can have regard for what you are saying and then completely ignore it and vice versa.

Mr George Mudie: It would be the first time.

Ms Knight: So "have regard" is not quite enough. We don't live in just an isolated country and these committees will not be operating as solely dependent upon what happens here in the UK. We will be operating very strongly in conjunction with the European authorities, given the very much increasing powers that they have, both in terms of rules in banking but also in co-ordination and oversight. For example, some of the powers that have been given to the European supervisory authorities require them to take account of the impact of their activities on competition, innovation, global competitiveness, financial inclusion and the strategy for jobs and growth. So the European authorities are given a much broader set of criteria under which to give their consideration than is proposed within this consultation document. That doesn't mean I think everything is wrong but I do think that it looks a little bit too narrow and, whilst that might be the right thing now, in two, three or four years we may well regret it.

Q137 Mr George Mudie: Maybe I am pushing it too far and you will disagree with me, but do you think we are in danger of giving too much power—like in other countries, it is becoming the conventional wisdom—to central banks, particularly as that will eventually affect day-to-day issues such as unemployment, employment, mortgages and so on?

Ms Knight: I think we are at risk of that because, irrespective of what the regulatory structure may be and irrespective of how independent our new authorities may be, if people are having a problem and you, as an MP, say to them, "It is not me. It is that thing over there to which we gave the power", they will say, "I don't care, you must take responsibility". So there is absolutely a need for independence but there is also a need to be careful about exactly what you mean by independence and about the criteria under which you want that independence exercised. I am always slightly concerned about comparing with other countries because when we do something here in the UK, we do tend to do it properly. We tend to do what we say we are going to do and I don't feel that sometimes the separation between central banks and governments is quite as pure in some other countries as maybe it says so on the piece of paper.

Mr Coles: Could I come in to back Angela's point? If we look at the question of mortgage controls—irrespective of the views of the Department for Communities and Local Government, irrespective of the views that we have as a society on whether owner occupation should be growing, irrespective of the views of the development of housing policy—if the Bank of England thinks that, for financial stability reasons, we should restrict mortgage lending, there is a danger that that becomes the overarching objective; whereas there are a wide range of other societal, governmental and MP interests in these decisions that may not get recognised under this new regime.

Q138 Chair: I just wanted to ask Angela, once taxpayers' money is at risk in decisions that have been taken by the FPC, does she think there is a case for the Chancellor taking over the chairmanship formally of the FPC for the duration of the crisis?
Ms Knight: I think there might be. One of the things that worry us in the proposals as they stand is that, of course, the Bank of England is the resolution authority; it will lead responsibility of crisis management and could put a bank into resolution without having reference to the Chancellor. Now that seems to us to be not quite right. There has to be that involvement earlier and, as you rightly point out, if taxpayers' money is involved, then it should be the taxpayers' representative who takes charge. That means the elected representative, the Chancellor of the Exchequer.
Chair: John Mann?

Q139 John Mann: Thank you, Chairman. I just wanted to follow up, before I ask a couple of other questions, on Mr Mudie's question on democratic deficit. You know this Committee well and you will be aware that this Committee is now elected rather than appointed for the period of this Parliament, which may not have dawned on everybody beyond the Committee. Do you think there is a case for—I am not suggesting any specifics—looking at the role and remit of this Committee and how it operates and at whether there is a wider role for this Committee in bridging some of the potential democratic deficit?
Ms Knight: I think there has to be, yes. The Committee has extended its powers quite significantly over the year, and it is clear that there is some more that can be done by this Committee in bridging that deficit. At the same time, you may also want to look at some of the wider governance procedures within the operation because, as has been said, the Governor is chairing the Monetary Policy Committee, the Financial Policy Committee and the Prudential Regulatory Authority. Within the Bank of England sits the Resolution Authority on crisis management for payments. How does, for example, the Court of the Bank of England fit in all this? What are the roles and responsibility of that organisation? How do you seek to address some of the points and bring to bear the democratic questions? They do require some serious thinking through.

Q140 John Mann: Thank you. I do think a rather important issue has arisen that we will need to come back to in some early or later stage in some depth. If I may, Mr Beales, I would like to ask you a couple of questions in relation to the over-the-counter market. Where will or where should regulation of the over-the-counter markets be in the new regulation framework?
Mr Beales: I think one needs to draw a distinction between prudential regulation and conduct of business here. A bank's over-the-counter business, to the extent that it gives rise to prudential risk, will be rightly reviewed by the PRA. When it comes to market conduct and the question of whether a firm is abusing its position in the market, for example, that will be a CPMA matter, which gives rise to questions about where market regulation more generally should take place. There is an argument that perhaps putting market regulation and consumer regulation in the same place is not the optimum outcome. Our members haven't reached that conclusion. They think the proposals that the Treasury have brought forward can be made to work, but there is a point about ensuring that market regulation is strong and that the CPMA is structured so as to ensure that good market regulation isn't undermined.

Q141 John Mann: Do you think that the CPMA and PRA have enough powers to effectively regulate over-the-counter markets?
Mr Beales: Yes.

Q142 John Mann: It would be helpful, just as a fact of information, to know what kind of profits UK banks are making from this sector at the moment.
Mr Beales: I can't provide the detail on that question, I'm afraid. We can perhaps write to you separately about it.

Q143 John Mann: That would be useful. Some people are suggesting, not many, that clearing houses are not the right place for over-the-counter trade to be taking place. I don't want to go into the issue of whether that is an appropriate view or not. But if that was felt to be an appropriate view, where should any initiative for change come from? Should it be from the Bank of England? Should it be from one of the regulators? Should it be from government? Who should lead in that?
Mr Beales: I think the regulatory background is that certain products are sufficiently commoditised to be appropriately cleared through a clearing house. The more tailored they become, the less that is the case. And the general view is that if there are commoditised products of that sort, central clearing reduces counterparty risk and, therefore, should be encouraged and I think there is consensus about that.

Q144 John Mann: There isn't a total consensus and I'm asking a theoretical question. What I'm interested in is not what should be the solution but, if there was a change, who should initiate it? It seems to me that that is an important issue. If it was felt that a change should come, should that be initiated by one of the regulators? Should it be the Bank of England? Should it be the Government? Dame Angela, do you have a view?

Ms Knight: I'm not a Dame.
John Mann: Sorry. You are now.
Ms Knight: There is one computer that has me as a Dame but I'm not a Dame. I haven't taken part in a pantomime yet. It sometimes feels like it.
Anyway, I think the question of OTC derivatives and central clearing is a very important one. The first thing about over-the-counter derivatives is that they are very important for some of the end users. Oil companies, for example, use them for the purposes of bringing stability to knowledge of what their raw material is going to be; exporters, too. Over-the-counter derivatives sometimes get put into a demon spot and yet, for any importing/exporting industry, they are of vital importance.
The shift to simplification of derivatives and to the use of central counterparties means that you are centralising risk in certain areas. There is a view across the EU that there needs to be a pan-EU regulatory oversight in these areas and that they will consider some more detail of how these central counterparties are regulated. There is a point to that in the sense that you don't necessarily have one in each country, and worldwide just use a few. The more we move to a greater degree of harmony in the way in which derivatives are treated, the more we end up with just a few CCPs around the world.
At the moment, it looks to us as if we're diverging from some common thinking, common oversight and common rules for this area. Thus we have a European structure for CCPs. There's a US structure for CCPs and a Far East structure for CCPs. As to where it should go next, we need to settle that a bit; interact the CCPs together, but consider very carefully that, while these are risk mitigators, they cause centralisation of risk in a few fairly intensive places. So, I hope that helps a bit anyway.
Chair: John Cryer?

Q145 John Cryer: Thanks. Going back to the questions of accountability that have been asked before, there's been a fashion for years now for Central Government to divest themselves of decisions and to put them into quangos. One of the first things we did after 1997 was operational independence for the Bank of England. Personally, by the way, I was opposed to it. I don't remember, during the 1997 campaign, campaigning for Eddie George at all but it's turned out that that's what I was doing. On top of that, there is the EU; an awful lot of our regulations come from the EU now. My view is that there should be more responsibility in Whitehall and in Westminster so that people can be held to account in the Chamber. Do you think that's an understandable argument?
Ms Knight: Yes, I think it is and I think I made some of that clear when I was answering the questions earlier, particularly from George Mudie, on this point. On the one hand, there is a need to have some functions that are separate from Government so that they are seen to be completely independent from political interference, but there comes a point where people expect Government to have control. So if we start to work out how that operates in this area—the day-to-day operation of regulation, rules and supervision—it is clearly a function that has to be outside Government. But if it comes to a point where an action is taken that is going to have a very real and present effect on your constituents, that's the point at which the constituents expect you, the MP, to be able to help and to get answers from somebody else who is elected; a Chancellor or whoever it may be. That is why I think that how you work through the democratic involvement in the new arrangements, given the sorts of powers and sorts of actions they can take, is very important indeed.
Mr Coles: May I offer a supplementary answer to that? I agree with the basis of the question and what Angela is saying. As a result of what's happened over the last two or three years, we're building a more concentrated regulatory system with a greater amount of power in fewer hands and, at the same time, building a more concentrated banking system with greater market share among fewer institutions. So you need fewer people to get it wrong now for a disaster to occur.

Q146 John Cryer: That's an argument for much closer regulation, effectively?
Mr Coles: It's a question of how you diversify that regulation. Should it be concentrated in the Bank of England where, as I've already said, one person will be chair and they'll have a wide range of committees influencing this? And if that person gets it wrong, and at the same time the two or three people who control Lloyds Banking Group, Royal Bank of Scotland and HSBC, get it wrong, there is less stability in financial services and in regulatory structures. That could be dangerous.

Q147 John Cryer: If you divorce decision-making from accountability, you can get to absurd situations. For instance, I remember when Northern Rock was nationalised, the EU rules that applied meant that the Chancellor had to find a way of making Northern Rock less competitive by stripping out some of its functions at the same time as trying to make it a going concern. Now, the idea that you can balance those two is well near impossible. Now, don't you think that is indicative of a process within the EU that is completely divorced from accountability? There is no way we can hold the people in the Commission to account, or only with great difficulty, and so you get these odd directives and regulations flying out of Brussels that are completely unrelated to reality.
Ms Knight: We can't do anything about how Brussels operates but one of the aspects that we've put in our submission to this proposed regulatory structure document is that each of the new authorities has to have a very strong European focus. It has to have its department that is out there and at the table, whether it is on directives or whether it is on the rules and regulations that are coming from the European authorities. You will have to decide yourselves what is your relationship with the EU arrangements but certainly these new regulatory structures, in whatever form they ultimately pan out, must have a very close involvement with Europe as that means that you can at least get some influence in, rather than just finding

that there's an adverse consequence at a point at which you're trying to sort something out locally.

Q148 John Cryer: Just one final question; I represent some of the most deprived wards in East London and I've got people, lots of people, who are on the minimum wage, maybe with two jobs. In the near future it's going to be confirmed what sort of bonuses we're looking at and it's going to be in the billions. Now, many of the people I represent will be thinking, "Well, these are the people, the bankers, who caused the crisis in the first place, to an extent, because of their risky behaviour. Now I seem to be paying the price, whereas they're getting away scot free". Do you think that's an understandable point of view?
Ms Knight: Yes, I do.
John Cryer: Good.

Q149 Chair: Do you have anything you want to add on the European angle of what you've just heard, Mr Beales?
Mr Beales: Yes. I think the relationship between the authorities that we're establishing and the new European bodies which have yet to be established is clearly going to be crucial. Much of the rule book will be written in Brussels rather than in London. I think that leads one to consider the scope of the authorities because what one wants to achieve, if one can, is a good match between the UK entities and their opposite numbers in Brussels. On the PRA front, it looks relatively plain sailing; the European Banking Authority is the natural interlocutor. For the FPC, we have the European Systemic Risk Board. I think there are questions, though, about the CPMA. In particular, if we alter the scope of its market work we may find that part of the market activity that FSA currently conducts won't be mirrored properly within CPMA and, therefore, won't be reflected in CPMA's work in Brussels.
Chair: We'll come back to this later on this morning. John Thurso?

Q150 John Thurso: Can I just follow up on that point with you, Mr Beales? One of the possible failings of the past has been a certain lack of engagement by Ministers in the early stages of directives and other matters, such that by the time we get involved the thing has been broadly formed and it's much more difficult to put a point of view of British interests across. It's not implicit in your answer. The problem posed by the Chairman was that Ministers are going to have to get involved much earlier and, therefore, are going to have to be much more engaged in this process.
Mr Beales: Yes, I think that is probably right. There have been cases, of course, where the opposite has happened and where early UK engagement has helped to shape a measure and the outcome has been a good one. But we will have to judge, case by case, the degree to which intervention at the official level or at the political level is appropriate but we'll need to be much more attuned to the risk that you mention.
John Thurso: Thank you. Angela, can I—sorry.
Ms Knight: I wonder if I could just add a bit to that because I think there is a multiple engagement which sometimes we manage quite well in the UK and sometimes we don't. There is engagement in terms of getting in early before a directive has got to a directive stage. Sometimes we manage that and sometimes we're caught flat. Sometimes we've sent senior people early enough and sometimes we haven't. So that engagement has to be very clearly thought through at that level. The second is that the new European authorities, just like the existing ones, take secondees from different countries. Do we manage to make sure that there are enough UK secondees in one form or another or enough UK employed in there? I don't think we've taken that as seriously as we should do as a country because the financial market, whether one criticises it or not, is very large here in this country. Therefore, the sort of breadth of business it undertakes is equally large. It is very important for us, therefore, that as proposals are created, they don't have the effect of impacting here in a way that they don't elsewhere. So that sort of engagement, by getting people within the authorities who understand this market, is vital and I would like to see it reinforced.

Q151 John Thurso: I know one of my colleagues has some questions around European regulation. That wasn't what I really wanted to ask about.
Ms Knight: Sorry.
John Thurso: What I'd like to ask you about is the whole role of the CPMA. In your submission you said that you were concerned about the CPMA being described as a consumer champion and put the "champion" in inverted commas. Why would bankers be so scared of having a consumer champion, or worried about it?
Ms Knight: We're not scared of having a consumer champion. We think there should be a strong consumer champion; there's no doubt about that. We think a regulator should be a regulator and a consumer champion should be a consumer champion. The regulator is there to produce rules and requirements. Let's say on the consumer side to ensure that the rules are right for consumers; open, transparent and understandable. They get redress when redress is due if something has gone wrong. That's the role of a regulator. We think a consumer champion is an entity that is separate from a regulator and takes on the consumer issues and really brings them to the forefront, whether it is with a regulator, governments, industry or whatever. We don't run away from there being a consumer champion. We think that it is confusing if you put it in with a regulator.

Q152 John Thurso: In a speech, Lord Turner accepted that one of the areas not of failure but perhaps of weakness in the FSA was its role in looking after the consumer. In particular, he said that the assumption that you put out the information and the informed consumer makes a wise choice didn't work.
Ms Knight: I agree.
John Thurso: You've probably heard the speech. On the other hand, in your evidence you say precisely the opposite, which is that all they have to do is make

sure the information is out there and they can make the informed choices. If you accept Lord Turner's position that the market is far too complicated for that or that the deck is entirely stacked in favour of financial services—in particular banks who can stick up overdraft rates when they want to and can do whatever they like—why shouldn't there be a champion with teeth who can take them on and stop them doing that?

Ms Knight: I take your points; they are very well made. The fact that we may have just given a brief answer in our response in no way detracts or tries to remove us from believing that the consumer not only needs information, but needs a lot of assistance. On the whole area of understanding financial products and financial services, people aren't there; there's a long way to go. Nor would we seek a situation, as you describe, where the industry can do what the industry likes. Industry is not in that place.

There are a few things underneath all this. We agree that what is required in the retail place is a set of rules. Yes, the rulebooks are big but so are the gaps and I don't think that that has served the consumer well. There needs to be much better rulemaking as well. There needs to be much greater openness and transparency from the industry itself. There needs to be good regulation and good supervision by the regulator and there also needs to be consumer assistance and help. I appreciate that there is another authority there too but there is also a lot of consumer assistance and help around anyway, which is important and vital. If there needs to be a consumer champion. We say that the consumer champion should not be within the regulator. If we have used summary language that doesn't properly explain what we mean, I apologise for that.

Q153 John Thurso: Let me get this straight; maybe I've misunderstood the architect, because it's quite a difficult piece of architecture.

Ms Knight: Yes, I know.

John Thurso: I had understood it that, broadly speaking, you have financial stability, the great macro that is with the bank and the committee. You have the PRA, which regulates the conduct of firms in the market. You have the CPMA, which basically regulates individual products and looks after consumers. You obviously feel that the CPMA is not primarily doing that. Have I misunderstood?

Ms Knight: No, that's fine. I was talking about the consumer champion. We have some consumer champions right now. We have a group called Consumer Focus. The Citizens Advice Bureau is another one. Which? is a third.

Q154 John Thurso: They're all lovely people and work very hard and do a great job and are completely toothless. What we want is not somebody who will advocate well, but somebody who can tell you what to do.

Ms Knight: You want a regulator that regulates well. You want a regulator that regulates in the consumer area properly with teeth. I have no problem with that.

Mr Coles: There is no problem, I think, in the CPMA introducing a set of regulations that might well favour consumers, but in the application of those regulations the CPMA should be disinterested in the outcome. It should look at the regulations and assess whether or not firms are complying with them. It should not be the consumer champion in applying its regulatory and supervisory tools. It should be equally and distant between the firms and the consumers in assessing whether or not firms are applying those rules appropriately. I think that's where the concern is about the nature of the consumer champion; is it always going to take the consumer side if it is forced to take a view between the application of the rules and the use of the rules by the firms? I think if it does do that then firms will find the CPMA very difficult to trust or to build a relationship with. We might well get a less than optimal relationship between firms and the CPMA if it is always seen to be taking the consumer side and never understanding the firm's argument.

Ms Knight: The critical point is it has to get its rules right and I think that in that area we have all had concerns in the past with existing arrangements.

John Thurso: I think that is probably as far as we can go today but it is an interesting point to take on. Thank you.

Chair: Yes. We need some hard numbers from the industry—all these industries—on what the consumer is paying. Stewart Hosie?

Q155 Stewart Hosie: Going back to Europe for a little while, in the BBA evidence it said it was the case that the FPC will, in some instances, need to take its lead from various European global bodies: the Systemic Risk Board, the Financial Stability Board or the Basel Committee. Peter, your organisation's evidence was very similar. It said, "The structure and relationships between the proposed authorities must take into account fully"—the emphasis was yours—"the new EU supervisory structure". Now, it is due to be effective from next year. So what are the risks, the impacts, the dangers from next year to the UK financial sector?

Ms Knight: Well, hopefully none. But what we're saying in our evidence is that the European Systemic Risk Board, for example, has responsibilities in which it will be looking at systemic risks that are being created either in Europe or that can impact on Europe, or systemic risks that relate particularly to one country or some countries in Europe. So, what it considers as being the systemic issues, which may be general or may be specifically targeted at one or some countries, are ones that we would have to take into account here. The same relates, of course, to the Financial Stability Board, which has a broader and more global reach but, nevertheless, will certainly have some commentary that, when we have a Financial Policy Committee, it would be difficult—indeed, probably very inadvisable—for it to ignore. That is the point we're making and I think it is reflective of many points in other areas within our responses; there is a lot happening in different forums, both regional and international. We're part of it here in the UK and decisions that we take here are not necessarily isolated here and decisions that are taken elsewhere can impact on us here.

Q156 Stewart Hosie: I'll come back to that specific point at the end but I want to get through some of this general stuff first. It's quite important. Do you think that the balance between power and influence between the EU and the UK authorities is right at the moment?
Ms Knight: I think that at the moment it is probably not too bad. It is in looking ahead that the question marks start to arise.

Q157 Stewart Hosie: In terms of looking ahead to the immediate future, what should the tripartite authorities be doing now in this transition period?
Ms Knight: In this transition period, they should be focusing very clearly and very carefully on and be debating what should be the powers of, for example, the European Banking Authority for taking action over the regulation or other issues of a bank operating in this country. These are areas that were, as you know, hotly disputed as they went through their European processes. There were, and remain, different views in Europe as to whether the European Banking Authority—or the other European authorities should in effect be able to override local decisions and, if so, at what point they should override. There needs to be some very significant clarity on the rules that the European Banking Authority will be writing, as it is charged with the responsibility of bringing about a harmonised rulebook for Europe. Most countries of Europe do not have international banks before we even start. Secondly, who carries the ultimate responsibility for a country? The answer is the Government of the country.

Q158 Stewart Hosie: Please feel free to just come in at any time. Given that you've just said that the countries are different—some have headquarters of international banks, others don't—how serious is the misalignment? Is the misalignment between the UK and EU regulatory structures, given the different starting points?
Ms Knight: Well, in the regulatory structure the real concern that we all have is with the markets authority. If the markets authority was split such that primary market regulation no longer sat with the conduct of business part, which is what moving the listing authority out means, we would not have a regulatory shape that is the same as, in this instance, ESMA, which is the new European supervisor in that area. Undoubtedly, our voice would be very weak or certainly much weaker than it should be. UK markets are some of the deepest and most liquid in the world, they're some of the biggest in the world, and so we would put ourselves at higher risk of having changes to that market done in ways which may not be in keeping where the UK voice was either split or weak. That is perhaps one of the highest concerns that all of us have.

Q159 Stewart Hosie: That's interesting and I'm sure we'll take that further. I have one final question, which goes back to the point you made about the Financial Stability Board. You said its commentary couldn't be ignored and I think that's absolutely right. How do you judge the risk between a counter-cyclical economic policy in Europe and a pro-cyclical one here or vice versa, or any sort of contradiction between monetary policy in this country and what might come out as a commentary from the Financial Stability Board?
Ms Knight: Well, it's even broader than that because whatever decisions are taken in Europe, the USA or China will certainly have some effect here because of our financial centre. So one then starts to think through what changes these may be and, indeed, what could one do about it. Let us take a step back to the point in 2007 when there was a lot of concern being raised at the US subprime and the way that components containing US subprime had been sold around the world. US subprime was a stability issue for much more than just the US. It was a stability issue for here; it was a stability issue for Europe. So what could the European Systemic Risk Board, or indeed our Financial Stability Committee, have done if we had had both of those? They could have raised a concern, yes. They could have said to the US, "Well, you should regulate your mortgage market better; you should perhaps not have non-recourse mortgages but you should have recourse mortgages". Would it have made any difference? Probably not. So there is a limited capacity as to what any of these bodies are going to be able to do. What they can do is flag early where the problems arise.
There can also be some differences, as you rightly point out, that you could have a situation in which a European Systemic Risk Board said that they believe an economy in some countries was inflating too fast and they could point at the UK. They could indeed point at some other countries and say, "You are letting your citizens borrow in an overseas currency and that is dangerous as well". We would have to take cognisance of that. The degree at which it will have an effect, whether people will stop doing that and whether changes will be made will depend upon, first, what sort of authority these relevant bodies gain once they have their powers and they start to opine and, secondly, what actions governments take as well. I see that this could be quite awkward.

Q160 Chair: It doesn't sound as if you are keen for them to have much power.
Ms Knight: No, I think you have to have these things but the concern that I have is everybody comes along and says, "It will be a very good idea if we have these things". Yes, it is a good idea but then they do not necessarily think things through to conclusions. In this country we tend to do that but the case in Europe is often to say, "We have the impetus now. We can get the votes to get it and then, having got it, we will then decide what it should be doing and how it should perform". We have a little bit of that happening at the moment.

Q161 Chair: Yes, and we have an industry that has two-thirds of the EU's global financial market and we have only 8% of the votes.
Ms Knight: I know, absolutely right.
Chair: That strikes me as an imbalance.
Ms Knight: In some of the markets, the activities are almost not replicated in any other country. So we have

a much larger proportion of that market and still have only one vote in 26.

Q162 Chair: Before I bring in Andy Love, is there anything you want to add, Mr Beales? I keep on asking you whether there is anything you want to add on these European questions since you are—

Mr Beales: I think all I would add, building on the point that Angela has just made, is that one of the difficulties that the Government have is that they are defending an extremely large industry but only have so many votes. This relates to the point that was raised earlier on about our effectiveness in Brussels. When you are trying to defend so much, but with so few votes, there are going to be some debates that you lose. What we need to ensure is that we only lose the ones that we can afford to lose.

Chair: I think that sounds like a very important statement of the obvious. Andy Love?

Q163 Mr Andrew Love: I want to take you back, inevitably, to democratic accountability. Concerns were being expressed that we needed to take some care over macro-prudential regulatory independence. Of course, picking up on Mr Cryer's comment earlier, the classic argument used in 1997 about independence for the Bank of England was that it was the very short-term political interference that led to long-term economic underperformance. I wonder, in relation to macro-prudential regulation, how you would respond to the argument that we need to do this and that it will be difficult, but it will be in our longer term economic interest? I shall hear from Ms Knight and then Mr Coles.

Ms Knight: Yes, and the answer is one of balance. You need to get your balances right. If you have political involvement on every decision every time, then there is always a belief, rightly or wrongly, that that decision will have been taken not necessarily for the true economic reasons. In the case of the Financial Policy Committee and its powers, if the decision was taken by politicians, it would not be truly on financial stability grounds. At the moment, of course, that has been enhanced by looking at who and where had very big property booms, even bigger than ours, and what actions could their governments have taken. The answer was the governments could have taken some actions but that it was deemed to be politically impossible to do them. You can always tax a boom in some form or another.

So, therefore, to say we need to get some greater degree of independence and some greater degree of authoritative action in some of these areas is right and proper. What we are saying is that there is also something about keeping that link to the democratic process, which is important. Ultimately it is Parliament that carries the responsibility and the Government of the day that will carry the can. We don't think the arrangements that are currently within the document do bring a sufficient involvement of the democratic process. We don't think that one non-voting member, for example, on the FPC from the Treasury is quite right. We don't think that having some independent non-executive directors on the new Prudential Regulation Authority, who then have to detach themselves and not have any voting rights when it comes to making decisions, is perhaps quite right. We don't think that just two reports a year is quite right of the FPC. There needs to be more there. That is why we said, "Have it as an independent body, get more Treasury involvement in some form or another." We need an arrangement so that in socio-economic decisions we cannot be taken by the FPC in isolation. We should think about what the relationship is here in response to questioning, and about what the relationship is of the Treasury Select Committee in this process, rather more deeply because that could provide a greater and better bridge; so there remains that independence, but you also have that ability to have the involvement that, when a problem arises, you will be expected to have.

Mr Beales: May I add one point? We think that the terms of reference of the organisations, if properly drafted, should help to establish accountability because there will be something to assess their conduct by. In addition to that, it may be that the authorities should provide some kind of account in advance of how they plan to utilise their powers. In thinking of the latter, we had in mind how, under the special resolution regime, the authorities have to produce a code explaining their approach to their powers and the kind of circumstances in which they will be used. This material is not necessarily binding but it would help Parliament, and indeed this Committee in particular, to assess much more closely the degree to which the authorities were performing in the way that they had been intended.

Ms Knight: You could, for example, have a series of risks—sorry, I have jumped in. Carry on.

Mr Beales: Go on.

Ms Knight: You could, for example, develop the sort of risks that that the Financial Policy Committee should look at and report on. You could consider the sort of tools—

Mr Andrew Love: I am going to come back to that. Let me just get Mr Coles's initial comments.

Ms Knight: Of course.

Mr Coles: As ever it is a question of balance and I just repeat the point I made to John Cryer; we are building a hugely concentrated regulatory system with very great powers in the hands of one individual and one institution.

Q164 Mr Andrew Love: The way that they resolved this issue in terms of the Monetary Policy Committee—I would accept that it is not equivalent and therefore we can only look and see what we have done in the past and how successful that has been—was to give it operational independence but to set a target with a reporting regime should it miss the target by more than a certain amount. Is there a structure similar to that that we could introduce that would take on board some of the concerns that are being expressed around this table? Mr Coles?

Mr Coles: The great advantage of the Monetary Policy Committee is that it has a measurable objective: 2% inflation. How do we measure financial stability? How do we measure the success of the PRA? Is it one collapsed institution a year is okay but five, the Governor of the Bank has to write a letter

to the Chancellor of the Exchequer? It is much more difficult to give you, using the management acronym, SMART objectives for the new structures that are now being introduced compared to the MPC. Again, I don't think I have an answer to it.
Chair: That is why we would like some numbers on the cost base.
Mr Coles: Yes.
Chair: Sorry, Andrew.

Q165 Mr Andrew Love: Ms Knight, do you want to add to that?
Ms Knight: No, it is just exactly that. There have to be some series of risks that it will need to address and some means of measuring what is happening in the economy, but it is not going to be simple and straightforward. That is what makes this different from the Monetary Policy Committee.

Q166 Mr Andrew Love: Let me take something that you said earlier on, Mr Coles, about the need to take into account a wide range of other issues in terms of limiting the provision of mortgages. Is there a way that we can do that sensibly? I take the example, and you used it yourself, of this Government, the coalition, the previous Government and indeed all Governments that I can remember, who have always had an objective of increasing the level of owner occupation in the country, yet this could clash. Is there some way that that can be used as a way of at least moderating the consideration that the new Financial Policy Committee would have in terms of introducing restrictions on the provision of mortgages?
Mr Coles: Well, that gets to the heart of the answer I was giving to Michael Fallon, I believe. If we are only looking at financial stability and not taking into account broader objectives of society, that, I think, would be a weakness of the new system. Owner occupation is now falling in this country; it peaked as long ago as 2003. That may concern some politicians or it may be welcome to others, but the objective that we have for owner occupation should not solely be a financial stability concern. It should be a wider concern with a much wider debate among a much wider group of individuals. Also we have not had the chance to discuss yet that there should be a diversity objective in the FPC and the PRA; objectives so that we have a wide range of institutions competing to meet the demand for mortgages, whatever the controls on the supply of mortgage finance are.

Q167 Mr Andrew Love: One final question. I would respond to what you said by saying that the classic economist's argument would be that the reason why owner occupation is falling at the present time was the very bubble that we did nothing to address and that longer term sustainability of owner occupation may require the type of activity that has been suggested in the paper. It has been suggested to us that we need to beef up the role of the Treasury Select Committee in ventilating some of these issues and, of course, in monitoring them. I don't think you would find anybody around this table that would argue against that. It has been suggested that we need to make Treasury involvement in some of these actions more of a reality and perhaps strengthen the boards of some of these organisations. Are there any other mechanisms that any of you can think of that would strengthen accountability, democratic or otherwise, in order to ensure that proper consideration is given of the wider issues before any of these macro-prudential tools are used?
Mr Coles: I wonder in the light of this debate whether there should be a formal explanation of the powers of the Treasury Select Committee. My understanding is that the Treasury Select Committee works through influence; it works through its ability to address the arguments that are out there in the media, in Parliament and in the new centralised regulatory bodies that we're now building. Should there be a set of formal responsibilities of TSC built into this legislation? I am not certain that there is at the moment. Maybe I've missed that, but I do not believe there is a set of formal responsibilities.
Chair: You are correct.
Mr Coles: Perhaps this Committee should be addressing that.

Q168 Chair: We would be very interested to have any further detail from you on how that might be formulated.
Mr Andrew Love: Maybe we could recommend an increase in our powers, Chairman.
Chair: I thought you were going to mention a bonus there for a moment.
Ms Knight: If I may, Chairman, the only addition that we said was that if a macro-prudential tool is going to be used that had a significant socio-economic effect, it had to be agreed with the Treasury, with the Chancellor first. We think that is an additional safeguard.
Chair: David Rutley?

Q169 David Rutley: Absolutely no bonuses here; a bonus-free zone. I think this is the last contribution, so we are saving probably one of the most important issues to last: competition. I think it is absolutely vital to restore trust in financial services, in banking and in building societies and to get consumers really to want to put trust back into these institutions again after everything that they have been through. I just wanted to focus on the mutual sector to start with, because I think that we have been seeing a huge amount of consolidation in recent years. We're seeing it locally in Macclesfield with the demise of the Cheshire Building Society, the backroom operations are being stripped out and a lot of those local links that were so unique to the smaller building societies are going to go, probably, if they have not already gone. I wanted to know what you thought the impact of this reduction in competition, and this increased consolidation, has been for customers in the sector you operate in.
Mr Coles: It's not surprising that a number of institutions have merged over the last five years. People don't often understand the extent of the decline in mortgage lending. In the years to 2007, we had over £110 billion a year in this economy of net mortgage lending. Now, you can well argue that that's too much. Over the last couple of years, that figure has been £10 billion, not £110 billion So it's not surprising we now

have a smaller number of institutions and I don't think I would argue for a return to £110 billion worth of mortgage lending every year. So it is probably right that we have fewer institutions. There are still 50 building societies. There are probably at least 50 other providers of mortgage finance, so there is scope for the development or the redevelopment of a competitive market.
The problem is what we have done over the last three years is give inordinate market power to very large institutions with taxpayer support that had previously failed in some way, that would have gone bankrupt without that taxpayer support. We have now one institution, Lloyds Banking Group, with 25% of the mortgage market and 30% of the current account market. The markets are highly concentrated and, at the moment, although there is a wide diversity of examples within the mutual sector, it is difficult for many mutuals to compete with that very powerful competitor, which is backed by the taxpayer and has significant pricing power under political direction to lend particular amounts into the mortgage market irrespective of the commercial returns on that lending. That is not a good position. So we need to move away from one or two institutions dominating the market. My view is that the PRA and CPMA and indeed even perhaps the Financial Policy Committee should be taking a view on the extent to which their actions promote or otherwise diversity in the marketplace.
The Coalition Government have an objective of fostering diversity and promoting mutuality. The new regulatory agencies that are being created under the structure that we have been discussing should mirror that objective and should be required to report on the extent to which their actions are contributing to that objective.

Q170 David Rutley: Thank you for the contribution. I think that leads us nicely on to the BBA. In terms of consolidation and concentration, do you think that that has been in the interests of the British customer?
Ms Knight: I think that at the time we, like many other countries, followed suit in how to bring stability into a financial system. In this instance, of course, Lloyds was used to stabilise HBOS and bring about a better net effect than would have been the case otherwise. At the same time, of course, there are requirements placed upon that particular bank to divest and that is done against a timetable set up by the European Competition Authorities. RBS is already in the process, as you know, of divesting again part of its operation. In both instances this willo provide more competition in the market. I think there are two further areas though.
There is competition and there is competitiveness. Competition; are there fewer players? The answer is that there are fewer players. There are still quite a lot of players around—I don't think we should forget that—and many of them have not been particularly competitive over the years. One of the things that we have seen in the banking industry in this last two or three years is the building societies effectively almost stopping lending in the market and much more of the new mortgaging and re-mortgaging moving from the building societies and to the banks. So I agree with Adrian that we need to find a way to have a mutual sector that is more competitive. That will require some significant changes for their operations.
We also need to have a market where it is attractive for people to enter the market and the cost of getting into the market, and operating in it, is very high. There have been very few new entrants and there is an aspect of looking at that, which is a very important aspect. We need a market that is plural. It is easy to say that big is bad and I don't think that is, in any respect, either a fair analysis, nor is it one that we use in other sectors. It is common for many sectors to have a few large players and other smaller players around in some satellite form. In banking, the UK provides more in the way of choice than in many of the other major countries. Does that mean that we should not make changes? No, of course it doesn't. We need to be careful that we have a range of different types of institutions that are competitive in the market and some of that is about regulation, some of that is about existing market structure. At the same time, we are on a change process because there are divestments that are either under way or are shortly to take place.

Q171 David Rutley: There is a lot that can be done within your own organisation, notwithstanding the concentration. One of the key factors is the high switching costs for customers. There must be more that can be done within your own organisation to reduce those switching costs—to make it easier for people to move around—that will be of benefit to everybody if they are truly competitive. At the moment, I don't see that and I don't get any feedback from customers that they believe those switching costs have been reduced in any way. So what are your members doing to facilitate this? This must be of ultimate interest in your industry, too.
Ms Knight: You are entirely correct. The banks don't charge for switching, by the way. What tends to be the problem—
David Rutley: It is not the cost. I am talking about the associated hassle and bureaucracy.
Ms Knight: I know; exactly. I am coming to that. The hassle is there, although not if you have direct debits or whatever set up with entities that allow the switching to take place electronically. If you do not, you, as the individual, have the hassle of having to re-sign up. It is not the problem of the banking industry. Some of the ones who are keenest on having re-signs tend to be local authorities, or social security. There was one particularly popular commercial organisation that many people watched who, until very recently, required you to re-sign. So a lot of the hassle factor is outside the control of the industry. Now, can the industry make things more seamless? We have revisited our switching code and you are absolutely right to raise the point but until and unless you have the public sector, local authorities, social security and so on prepared to allow that change electronically, individuals who seek to switch will have to re-sign mandates.

Q172 David Rutley: This area for me is vital.
Ms Knight: I agree.

David Rutley: If there are issues that you think need to be tackled, I would have thought that you could write to us because we are very keen to—
Ms Knight: That's fine. We did bring them all to the attention of the Office of Fair Trading when it recently looked at switching because it has taken a very close look at this. There has also been some interesting surveys where people have said, "Well, I thought about switching but I decided not to do it", which don't refer to bureaucracy or difficulty at the bank. But, yes, there is a list with the OFT—which, as I say, has looked at this before—of where the glitches lie. We can do our part and I think that we have done quite a good job but there are other aspects as well.

Q173 Chair: We would be very eager to see it particularly in the context of the banking competition inquiry, to which you initially felt you didn't want to contribute. It would be very helpful if you could reconsider that decision.
Ms Knight: The Independent Banking Commission; we are contributing to it.
Chair: To our inquiry.
Ms Knight: Sorry, your inquiry, yes.
Chair: On retail banking competition; you have sent me a letter that I have in front of me—
Ms Knight: Yes, I have sent you a letter.
Chair:—saying that you are not going to contribute to it. You have just begun to touch on some of those areas and we would be very interested to hear what you have to say on it; perhaps not now, later. I would like to bring in Mr Coles.
Ms Knight: But on that letter—

Q174 David Rutley: Chairman, just one other question.
Chair: Yes, sorry. I know that Mr Coles is eager to get in.
David Rutley: Under the new proposed regulatory structure, it is not immediately clear to me who is going to be monitoring competition. Maybe you have a better view. If it is still not clear based on the proposal being put forward, who do you think would be best placed to do that? Is that a role for CPMA?
Ms Knight: Neither has competition written into their principles and we believe that competition should be there. We think it's in the interests of the consumer and so we would say that both organisations needed to have, among their principles, a competition requirement.

Q175 Chair: Do you mean objectives? Are you talking about objectives or principles? At the moment, it's listed as a "have regard" principle.
Ms Knight: As a "have regard", yes.

Q176 Chair: It does not have the status of one of the four main objectives. Do you think that now needs to be reconsidered and that it might need to be moved to the status of an objective?
Ms Knight: Yes. We think so, yes.

Q177 Chair: Is that the view of all of you?
Mr Coles: At the moment, there's a fairly uneasy relationship, in my view, between the FSA and the OFT. If the principal regulator of competition is remaining in the OFT, I think a similar discomfort between the OFT and the new regulatory structure remains and we haven't addressed that. I think it's very important that we do address the role of the OFT in financial services, both in the regulation of consumer credit—it's still a bit odd that consumer credit is outside the whole of this structure—and, more generally, in the barrier between the competition policy, as it applies to financial services, and everything else that we've been talking about. It's very jagged and, at times, imprecise and not clear who holds which responsibility. Don't forget that we're creating three new regulators here—the FPC, the PRA and the CPMA—but we've still got the OFT taking a big regulatory interest in the way financial services develops. Although we haven't mentioned it today, we still have the Financial Ombudsman Scheme that has quasi our regulatory status, which also has a big impact on the approach of firms to regulated activities.
Mr Beales: Can I just add something on that? I think one element of the current legislative framework—on which the Treasury doesn't comment, I think, in the consultation paper—is the formal role that the OFT has for assessing the impact on competition of the regulator's rules. It may be that isn't the optimum mechanism but we certainly need something akin to it.
Ms Knight: That's right.

Q178 Chair: Are you all agreed that this principle should be elevated to the status of an objective of the regulator?
Mr Beales: I'm not sure that we would be. I think we would be interested in exploring the way of delivering that objective.

Q179 Chair: Mr Coles, on that point?
Mr Coles: Yes, I think I'd like to come back to you on that. I think it needs more thought.
Ms Knight: We also think, of course, that there should be some changes of the responsibilities of the OFT in respect of consumer credit for regulated institutions as well. So there is more to it than just an easy question.
Chair: John Mann had one very, very quick—
John Mann: No.
Chair: He has changed his mind. Well, I think that is all today. Thank you very much for coming. I realise that it has been a bit bumpy, particularly at the start. I feel bound to mention on behalf of my staff that there appears to have been some failure of communication because they did specifically mention to your staff that bonuses may be raised. But, after we overcame those early bumps, I think we progressed fairly well and had a very interesting evidence session with all three of you. Thank you very much for coming today.

Thursday 14 October 2010

Members present:

Andrew Tyrie, Chair

Michael Fallon
Stewart Hosie
Andrea Leadsom
Mr Love
John Mann
David Rutley
John Thurso
Mr Umunna

Examination of Witnesses

Witnesses: **Ms Natalie Ceeney,** Chief Executive and Chief Ombudsman, Financial Ombudsman Service; **Mr Tony Boorman,** Decisions Director and Principal Ombudsman, Financial Ombudsman Service; **Mr David Hall,** Chairman, Financial Services Compensation Scheme; and **Mr Mark Neale**, Chief Executive, Financial Services Compensation Scheme, gave evidence.

Q180 Chair: Good morning. Welcome to the Treasury Select Committee. Thank you very much for coming to give evidence this morning. We'd like to get straight into questions. I'd like to ask Natalie Ceeney, you're costing £100 million a year, I think that's right, broadly speaking. Do you know what the counterpart cost, the total compliance burden cost, is for the people with whom you interact? Have you ever asked that question? I can see there's silence to the first question. Could I suggest that you start to gather that information? It strikes me that what we really need to know if we're going to work out whether you are providing value for money as a service is not what your cost is to the consumer but what the cost is of the total compliance burden; that is, both the firms that you're dealing with and your overhead combined. Because the £555 figure doesn't actually tell us very much without that information.

Ms Ceeney: Maybe I could answer the question but in a slightly different way, because I think at the heart of the question is what value do we add. Our role, of course, is to look at individual cases.

Chair: Sorry, could you speak up?

Ms Ceeney: Sorry. Our role, of course, is to look at individual cases and decide really what needs to be done to put that situation right. So, in a way we add value in a number of ways, which is I think why I was struggling a bit with the question. Some of it is to put right what was wrong in a cheaper way than the courts. So, some of our value can be measured in the fact that our cost is significantly less than if cases were brought in the courts, both to firms and consumers. But a significant part of our role is also about underpinning financial service confidence. So, the fact that firms are able to say to consumers, "If it goes wrong there's a body that we fund that can put things right", that has a number of benefits, not just in terms of financial benefits to firms and consumers but also an underpinning of confidence benefit that's pretty hard to quantify.

Q181 Chair: Yes. I understand that what I've just asked of you, if you hadn't already started to do that work, might generate quite a bit of activity for a while and needs quite a bit of thought. You need to work out not only what is the cost of running the compliance offices of these firms, which they'll be able to tell you quite easily, but what the additional cost to the rest of their firms is of the questions that are asked of them via you.

Ms Ceeney: But, to answer that in a bit more detail, what we do is resolve complaints that can't be dealt with by the firm. Now, that's a function that will be done by someone whether we existed or not. The value of the Financial Ombudsman Service and why we were set up voluntarily by firms and then made a statutory function in 2000 was to make us easier to deal with than the court service. The functions that we deal with in firms have to exist whether they deal with us or whether they deal with the court service. Because we don't require legal representation, we don't require firms to have lawyers who deal with us. We require firms to have teams who simply forward us their documentation.

So, one of the reasons I'm struggling with your question is I don't believe there is a direct cost of dealing with us in the way I think you're suggesting. To give a pretty live example, if a consumer refers a complaint to us, all we require of the firm is to send us their documentation, which they've already gathered to do their own complaint handling. So our direct cost requirement for compliance of that firm is pretty small.

Chair: I'm not going to get into the detail of what answer you might come to us with now, but I'd be grateful if you could start to think about the question. Andrea Leadsom.

Q182 Andrea Leadsom: To Mr Neale, to what extent do European issues make a difference in how you'll be delivering your service later on? Are there any concerns about the way regulatory structures in Europe are changing?

Mr Neale: We're very much involved in the discussions that are currently under way bearing on European legislation on deposit insurance schemes. I think I would say that Europe is to some large extent moving in the direction in which we have already travelled. So, the European Union directive that is currently under discussion aims to bring about faster payout to depositors in the event of the failure of a bank or other deposit taker. We are already taking action to ensure that we can pay out depositors quickly in the UK so that banks can fail without jeopardising the interests of their depositors. Indeed, we aim to have by January a capacity to pay out

depositors within 20 days were a bank to fail and were the authorities to choose insolvency and payout as the method of resolving it.

Q183 Andrea Leadsom: So, are you saying, then, that in some ways Britain is already ahead of the game, ahead of where Europe is moving?
Mr Neale: I would say that we are, indeed, ahead of the game and that much of the European legislation aims to bring Europe up to some of the standards that we are seeking to put in place here.

Q184 Andrea Leadsom: So how closely are you involved as an organisation with the writing of European regulations?
Mr Neale: Closely involved. We're involved in two ways. We obviously work very closely with our partners in the UK, both with the Treasury and the FSA, in seeking to influence European legislation. But we are also members, and influential members, of the European Forum of Deposit Insurers and we also seek to influence European legislation through that forum.

Q185 Andrea Leadsom: So, not wanting to put words in your mouth, but could we say this could be a European success story that Britain is having a hand in a co-ordinated approach?
Mr Neale: What I want to say is that it is clearly in the interests of consumers across Europe that we have efficient, fast, responsive compensation arrangements in place.
Andrea Leadsom: Thank you.
Chair: Chuka Umunna.

Q186 Mr Umunna: Could I just ask a bit more about the Financial Ombudsman Service? The director of the Association of Independent Financial Advisers has suggested that with the changes to the regulatory regime it really necessitates a review of your organisation's role, Ms Ceeney, and also the accountability of it. Are you confident of both the role and the accountability of your organisation?
Ms Ceeney: I am confident of our role and I would also suggest it's not hugely surprising that there is conflict around what we do. And what we do is look at individual cases, and in every case there's a winner and a loser. We deal with around 200,000 cases a year, so it's perhaps unsurprising that people, whether it's on the consumer side or industry side, quite rightly look closely at what we do and look at whether we can do things more effectively.
We are quite regularly reviewed and we're quite keen to be accountable and to demonstrate that to our stakeholders. So, we were, of course, set up 10 years ago. We were also reviewed in 2007 by the Select Committee as we took on consumer credit jurisdiction. Our board voluntarily does reviews every three years, external reviews. So Lord Hunt reviewed us a couple of years ago; we've got the National Audit Office reviewing us next year. And we have regular dialogue with stakeholders because we are keen to constantly improve and be accountable. But I do believe the Financial Ombudsman Service has been a success story and I do believe we play a pretty valuable role.

Q187 Mr Umunna: The AIFA has also accused you of acting in a quasi-judicial way. How do you respond to that?
Ms Ceeney: We are a quasi-judicial service. We were set up 10 years ago as an alternative to the courts, as a low-cost, faster alternative to the courts, and it is our role. Our role is inherently quasi-judicial. We look at cases and we decide on the merits of each case who wins. So, we are unashamedly quasi-judicial.
I think where I hear more criticism from industry, if I can take this head on, is that we act in a regulatory role, and there I would be more robust. We're not a regulator. We look at cases, so we extrapolate from what we see a case is and sometimes we do have issues that arise from that that we pass back for wider insight to the regulator. But we are quasi-judicial; we're not regulatory.

Q188 Mr Umunna: With the review and the new structure coming into place, what are you going to do to respond to that? How are you going to change the way that you work? Obviously, your contact and your relationship with the new different instruments that there are going to be, are going to be crucial. How are you going to respond to the big change that we're about to see?
Ms Ceeney: In a couple of ways. Directly, the proposals pretty much leave the Ombudsman working as is, which we're pleased about because we do believe the model has worked well. But obviously we'll be dealing with different bodies and we're already starting to explore that with all the key stakeholders. I think one of the potentially most significant impacts on us will be if more is done to address systemic failures early. Because one of the issues that we've seen in the last decade is as we deal with individual cases we've seen a lot of cases that hinge on the same underpinning systemic failure in the market. And I think probably most people would say those systemic failures haven't been tackled quickly enough. So, one hope we have for the new structure is that by raising the bar on consumer protection lessons will be learnt on systemic failures earlier. That will be good for us, good for consumers and good for industry.
Mr Umunna: Thank you.
Chair: Michael Fallon.

Q189 Michael Fallon: I come back to this issue of cost. You say you're dealing with 200,000 cases a year. What is the average cost per case?
Ms Ceeney: The average cost per case is around £600. The reason I say "around" is we can deal with very, very complex investment cases but we could also deal with pretty simple cases. So, the individual case ranges hugely but the average is around £600.
In that calculation that doesn't include the million calls we get a year. We try and resolve things at the earliest point of contact. So, we take around a million calls in our contact centre, and a lot of times, we can give the right answer to the consumer on the end of that phone instantly. So, the cost I'm quoting is for the cases we then take on because we can't give an instant answer and progress in that quasi-judicial way.

Q190 Michael Fallon: Yes, but that doesn't take account of the cost to the industry itself.
Ms Ceeney: No, but as I've said earlier, I believe we're actually cheaper to deal with than the alternative, which would be the courts, to industry.

Q191 Michael Fallon: Well, you said in your annex in paragraph 6 that you're dealing with this at a fraction of the costs incurred in court.
Ms Ceeney: Yes.

Q192 Michael Fallon: So you must know what the overall cost of your service is if you know it's a fraction?
Ms Ceeney: Yes, when we were set up in the year 2000, at the time the cost of an average court case was around £3,600 compared with our unit cost at the time of around £700. Now, we've gradually over the last decade brought those unit costs down and I'm still continuing to try and bring those unit costs down. Average court case costs have not come down to anywhere near £600. So, our direct alternative would be to use the courts and we're confident we're a fraction of the cost of dealing with the courts.
And to add, that's our direct cost. If industry or consumers take a case to court, of course, they need legal representation. One of the big benefits of the Financial Ombudsman Service is you don't need legal representation to deal with us.

Q193 Michael Fallon: Yes, but how do we know whether the charges you're imposing on the industry are the right charges?
Ms Ceeney: It's a very good question. We are the largest ombudsman service in the world, so we do regularly benchmark but in a way by being the largest we're often the one looked to as opposed to finding easier comparators. It's one of the reasons our board has invited the National Audit Office in next year to do a value for money study because we're keen to look at how we can improve. So, that will be a published study which will be tabled to Parliament so that we can be as transparent and as open as we can about value for money. I'm also, as a new chief exec, looking closely at our costs because my ambition would be to make us as cost effective as possible. So, I'm hoping to—

Q194 Michael Fallon: Yes, you're telling us how you might improve. What I asked you is: how do we know whether the charges you're imposing on industry are the right charges? How do we know that?
Ms Ceeney: Well, in a way, the way to look at that is I think two measures: one, what's the cost of the next best alternative and are we better than that; and the second is external review of value for money. And we're doing both of those exercises. So, as I mentioned, we are significantly less than the courts but we have also invited the National Audit Office in to review us because we're keen to find ways of bringing it down. As we benchmark with other ombudsman services we do come out well. As we benchmark with the courts we do come out well.

Q195 Michael Fallon: How do we know the balance of charging is right? You're putting all the charge on industry. Have you considered putting some charge on the consumer?
Mr Boorman: Very briefly, the answer is in your hands, ladies and gentlemen, because Parliament presently provides that our charges are collected by two means: one a levy on the industry collected by the FSA and the other on a case fee basis which again is collected from the industry, collected from the firms that actually complain or are complained about. So, if people feel that there is a requirement for customers to meet some of the costs, that's not something that we ourselves can achieve; that's something for you.

Q196 Michael Fallon: Sure, but do you have a view on it? Do you think the balance is right at the moment?
Mr Boorman: I think it's been a helpful feature of an ombudsman service for 20 years that firms can say to customers, "If you're dissatisfied with my answer, you can go to this free service, free, impartial, independent service, which will look at that calmly and independently and reach a view about whether I, the financial firm, have reached the right decision on that case". So, I think that's a useful thing for the industry perspective. Obviously, it's of value to customers as well. So, perhaps that's a question you should ask industry and customer groups.
Ms Ceeney: And I think it's worth adding the model that Parliament put in legislation 10 years ago was based on the services that had been set up by industry. So, essentially, what Parliament did 10 years ago was formalised the industry set-up and it was industry that proposed the current funding model. I would say I talk a lot with industry. It's not the main concern I hear. I don't hear big questions raised about the funding model. I do hear hard-fought battles about individual cases, as you would expect for a quasi-judicial service. But I don't detect concern about the funding model for the reasons my colleague has said.

Q197 Michael Fallon: But you do get concerns about your charges?
Ms Ceeney: Actually, I would say it's not on the list of things people raise with me, I'll be honest. What I hear are concerns about individual cases. As I said, the alternative to us would be the courts, which costs infinitely more. It's not something I regularly get raised with me.
Michael Fallon: Thank you.

Q198 Chair: I just want to clarify what we're trying to obtain here, which is the process of dealing with all complaints is ultimately paid for by consumers, all consumers. What we need to arrive at is what they're paying for that, which is much more than the £555 per case multiplied by the number of cases. It is another number and at the moment we can't do a value for money study on you because we don't know what that number is. That's the point that Michael was trying to make and that I've been trying to make this morning. I recognise that you may not have come armed with an answer to that question, but we'd like one. Are you sure you want to add something or shall

we leave it there and ask you to come back? Why don't we do that? Andy Love.

Q199 Mr Love: I'd just like to pursue the final response you gave to Mr Fallon about the reasons why the consumer isn't asked to make a contribution. You must be aware of some of the industry concerns. I'll take the case of a mortgage endowment where there was a clear difference of view, I think, between your service and some in the industry in relation to the compensation that should be paid. Do you think there is any merit in the argument that's used by the industry that since it's free for the consumer to refer to the Financial Ombudsman Service when they don't have a case with the company, there's nothing to stop them because it's free going to you to gain some benefit from it?
Mr Boorman: Certainly. Do we see cases which are frivolous and do we reject those out of hand right at the beginning of our process? As my colleague has been saying, we receive a million enquiries from customers a year. We take on 200,000 cases. So, I'm very clear that what we should be doing is rejecting cases which are frivolous out of hand. We're very clear about that.

Q200 Mr Love: But I think the concern in industry is that you take a different perspective from them. Now, it may well be entirely correct for you to do that. They would say, and I take the case of mortgage endowments, that your interpretation of what was a good case for compensation on mortgage endowment was not that that many in the industry felt was a good case. How do you respond to that criticism?
Mr Boorman: I think you've described the challenge of our job. Of course not always will the industry, not always will customer groups agree with the judgments that we need to make in individual cases. Of course, many of the decisions that we have to make—whether it's about mortgage endowment cases, payment protection cases, spread betting, pet insurance or any of the other many issues that we have to deal with—can be controversial for the individual firms and for the customers and customer groups concerned. That is our world and it's a responsibility we take with considerable seriousness to reach carefully balanced judgments about the individual cases that we deal with.

Q201 Mr Love: Let me take another case. We're coming to, I think, a bit of a crunch over payment protection insurance. I wonder whether your service sees any merit in ventilating the principle of some of these issues in the courts to give a steer that would be seen as being entirely objective. I understand the argument about costs, but is it worth ventilating in the courts to give a steer so that both the industry and you have a clear view going forward about where it's appropriate to pay compensation?
Mr Boorman: The Committee will understand that we have to be a little bit careful of our answers because, as you're aware, at least four of the major banks have suggested just that in judicial review proceedings of the decisions that the regulator has taken about how to deal with what looks like an area where there was at the very least systemic allegation of systemic failure, and a review has also been sought of some of the actions that our service has taken. We always welcome guidance from the courts about the issues that we need to deal with. I have to say in careful frankness that we do not presently see that there is a need for particular guidance from the court about the decisions that we're making in these cases. But, clearly, that's now a matter for the courts.

Q202 Mr Love: Let me just come back finally to the issue about whether the balance of payment is right and to suggest to you the argument that a small contribution from the consumer would eliminate those frivolous cases that you've talked about, but also might establish a better balance between the consumer concerns and the industry concerns.
Ms Ceeney: If I can add, this debate really is a perennial one and, as my colleague said, this really is one for you who set our legislation to take an ultimate view.

Q203 Mr Love: But we're interested in your view because that will inform the recommendations we make.
Ms Ceeney: Yes. This was a key issue that Lord Hunt looked at when he did the independent review on behalf of our board that he published a couple of years ago. His view after careful consultation with stakeholders was that retaining the current model would be a benefit. I think there are many challenges. Would a small fee prevent some frivolous complaints? Well, undoubtedly, yes. Would it deter people perhaps on lower incomes or people who are less likely to bring cases otherwise? Also inevitably yes. I think our concern would be that deterring people from bringing cases who do have a legitimate grievance would be problematic and I think that's a difficult balance to bring. Our view is the current model has worked pretty well but it's not an easy argument, that one.

Q204 Chair: Would you take a careful look at that? The Committee has no view on whether there should be an entry fee. We're looking for your considered view, not on the basis of what was put on the statute book 10 years ago but as a consequence of the fact that legislation is now being fundamentally reviewed. I note that at £5 or £10 you got 800,000 frivolous cases. I think that's pretty much what you said out of a million?
Ms Ceeney: No.

Q205 Chair: Well, were there not 200,000 that were being taken much further? So there's 800,000 left.
Ms Ceeney: Yes, the 800,000 are calls we get. With some of those we can just give straightforward answers on the phone, so they're not all frivolous.
Chair: Oh, I see.
Ms Ceeney: I think what my colleague was saying is where we do get frivolous calls we do try very hard not to take them on because we don't think it's a good use of industry's money.

Q206 Chair: I think it would be very helpful to have advice on this area on the basis of the breakdown of the types of cases you have.
Ms Ceeney: Happily.
Chair: David Rutley.

Q207 David Rutley: Both you and the Government note the need for the Financial Ombudsman to be independent but you also note the "unique and impartial insight" into where things go wrong in retail financial services. How effective do you think you have been in the past at passing on your knowledge and insights to the regulator and to financial firms to prevent further complaints happening in a particular area?
Ms Ceeney: I think this is an absolutely core issue for us because, as you're saying, we see individual cases where it has gone wrong. Sometimes those are just a branch sale that happens to have gone wrong and we can put it right but we also see widespread systemic issues. I think there have been issues in the past. There are perhaps things we would like to be different from our side and there are perhaps things about the wider regulatory environment.
The two issues I would flag are one around transparency and one about speed. There are limitations in FSMA about what we can publish that I would welcome being looked at. For example, 18 months ago we started publishing data by firm on complaint volumes. We believe that helped improve industry practice so we are really pleased with the impact. It was quite difficult to work out whether we even had the power within FSMA to do that. We would welcome being able to be more transparent about what we're seeing. Our legal advice is that would require a change in FSMA and we would welcome that because our view is the more we can expose what we are seeing in individual cases, the more it would help everybody learn from what is going on.
We do talk very openly to the regulator about what we see. One of the other issues I would flag that I hope the new regulatory regime can address is the speed of acting on that. This is not just about will. This is also about structural processes for dealing with things. Where we have seen problems in the regulatory regime are—for example we have talked about payment protection insurance; we have talked about mortgage endowments; bank charges are another example—where the time lag from identifying a failure to resolving it has been too long for all concerned. So consumer detriment has built up; industry liability has built up. It has been frustrating for everybody. I think getting that time lag down would be a key thing for us to want to help achieve in the new regulatory regime.

Q208 David Rutley: Thinking ahead then, what needs to happen to ensure that you, within FOS, are going to be successful in the new structure? What are the key things that need to happen there?
Ms Ceeney: Again I would say transparency could be a key tool. As I said, we deal with individual cases. We are not a regulator. We do not have a policy role. We deal with individual cases. I think where we can be helpful is making sure that we all learn from those cases early, and I think transparency could play a key role in that. I think another key role for us, which I hope we have played quite successfully in the last decade but need to continue playing, is making sure we do share our insight and learning with all the players in the regulatory regime—whether it is FSA, the soon-to-be CPMA, our colleagues in the compensation scheme and the OFT—to make sure that we all are joining the dots where we potentially see things going wrong early.

Q209 David Rutley: It's all well and good talking about transparency and speed. Surely if we are going to try and make this new structure work properly there has to be some sort of escalation mechanism if you see something going wrong. How is that going to work?
Ms Ceeney: We have already started a new approach. We went out to consultation with the FSA in March on the concept of a co-ordination committee between us, the Office of Fair Trading and the FSA to make sure we were sharing insights early. That has now started. We are hopeful that, by making sure we all bring our learnings early—back to the transparency point—I think the next step will be exploring how open we are about what we all seeing because frankly I think we need to create a culture where we all learn and we all learn from things happening in a timely way so that detriment doesn't build up.

Q210 David Rutley: Again, it sounds good, but the problem with transparency and co-ordination, they are interesting words but I think what people want is action. I would have thought more work was required on how this escalation mechanism could work. It is all well and good co-ordinating people's views on a subject but if that isn't working and you believe passionately that this isn't working for the consumer, how are you going to ring the alarm bells?
Ms Ceeney: I entirely agree with your challenge. I think it is a challenge for the regulator as opposed to us.
David Rutley: Yes, but this is a chance to start focusing on how we are going to change the regulatory regime. This is the time to speak, based on your experience of the last 10 years.
Ms Ceeney: That's fair. From our perspective, we welcome the creation of a CPMA that is particularly focused on consumer financial services, because we think that should give a particular focus on these issues, which in itself, if that focus is applied effectively, would help things to be dealt with more effectively. But ultimately our role is to flag issues. I would like us to be able to do that more openly but what we really need is the regulatory infrastructure to be able to pick that up and act on it quickly. That is something I will do everything to help happen but ultimately I can't make that happen because we are not the regulator.

Q211 David Rutley: You've talked about CPMA. That will become the consumer champion. How do you think you are going to be able to handle that relationship with CPMA? What sort of bodies or

discussion or dialogue needs to be in place to make that successful?
Ms Ceeney: In a way, the relationship we would have under the new legislation as proposed with the CPMA is very similar to the relationship we have with the FSA. The key to success there has been constant regular dialogue; both at a sharing insight level plus, if we see things going wrong, talking early around what is going on in those cases and just dialogue at every level. It is absolutely critical that we continue that with the CPMA.
Mr Boorman: Can I just add one small point? I think it is quite an important point from our perspective. Your question, sir, raised the CPMA as a consumer champion and I understand Government's intent there but, to be very clear, our role is not to be a consumer champion. We are an important part of the safeguards set up in the FSMA structure but our role is not consumer champion. One of our perhaps rather esoteric concerns about a link with a CPMA that is a consumer champion is to continually make that point, that our role is independent of championing of consumer interests or championing of industry interests.
Chair: I am very glad you got around to making that point. I was getting nervous about the earlier replies. John Mann.

Q212 John Mann: My question is to the Financial Ombudsman Service. How accessible is your service to all sections of the community and what documentation have you published to demonstrate your research into that?
Ms Ceeney: We take accessibility extremely seriously. I have our annual review in front of us. We have a team that is dedicated to getting to sections of the population who would otherwise find bureaucracies hard to complain to. We work with a number of advice bodies, Citizens Advice, Age UK—groups who would directly get to people. We target disadvantaged sections of the population quite closely so they know we are here. It is one of those challenges that I think will be a perennial challenge. We need to keep doing more.

Q213 John Mann: My question is: what documents have you produced to demonstrate that you do that?
Ms Ceeney: I can send the Committee the relevant pages in our annual review. We take a section of our annual review that we publish every year, which I can pass to you, which explains—

Q214 John Mann: Yes, which we get. My question is not what you assert to do but what research you've carried out and what you've published to demonstrate how accessible your service is.
Ms Ceeney: Perhaps it would be helpful if I dropped the Committee a note on those details. We do have an awful lot of evidence. We do a lot of research. So perhaps I could write to the Committee and explain some of that.

Q215 John Mann: I will ask in a different way then. Of the 200,000 complainants coming to you, how many self-represent?
Ms Ceeney: The vast majority.

Q216 John Mann: Does that cause you concern?
Ms Ceeney: In what sense?
John Mann: When the Legal Complaints Service was taking tens of thousands of complaints from what it, after many years, determined were vulnerable sections of the community—vulnerable for example on literacy—what it was able to ascertain was that 90% of the claims required representation.
Mr Boorman: If I can help, I don't want to comment on other schemes which are now well in the process of being abolished—
John Mann: No, but it is an illustration of a large section of the community that would not feel able to represent itself on financial matters to you or indeed to many other people.
Mr Boorman: No, indeed. And I think that is a serious and significant issue. Of course, many of the people you are describing are part of the financially excluded and, as part of the financially excluded, they may not have the normal sort of complaints that many of the rest of us do with their banks and insurance companies and so on. We work closely with Citizens Advice and other advice agencies to support them in their work of dealing locally with people in financial difficulties and that's an important part of our work. But we are a service that is based here in London and, therefore, is, by definition, at the end of the telephone or at the end of the post or email from people. There are certain sorts of face-to-face services that I think it is always going to be difficult for us to provide.
We are pleased about the fact that our average customer base has become very closely related to the population as a whole. One of the challenges for us is to understand what our typical customer base should look like, given the ownership of financial products. As you will see from our annual report, we do reflect well both across the country and across socio-economic groups, but I entirely accept there is a group of people who have particular financial difficulties and needs and we may not be the best-placed service to provide for them.

Q217 John Mann: It would be useful if we could get a constituency or equivalent breakdown of where you get your cases from.
Ms Ceeney: We do have that in our annual review and I will drop that in a note to the Committee.

Q218 John Mann: My final question is, considering the current economic climate, would you regard accessibility of vulnerable groups as being increasingly or decreasingly important to your work?
Ms Ceeney: Without doubt, increasingly and we are seeing that in our case load. For example, over the last 12 months, we have seen a significant increase in the number of cases coming to us of financial hardship, and we have been working very closely with the consumer groups to make sure if someone is in financial hardship we fast-track cases and help consumer groups work with us to help consumers know how to access those services. We have dedicated resources set up to deal with those particular issues and absolutely they are increasing.

John Mann: Thank you. Again, a letter just outlining that in a bit more detail would be very helpful to the Committee.
Ms Ceeney: Yes, happily.
Chair: Stewart Hosie.

Q219 Stewart Hosie: You said earlier you get complaints across the financial services sector. You identify the trends early, the issues early: an early warning system. You said you do speak to the regulator. You say you share this information but there was a clear frustration perhaps about a lack of openness and perhaps all of the things that have been learned weren't shared. What would you do or what could you do to make sure there is more openness; to make sure that lessons are learned more quickly? Your organisation first; what can you do to make that better?
Ms Ceeney: I will say some of the things we are doing and I will say some of the things we'd like to be doing if we could use the opportunity of this legislation. Some things we are doing; we have a team of expert ombudsmen who, as well as looking at the most challenging cases, are also essentially experts in their field. We use them to draw out those lessons and talk a lot with industry. We work with trade associations and we work with individual firms to really draw together lessons we are learning, that may be evidenced in one or two firms but may have wider industry implications, to help industry learn. I know that is appreciated and we are committed to try and do more and more of that work.
The big message I get back from everybody is, "Can you share more of what you do?" I will come back to the transparency point because FSMA limits how much we are allowed to do at the moment because, for example, some of the decisions we publish and some of the information we would give privately to the regulator, it is questionable legally whether under FSMA we could put that in the public domain. That is an area where we think it would be helpful to industry to learn and to the regulator to identify systemic issues early if we were able to put more of our work in the public domain.

Q220 Stewart Hosie: That sounds like a good pitch, to have the legislation changed or toughened or new conditions to give you the protection you need to have that information in the public domain. What else could be done, not necessarily by your organisation but by all the structures in the new regulatory protection framework, to ensure the lessons are learned quickly and that, if there is a requirement for new regulation or a different sort of supervision, it's put in place quickly?
Mr Boorman: I think we have been making some progress and I think there has been recognition around the debate in the last Parliament about the amendments to FSMA, which the present Government have started to introduce some of. In particular, the introduction of the revised section 404 that provides a redress mechanism that the regulator can fire if they see systemic problems that suggest there ought to be some systematic answer to the question. In a way, that goes to a point that was made earlier by the Committee about some of these large-scale areas of dispute between customers and financial firms.
So I think ensuring that the regulator has strong, flexible tools at their disposal that fit these particular requirements, fit the requirements of cases where large numbers of customers are expressing dissatisfaction and where there's debate and dispute with financial firms about where liability lies. I think it's important that we have a mechanism whereby the regulator can intervene. Because the only alternative to that, the alternative that our service has had to live with over the last 10 years, is that customers individually, where they are able to, have to bring their cases to the financial firm, which may dispute the issue strongly, and if they are dissatisfied, to bring their case to us. As you know, they've done so in a million over the last 10 years; so good and relevant powers for the regulator, I think, are a critical part of this feature.
If I may, I think there's also a point for industry and consumer groups to play a role in this debate. It's not just for regulators or a quasi-judicial service such as ourselves to contribute. I think there is something for financial firms, for customer groups, to draw to the attention of the regulatory authorities where things may be going wrong. I think one of the issues in the past has been that that feedback, from the industry to the regulator, hasn't always been as open and clear as it might be on other issues.

Q221 Stewart Hosie: In terms of the good and relevant powers to the regulator, which is sensible, could you provide the Committee—not today, necessarily—with your idea of what those powers might be? Would you be able to do that for us?
Mr Boorman: Yes, as I say, and I think certainly section 404 amendments that the Government have put in place are a very important start, but let us come back to that question.

Q222 Stewart Hosie: To ask Mark and David, just on the FSCS—because we heard a bit about "systemic" there and obviously you, in a sense, pick up pieces if there is a problem with the work you do—you'll be expected to work very closely with the PRA in the new structure now. Have you any concerns at all about how that will work, about transparency and about the appropriate sharing of information? Where do you think that will go and how would the relationship work?
Mr Hall: As you know, the proposal is that we should be directly accountable to the CPMA but having strong links with the PRA. We think, in some ways, we would like to go a step further in our relationship with the PRA and have a more formal accountability to the PRA because, as you know, at the moment we have an accountability to the Bank of England to advise it on payout as one of the resolution options. That is an accountability we have now, so under the new regime to make that a formal accountability to the PRA seems to us to make some sense. So we would advocate that we both have formal accountability to the CPMA and formal accountability to the PRA. That could involve them appointing board members to us; it could involve us reporting to them, however often—

Q223 Stewart Hosie: What is the reason that that structure hasn't been set up or what reasons have been given for not having that formal relationship?
Mr Hall: I think it's just the state of the debate. I think when the proposals came forward about splitting the FSA the way they did, the bulk of our peacetime work, if you like, points us in the direction of the CPMA; the failure of intermediaries and us paying compensation to the customers of those intermediaries. But obviously, in the autumn of 2008, a large part of our interactions were with the Bank of England and the Treasury, as well as the FSA, and it was recognised in the consultation document that that link was very important. I think we suggest it's worth thinking about, whether we just push that further and formalise it some more, because there are some mutual accountabilities here. Just as we need to be accountable to the PRA and the CPMA, so we need the PRA to ensure that the industry has the databases—the single-customer view, as we've described—in such a position so that we can meet the seven day aspiration for payout. We can't do that as the FSCS. We will be relying on the PRA to enable us to get access to the institutions to familiarise ourselves with their databases and familiarise ourselves with their systems. So, in a sense, they need to be accountable to us for that. So we see mechanisms of a mutual accountability with the PRA and the CPMA.

Q224 Stewart Hosie: I presume you are continuing to make that case?
Mr Hall: Yes, we are.

Q225 Chair: Have you set that out in writing?
Mr Hall: We have, yes. It is part of our response to the consultation document, which I think closes on 18 October. It closes on Monday. We have written to the Treasury with that argument, essentially.

Q226 Chair: I think it would be helpful for the Committee to have your considered firm view with all the pros and cons of having two compensation schemes as well.
Mr Hall: Yes. That's a slightly separate question, Chairman.
Chair: Yes.
Mr Hall: Shall I comment on that now?

Q227 Chair: If you have firm, developed views, otherwise drop it to us in writing. But I think it's an important issue for us to examine.
Mr Hall: No, we do have firm views on that. I think the first point is that, in a sense, we already operate a number of different compensation schemes—a deposit scheme, an investment scheme, an intermediary scheme, and so on—and have done since FSMA in 2000. I think there are at least three key arguments why we believe a unitary scheme makes sense. The first one relates to the consumer, i.e. under one scheme the consumer will have one point of interface, which is us. In an industry in which many providers compete across a number of different product lines, if there is a failure in dealing with more than one compensation scheme, it raises complexities and hand-off issues, which we think could be avoided by having a single interface.
Secondly, there is the question of the industry interface. The industry at the moment has one compensation scheme that it can interact with as opposed to two. I think, thirdly, there is the question of critical mass and scale that you get under one scheme. So in the autumn of 2008, because we had critical mass in IT skills, data management skills, outsourcing arrangements, legal skills and communication critical mass, we were able to scale up very rapidly to deal with the crisis of the major banking defaults within the institution that we have. If you're going to separate all that out, I don't think you have that critical mass in order to deal with the wide fluctuations that we see in our business.

Q228 Chair: Have you set all this out in your response as well?
Mr Hall: Yes, we have. We have. Yes.

Q229 Chair: I think it would be very helpful for us if we could have that, with the full pros and cons of each, so that we have your view clearly on it.
Mr Hall: Yes.
Chair: John Thurso.

Q230 John Thurso: Can I just go back briefly to this question of the consumer champion? One of the weaknesses in the FSA was recognised to be the fact that the consumer side didn't get perhaps enough prominence. CPMA has been labelled as being a consumer champion. But Angela Knight gave us evidence that the BBA is extremely worried about that. There's evidence we've had from the stock exchange, and various others, on those lines and there seems to be a tension there. Angela helpfully suggested it should be Consumer Focus, which we now understand is vanishing today. Is there a danger, once again, that the consumer is going to be left out and are you not, by default, going to be dragged into becoming more of a champion?
Ms Ceeney: To echo what my colleague said earlier, we have also expressed concerns about the labelling of the CPMA as a consumer champion for the reasons we've expressed. We work very hard to be impartial. So we do look at every case on its merits. In fact last year we decided 50% of cases in favour of the consumer and 50% in favour of industry, which I think demonstrates that impartial role. One issue we do experience is obviously industry is well-established and has effective lobbying powers. We would expect that of a well-run industry. By contrast, when we deal with some consumer groups they are often very stretched and pretty under-resourced. But I think we're keen to say that is absolutely not our role and—whatever happens in the environment around us—we must not become a consumer champion, and are adamant we are not now and have no intention of being. But I think the reservation about making sure that somebody is is important. Our view, though, would be it shouldn't be the regulator.

Q231 John Thurso: In your written evidence, you noted the dividing lines between traditional financial

services and other retail markets are blurring and that there may be scope to simplify and improve access to redress. Do you see the FOS doing that or are we looking for another super-ombudsman?
Ms Ceeney: It's a good question. Over the last 10 years we've been in existence our jurisdiction has gradually increased. So, for example, three years ago we took on responsibility for consumer credit. I think those moves have all been very sensible because if you put yourself in a consumer's shoes it's about financial services. So, whether it's a credit card issued by this firm or this or a loan issued by this firm or this, the average consumer doesn't think, "Well, who is the regulator?" They think, "It's about financial services, isn't it?" So I think a very helpful development over the last decade has been that our jurisdiction has covered financial services as that has grown. The boundaries of any jurisdiction are always challenging. So a good example would be as supermarkets go into financial services, consumers can get quite confused about who deals with what.
House buying is another very interesting one. So we might be an ombudsman for the mortgage but if you're complaining against the estate agent you would go to another ombudsman and the removal firm, you'd go to another ombudsman. So, from a consumer's perspective, that's challenging. We're certainly not in the market of trying to bid for new things. I think we're keen, though, to make sure that consumers have a simple message about where they turn. But at the moment the message is pretty clear; if it's anything to do with financial services you can go to the ombudsman. There are edges that I think we should constantly keep under review, but I think it does make sense to say there's an ombudsman for financial services.

Q232 John Thurso: Okay, thank you. Can I turn to the FSCS? Mark, nice to see you in your new role.
Mr Neale: It's nice to be back.
John Thurso: You're still in the honeymoon period. What do you seek to achieve in your time as Chief Executive?
Mr Neale: I'm very lucky to have joined an extremely effective organisation with people who are strongly committed to providing a good service to consumers, but I think we're all very conscious of the need, significantly, to enhance our capability for the future. The financial crisis has shown that we do need to be able to respond very quickly to significant increases in the workload that we face. So what we're seeking to do is both to improve the service we provide to consumers on a day-to-day basis, because clearly financial businesses will fail even in good times, but also to lay the foundations and the capabilities that would serve us if we had to respond again to a major failure. That reflects the point that David was making about the organisation having accountabilities, both to the CPMA and to the PRA and the Bank of England.

Q233 John Thurso: Mr Hall, if I could ask you, you made a statement—and I'm not sure whether you were describing Mark or the whole organisation—you said you would be central to developing an even stronger focus on consumers. I assume that was the organisation. Given the FSCS was set up by statute, what exactly did you mean by that?
Mr Hall: Well, I think that we have to be very clear that our primary stakeholder, if you like, is the legitimate claimant. That's what we were set up to serve. The events of the autumn of 2008 have raised the bar, in terms of what we need to be able to do. For example, the seven-day payout aspiration is an enormous task, for both the industry to put together its data files in a way that we can then validate and the mechanisms for paying out in that period. It is an enormous challenge. So in terms of also helping financial stability, the fact that we can pay out in that aspirational time will help stability because it will, hopefully, help confidence. But the fact that we can then do it for the deposit takers means that we need to raise the bar on all the other product categories, in terms of how rapidly we respond and how effectively we respond to claimants. So, whereas we got through the autumn of 2008, the bar has been raised, which is going to require some investment on our part—enhancement of management team and significant investment in IT systems—in order to be able to meet that sort of higher bar, if you like.

Q234 John Thurso: Is there anything in this restructuring that's going on in regulation that you feel is either detrimental to you or there is an opportunity? Is there anything that's being missed that we ought to be looking at that could help you?
Mr Hall: I think there are a couple of things that we think are very important for us to have the right mechanisms in place to accomplish. One of them would be more effective contingency planning than we've had in the past. I think there's a broad agreement among the authorities that that is indeed something that needs to be done. I think it's fair to say that some of the contingency planning in the past has resulted in a happy ending, if you like, as opposed to an unhappy ending that would involve us. I think there's a considerable appetite, on behalf of the authorities, to get involved in more frequent contingency planning and the EU legislation, which was referred to earlier, is asking for that. So I think that's one key aspect. Related to that—I think it was mentioned earlier by Natalie—we need to create better gateways for information sharing, so we get to a point of it not being a signal of a crisis if the FSCS is seen talking to a banking institution, which creates all sorts of concerns as you can imagine. But if we can somehow create an environment whereby it is normal for us to be involved in stress-testing different institutions' capabilities in order to deliver a payout, then that's another key thing that we need to build into the new structure.
Mr Neale: Can I add to that? I think there are two things that it's very important that we retain in the new world. One is our independence. I think it is an important assurance, both for consumers and for the industry, that we reach independent judgments about whether compensation should be awarded or not. The other thing I think it's very important that we retain is our critical mass as a single organisation. My confidence that we can do all the jobs that we have to do, and provide a good responsive service to

consumers across the range of services, does depend on keeping the organisation together, so that we can deploy the skills and expertise we have across the full range of services that we provide. So although we would be very relaxed about running separate services for deposits, insurance and investment, I think it is very important that underpinning those separate services is the critical mass of the current organisation.

John Thurso: Thank you very much indeed.

Chair: Thank you very much for coming to see us today. We recognise that an hour is not very long in order to cover such a huge range of subjects, but we would be grateful for anything you feel you should have brought to our attention in writing. A number of areas have been raised today, which the Clerks will be in touch with you about. Thank you very much for what I think one of you described as "the careful frankness" with which you've delivered your evidence this morning.

Examination of Witnesses

Witnesses: **Mr Richard Saunders**, Chief Executive, Investment Management Association and **Mr Peter Vipond**, Director, Financial Regulation and Taxation, Association of British Insurers, gave evidence.

Q235 Chair: Thank you very much for coming before us this morning. Again, as with the last session, we have a lot to cover in a short space of time. As I also said, if there are things—and I expect there will be—that occur to you in the course of the hearing that you don't think you've been able to cover fully, please write to us. We're receptive to written evidence.

Could I ask you, Mr Saunders, to what extent the people you represent may generate systemic risk?

Mr Saunders: To a relatively pretty low extent. The reason for that is that fund managers, investment managers, do not carry customer funds on their balance sheet. So while the investment management industry in the UK manages over £3 trillion of assets on behalf of its clients, which is an awful lot of money, if any one of those firms were to go down those assets are held separately by a completely separate custodian or depository and, therefore, would not be at risk in that situation. So the firms themselves do not carry systemic risk, which is reflected in the fact that, rather than being regulated by the prudential regulatory authority, as banks and insurers are, they will fall to be regulated by the CPMA.

Q236 Chair: Could I turn to another even more sensitive issue, which is the bonus culture? Do you think that these bonuses are justifiable and do you think that the cause of them is structural—that is, a lack of competition—or some other cause?

Mr Saunders: Are you referring, Chairman, to bonuses in the investment management industry or elsewhere in the financial services industry?

Chair: I think it would be helpful for you to comment on both because they are quite distinct.

Mr Saunders: Yes, if I could take the investment management industry first. As I have already said, the investment management industry is rather different from other parts of the financial services sector, so that the question of bonuses does not raise the same sort of systemic stability issues.

In relation to the firms themselves, yes, there are high bonuses paid to high performers in the fund management industry. It is reasonable for that industry to have a high proportion of remuneration in variable form. Why do I say that? It's because the fund management industry's revenues are essentially determined by a percentage of the assets that are managed, and therefore a firm's revenues are quite highly geared to the capital markets. So, for example, in the six months after the Lehman crash, the equity markets, stock markets, fell by around 40% and that impact went straight through to the topline revenues of fund management firms. And they were able to deal with that by reducing or deferring bonuses, rather than having to sack large numbers of people, and so that's an illustration of the sort of flexibility that that gives you in an industry that is very highly geared to the market.

If I may turn then to banking, as shareholders, the investment managers only have a role in relation to remuneration at board level, which is obviously a very small part of the remuneration and bonuses within banks. So shareholders are not in a position to influence that. So coming to the question, are bonuses potentially destabilising, I think—and we saw this during the crisis—that the incentives on individuals within banks can clearly cause them to act in ways that can destabilise the system. As such, I think it is a regulatory issue, and therefore it is correct that it is being tackled as a regulatory issue through the European legislation that is now being implemented by the FSA.

Q237 Chair: Why can't the boards deal with it? Why are bank boards so pusillanimous in handling this? After all, it's the risk to the shareholders they are supposed to be representing that they should be concerned about.

Mr Saunders: Well, I think the experience of the last two to three years is that they didn't do that.

Q238 Chair: Yes. Why?

Mr Saunders: This takes us into a very broad question, which is, if you like, in the remit of the new commission on banking that's been set up. I think what I would consider happened in banks during the last three years was that proprietary trading became the be all and end all of activity within a number of banks. I think there was perhaps a loss of sight around what banks are for in terms in serving the broader economy and they became too focused on, as it were, not the outcomes of their activity, but in terms of rent extraction from the rest of the economy, which is a much broader question than simply remuneration, but remuneration was one of the ingredients in that.

Chair: Okay. Well, thanks for those helpful introductory questions and answers. Andrea Leadsom.

Q239 Andrea Leadsom: Richard, you and I worked together in the past on matters of corporate governance when I was in the funds management industry, just to put that on the record.
Just following up on what the Chairman was asking you, I feel—and I wonder if you do—that there is a role to play in a corporate governance sense for large institutional fund managers to force upon the boards of banks better management of the compensation culture. Would you agree with that?
Mr Saunders: Yes, I would. I agree up to a point. There is a limit to what shareholders can do in relation to the companies in which they invest. Shareholders have no access to information over and above that which is available to the rest of the market. They aren't in a position to manage banks, but what they do need to do is to hold to account the boards of companies, which in turn oversee the management of those institutions. They have a direct role, as I've said, in relation to remuneration at board level. I think it's more difficult for shareholders to take a view about the amount of compensation that's being paid to individuals within an organisation. That I think is properly a matter for management and for boards.

Q240 Andrea Leadsom: Yes. If I may, not so much remuneration sub-board level, at individual level, but more in the sense of holding boards to account on the level of quantitative compensation planning that they have versus these very sort of subjective and quite enormous bonuses, do you think that that is something that the industry could support as institutional shareholders?
Mr Saunders: I think the industry certainly needs to address the whole issues around the stability of the banking system, which I think the last three years showed was—left a lot to be desired. The existing structures we had, the way the banks are structured, the way they're regulated, didn't work. Remuneration is part of it, but I think it's only part of it, and I'm not sure I'd want to pull that out as the main issue. I think there are issues around competition in banking. You could argue that the levels of remuneration in banks in some areas, in investment banking in particular, reflect a lack of competition, and so there's excess rent extraction going on. But these, as I say, are quite deep-seated structural issues and I think that very high, excessive levels of bonus—and excessive levels are paid, which do exist in some areas, I think that's absolutely correct—are more a symptom of a problem rather than the cause of it.

Q241 Andrea Leadsom: Okay, thank you. Turning, if I may, to a slightly different topic, Mr Vipond, with the new European regulatory structures coming into place that are rather somewhat inadvertently misaligned with the new regulatory structures in the UK, do you anticipate problems, new challenges for the insurance industry that have not been seen hitherto? Do you expect this to be positive or negative?
Mr Vipond: Positive or negative, it's certainly going to happen from 1 January next year, and the misalignment is, I think, probably more at the margins than fundamentally.
For both banks and insurers, the most important core regulation will either be to, in our case, what's called CEIOPS at the moment—what will be the European Insurance and Occupational Pensions Authority—and a similar body for the banks, and so I think there's a good deal of alignment there.
I think there will be issues in the consumer regulation space, in the conduct of business space, because most of that will go to the European Securities and Markets Association, and that regulation will affect banks and insurance companies. So there is some misalignment, but it is undoubtedly the case that we have a European architecture of an importance and a significance that we haven't known before, effective pretty well now. Certainly next year they will be recruiting and operating. I think we need to think of the UK as fitting into a new European framework that is emerging, whether we like it or not, and we need to make that work. So that's put an onus on the industry to be effective, working with the UK authorities in making representations to those bodies, and realising that in future UK regulators, including the Bank of England, will be subject to a great rule-setting process that is essentially not of their making and not entirely within their control.

Q242 Andrea Leadsom: Do you see that as creating new barriers to entry, new problems for your members wanting to expand or indeed to come into the business for the first time?
Mr Vipond: I think there are two parts to that question. For our members and for big European insurance and banking groups, this is broadly good news, because it does mean there will be an alignment of the way they are supervised in Germany, in the UK, in Spain, in Poland and it does mean that the rulebook on which they operate will be much the same. In other words, there will be—harmonisation isn't always a loved word—an integration of the supervisory structures and the way it's done, albeit that supervision will itself continue at the national level. So I think that is good news for competition, good news for the single market and good news for our major members.
Where I think there is in reality a problem is that the costs of being a regulated business go on rising. It becomes harder and harder to meet the business costs and the solvency costs, above all. And so I think it's a brave group that comes into that market, though of course in the UK we continue to see new authorisations, new insurance companies and new banks.

Q243 Andrea Leadsom: Thank you. Mr Saunders, can you comment on the asset management industry in the same regard: how do you think European regulation coming in is going to impact on the British funds management industry?
Mr Saunders: A large part of the regulation which the industry now has to deal with comes from Europe, and that is simply a fact. Like Peter, I think the

establishment of a stronger European Securities and Markets Authority is good news for the industry, because many firms, particularly larger firms, operate on a pan-European basis. They operate in all European markets and so the inconsistencies in regulation between those different markets is a problem. If ESMA can operate effectively to iron those out, it will enable firms to operate at scale with greater efficiency. There are loose edges—sorry, loose ends. The UK has only one seat at each regulator, so the CPMA will take up, for example, a seat at ESMA. That is one reason, I think, why—as I say in the paper—we think it would be a great mistake to peel off the UK Listing Authority from the CPMA, because that would then further fragment the UK's representation at the European level. But on the whole, I think the changes at the European level don't, in and of themselves, raise big issues for the industry and on the whole it's positive.

Andrea Leadsom: Thank you.

Chair: Andy Love.

Q244 Mr Love: One of the objectives of the Financial Policy Committee is to spot and control asset bubbles. To do this, it has been given—or it would appear it has been given—some macro-prudential tools. Is that an appropriate thing for it to have? Perhaps I could get a comment from both of you, one at a time.

Mr Saunders: Okay, I'll go first. I think broadly speaking, yes. I think it certainly ought to be an objective for it. I think the $64,000 question is whether it will succeed in that objective. Spotting bubbles when you're in them is extremely difficult, because on the whole, people get carried away in the bubble, and we saw this in the run-up to the credit crisis. So I think yes, it should have it, but the key then to this—and I think the key to this whole structure—you can devise blueprints, draw regulatory organisation charts until you're blue in the face, but what is going to matter and what's going to determine whether it works is the quality of the people involved and the way in which they work together. I think that softer end of it is what will determine whether those objectives are met effectively.

Q245 Mr Love: In responding, perhaps you could also respond to Lord Turner in his speech at the Mansion House who said they won't always be popular, exercising these macro-prudential tools. Will it be popular with your members?

Mr Vipond: Well, it will be popular with our members if we can maintain macro-prudential stability in the United Kingdom and more broadly because that's just good news for a long-term business like insurance, and bad news if it doesn't happen, and it's good news for our consumers, if they do it at one level. But I think what Lord Turner might have been saying, and it's one of the reasons why it may merit further consideration as to who are the people involved in this process, and what is the involvement of Her Majesty's Treasury in this process, rather than just the Bank of England, because some of the tools they are going to have to make use of will not be easy and will not be comfortable. The institutional structure looks in the right sort of place, but it's a little bit top down.

The people, as Richard says, are very important. It's important that they're not just central bankers. They must come from across the financial services industry, they must be based not on people who are sort of quasi-academics and have lived their life in the Bank of England, and they must be capable of making decisions about how you not just spot those bubbles, but manage them. Then things do get very difficult and they get very political, because what you're talking about in some form or another is policy instruments, about things such as the control of credit in the economy; determining how many people will get a mortgage; determining how much money people must put down if they want to buy something; determining how much banks can lend, even when they tell you they want to lend a different amount. Those are all tough decisions. They are profoundly important macro decisions for the UK economy, and it's important that the FPC has the policy instruments to make them.

Q246 Mr Love: Sorry, Mr Saunders, but let me pursue just a second—you can comment yourself on this. You've thrown up a number of issues there, but let's start with the first one, and that is the role of the Treasury. At the moment, they are going to have a non-voting member. You clearly don't think that's sufficient. What would be sufficient?

Mr Vipond: I think there needs to be some political accountability and ministerial involvement, because if the analysis is right that this is such a profoundly important body and the decisions it's taking are going to affect the lives of citizens across the United Kingdom—frankly, more than anything the CPMA or PRA will do, important as they are—it's very important there's a link to the political process and that Government Ministers are involved in that more directly than just as observers. How you make that happen I think needs some further thought, because clearly this body has to be able to bring to Ministers difficult decisions.

Q247 Mr Love: Mr Saunders, have you given it any further thought? Would you like to put on record today how you think the Treasury and Ministers therefore should be involved in this process or more closely involved in it?

Mr Saunders: I don't have a proposal to offer today, I'm afraid, except that I would broadly agree with what Peter has said. I think it was evident in the run-up to the crisis that the tripartite arrangement wasn't working effectively, that too many things fell between stools and it wasn't sufficiently joined up.

Q248 Mr Love: Can I move you on then? There's been some discussion, and we've heard it at the Committee, about whether or not the FPC should consult in some way, when it is thinking, to signal in some form for the market whether or not it is going to make use of some of these levers. We've heard opposing views, shall we say, on that matter. How do you think the FPC should take the markets or the industry with it when it seeks to introduce these? You

have already mentioned how difficult it is to measure when a bubble occurs. There's great controversy over that, therefore there will be great controversy—how can we minimise that controversy?
Mr Saunders: Well, I think it's very important that the FPC should be open to receiving views from all quarters. This is a particular hobbyhorse of mine. It needs to ensure particularly that it gets views from what one would call the buy side of the market, which is investors. My observation from dealing particularly with the Bank of England during the early stages of the credit crisis was that they were talking a lot to the, as it were, sell side of the market, which is the market intermediaries, the investment banks. They were getting one message, which was a more reassuring message about what was going on in the credit markets than we were hearing from our members, who were saying that conditions were absolutely terrible, "We cannot do any business at all". And I remember having a conversation with a very senior person at the Bank of England at one point, who said to me, "Conditions are getting better" and we said, "Well, no, they are getting worse". Indeed they did, and we had Lehman later on and so on. So I think it's going to be very important for the FPC to reach out, not just to a narrow group.

Q249 Mr Love: Let me ask Mr Vipond how you would reach out, because of course the classic case about consultation or signals is that the market will respond and react to it, and that could dissipate the benefit that could be received. So tell me what kind of structure would the industry like to see that would satisfy it, but would still allow the FPC to make use of these instruments to the benefit of stability and financial markets?
Mr Vipond: I think, to get to the nub of your question, it must consult more widely with stakeholders in the UK and internationally, because the sorts of crisis we now have are not UK-specific, for the most part. It must be more open; it must have a kind of expertise on its board and in its staff that's different from the past. But let's be very clear: it must have the right to act out of a clear blue sky with no notice and no particular stakeholder involvement. In other words, if it's required to act without telling the markets what it's going to do in advance, it must be absolutely clear that it has that right and there's no question about that. I think in that regard that the FPC's position is different from the PRA's position—which I know you weren't asking about directly. It seems to me, with the PRA, that we need to carry on with the benefits that the FSA has introduced about clear and formal consultation and appeal on everything it does. That's something we need to bring into the Bank of England for the first time.

Q250 Mr Love: I take your point about the PRA. Let me press both of you on the wider membership of the committee. We've touched upon it. How could we ensure that there is industry confidence in the Financial Policy Committee in terms of that wider membership? We've talked about the Treasury being more formally represented. What other ways? Who is it they need to involve? You've made the case about not using too many academics, but do we want to staff it entirely with industry people? How do we get a sensible balance?
Mr Vipond: I think there must be a case for some people on that group who are, for example, chief executives and chairmen of major city institutions, insurance companies, life and general, of course, and investment banks and others. They would be in a position where they would be, in compliance terms, beyond the wall—they wouldn't necessarily be able to go back to their firm and talk about any of the conversations they've had—but that would bring you a kind of market sensitivity at the highest levels. It would bring you a credibility and engagement and that has to happen, and it has to happen lower down. One of the failings of the consultation paper is it's all about what great men and women as chief executives will do. We've seen with the tripartite structures that that doesn't work if you don't engage people at middle and senior management in those companies and regulators as well.
Mr Saunders: I would agree with that. I trust that the FPC will carry on the present practice of the Bank of England with its excellent financial stability reviews that it publishes every six months. I think that it needs to set in place formal consultation mechanisms with different participants in the market. I think one of the striking things about—drifting off again on to the PRA—the PRA relative to the CPMA is that it does not have a practitioner or a consumer panel, which the FSA currently does and the CPMA will do. But I think some sort of body of that sort, where the FPC can consult the different participants in the market, buy side and sell side, would, I think, be advantageous.

Q251 Mr Love: Finally, can I just ask you, these are all matters of judgment which are of course difficult to lay down in guidance, rules or legislation, but is there any sort of framework that you can see—and I'm thinking about the comparison with the Monetary Policy Committee—that would help to ensure the confidence of the industry that the FPC was working within that framework and therefore it would be more satisfied that it was doing its job as objectively as possible? If the answer is no—I think most people would say that you can't set up a framework—then just say no, but I wondered whether you had any views on that.
Mr Vipond: I would very much stress, as Richard has stressed, this issue about the quality of staff and about the policy instruments as much as the institutional structure, and that needs to be where the focus of that expertise is.
Mr Love: Okay, thank you.
Chair: Chuka Umunna.

Q252 Mr Umunna: One of the things that is exercising me quite a lot is what's happening in Europe. We have a lot of people appear in front of us talking to us about these issues, yet so much of it seems to be affected by what's going on in Brussels. What do you think our new bodies, the authorities, the tripartites' position should be, or their priority should be in their negotiations with the European bodies active in these areas over the next two or three years?

Mr Saunders: I think the priority is to get stuck right in. There is a very large regulatory agenda coming from Brussels. I think that we cannot assume that the motives behind what comes out are always going to be aligned with the interests of the UK and it's very important for all UK parties to take this very seriously. As trade bodies, at least as much of our efforts now are focused on Europe, as opposed to the domestic authorities, and we try to work very closely with both the FSA and Treasury. On the current negotiations around the alternative investment fund managers' directive, for example, the Treasury has put an enormous amount of effort into reaching out to the industry and finding out what people think about different aspects of it, and that's the way we're going to have to operate going forward.

In relation to the new bodies, it is very important that the FSA should, at this point in time, be getting right into the establishment of ESMA and making sure that it has people in there; that there's the right sort of degree of UK participation in that. The UK—

Q253 Mr Umunna: Our reforms aren't going to be completed until what, 2012, and obviously with the FSA as it is, there's going to be a churn of staff. This is an incredibly unsettling period for the staff who work within that body. Do you think there is a danger that they will be taking their eyes off the ball as they look at the post-2012 scenario?

Mr Saunders: Absolutely there's that danger.

Q254 Mr Umunna: What do you think they can do about that?

Mr Saunders: I think they have to focus laser-like on Europe and not fall into the trap of taking their eye off that ball. It is something that people like us say to them all the time.

Q255 Mr Umunna: So it means you have to keep nagging?

Mr Saunders: Yes.

Q256 Mr Umunna: Mr Vipond, do you have anything to add to that?

Mr Vipond: To be fair to the FSA, it is enormously highly regarded on the continent, and quite rightly. The FSA is a repository of excellence, which will be carried on into the PRA and the CPMA, because the UK is a much more sophisticated market for financial services, where a lot of the standards, both in consumer protection and in prudential work, are a generation ahead of what goes on in Europe. I think that would lead me very much to the point that we shouldn't be too despondent. There's a real win for the UK if we take a positive, engaged agenda to Europe, and we work constructively to make the single market work better, and we work constructively to make things like the solvency II regime, the new prudential rules for insurance and the Basel 3 rules, get those in in a way that works for the UK and works for Europe as a single market. I think if we do that, frankly, we'll continue—and particularly the FSA—to be held in the highest esteem on the continent.

Q257 Mr Umunna: What do you think we do about this mismatch between the regulating structure at a European level and the new structure being proposed here, because they are quite different? I am just looking at the diagram of how each of the different bodies feeds in. They are quite different and what can we do to overcome that? Is there a danger that we lose focus, or priorities are not given due attention because we have different authorities here dealing with completely different authorities at a European level?

Mr Vipond: Well, it requires high skills in management and it can be done. Wherever you draw the lines, whatever the UK have come forward with in the White Paper we have, then even within the UK, the day after you draw those lines, you have to work about pragmatically working across them and getting the right people in the right room on the right issues. That's the same issue in Europe. I do think a lot of the European structure for solvency for the prudential side works pretty well, because it will reflect what's going on. The banks and the insurers, which are the major prudential regulated firms—because unlike the fund managers, the banks and insurers hold risks on their balance sheets, they have the sophisticated Basel insolvency rules—that will go through to the European Banking Authority and the European Insurance and Occupational Pensions Authority.

I think the more interesting work for us, or the more problematic work, is around the area that Richard has already referred to, the European Securities and Markets Authority, because that body has to do wholesale and retail conduct of business rules and that will fall differently across Europe.

Q258 Mr Umunna: What about the Treasury, because obviously Treasury has a role here? How do you think that the Treasury should be engaging with the European authorities? I would also ask a subsidiary question to that, without appearing vain for the Committee that is. Do you think there is more of a role there for us as a Committee in terms of the way the Treasury engages with its European counterparts, given the volume of regulation and legislation coming out at the moment?

Mr Saunders: I think that is a very good and very interesting question. My observation, as somebody who deals with regulators and legislators, is that the great weight of stuff that comes and hits us as an industry comes—we go and talk to people in Brussels, we talk to members of the European Parliament but we don't come along and talk to members of the UK Parliament about it.

Mr Umunna: About the European—

Mr Saunders: Yes. All the significant stuff that affects us comes from Europe, yet the UK Parliament is completely outside that process. To me, that's very striking. Your colleagues who are in the European Parliament are very heavily engaged in all these negotiations but it seems—

Q259 Mr Umunna: We're slightly apart from it, yes.

Mr Saunders: Yes. And it's quite a big constitutional conundrum I think.

Angela Leadsom: It is.

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Q260 Mr Umunna: Obviously, there are things on which we will disagree with European legislators and regulators and there are ongoing debates; bonuses for example, some of the stuff that came out of Brussels last week. What fights do you can think we can afford to lose and what debates do you feel we can't afford to lose going forward? I suppose you could start with the bonus one for example, because obviously there was a difference of view between us and some of our European counterparts on some of the proposals that were being put forward last week.

Mr Vipond: Yes. I think, if I were answering that trying to be very analytical, the ones we can not so much afford to lose but the ones where we should be looking to build a majority consensus across the single market are very much around how customers are treated, the next generation of customer rules and follow-up rules, so that it's possible to make the internal market work to the benefit of consumers more and get better outcomes. There, I think, we need to make sure that those internal market rules have legitimacy across the EU and we get a buy-in as to what the single market should look like, because I think if we get that then some of the other things would be easier to fight on.

On the specific question of bonuses, clearly, there is a wish to regulate bonuses across the world at the moment. The G20 in Korea this autumn will discuss bonuses and VAT taxes and the rest. There is a tremendous upsurge in interest in how you regulate remuneration in the banking industry primarily. I do not think it's so much a problem for insurance. To do that, I think it is still the case that the whip hand is with the national regulator because you have fiscal issues, and on fiscal issues the EU's authority and power base is much more restricted. So I think if you still want to be regulating bonuses nationally, then you are in a position to do so if that's your decision.

Mr Saunders: I think things we cannot afford to lose are those that are essentially protectionist in their nature. The UK is by far and away the primary financial services centre in Europe. We have an important national interest in it because it's an important part of our economy. The AIFM directive, the alternative investment fund managers directive, is in its final stages—we are getting a new draft every day practically—but certainly versions of it we have seen would be quite overtly protectionist in that they would deny access to the European market for funds and products based outside Europe. Were we to see retaliation by the US Congress against that, then the principal losers would be fund managers in the UK. Those are the important battles, I think.

Q261 Chair: Don't you think the biggest tool we can deploy to deal with bonuses is increased competition and a reduction in protectionist environments?

Mr Saunders: Yes; I think that is absolutely correct.

Q262 Chair: Do you agree with that, Mr Vipond?

Mr Vipond: I do. There is no Archimedean point to bonuses. There is no one thing you can do that will resolve it. It's a complex issue. It has been going on a long time. The UK has quite a good record in things like Cadbury and Greenbury and the new stewardship code, and we haven't got there yet. It's a journey. But if you could make a more efficient market and if you get those macro-prudential rules right as part of that, so you don't get those bubbles, then you don't create the opportunities for those absurd bonuses. That is part of the picture.

Q263 Chair: Putting words in your mouth, aren't I right in suggesting that if we are not careful we're going to write new regulation that could generate the conditions in which the bonus culture is sustained because it creates the opportunity for protection?

Mr Vipond: Yes. I think that could well be true. If you get protectionism within Europe and people cannot get access to markets and markets do not function, that is a way that people can earn excess economic rent.

Mr Saunders: I absolutely agree. Most fund managers would take the view that there is insufficient competition in investment banking. I think they would perceive that there is a global oligopoly of investment banks.

Q264 Chair: And it has become worse?

Mr Saunders: There has been more consolidation through the crisis and I think just one tiny step, which I hope is a step in the right direction, is that the IMA Chairman, Douglas Ferrans, is currently leading a study to look at the issues around underwriting fees charged for raising equity capital through a rights issue that have been steadily rising while the apparent risks associated have been falling. So that report will hopefully appear about the end of November and, while I wouldn't want to promise anything revolutionary from it, hopefully it's the beginning of a step just to push back. The problems of excess rent extraction are essentially problems about a lack of competition.

Chair: Very helpful. David Rutley.

Q265 David Rutley: I think everybody would agree that savings ratios aren't where they need to be in the country and I think Money Marketing has launched a new campaign, "Pave the Way to Save". Should the CPMA have a statutory objective to encourage people to save?

Mr Vipond: Yes, it should and it should also address the issue that, in this country, when your constituents seek debt it's delivered to them. In fact, they do not even have to seek it. It comes to them as an offer just about every day. But if they want to save and they want to take some responsibility for developing medium and longer-term savings, it's often very difficult for those products to be sold to them. It's often an enormous compliance process and it puts people off, particularly those who are perhaps not used to doing it and are not natural savers. So we think, as part of the CPMA's work, it does need to have an obligation to support and to promote savings in the context of feeding into the discussion we've already had at this session about macro-economic stability and getting the balance right in the UK.

Q266 David Rutley: Before we come on to you, Mr Saunders, what do you think about Mark Hoban's view that that's absolutely inappropriate?

Mr Vipond: Mark obviously has a leading role in this and we respect and listen to his views and it will be part of the continuing dialogue, but if we don't have a situation where somehow or other the conduct of business rules in this country are rethought and reworked, it becomes very difficult to turn around the situation we have in this country where people, the majority of the population, are not saving the sorts of sums they will need for their own long-term well-being, given the kind of political decisions we see on a daily basis now about a state that's going to do less for more of the people.

Q267 David Rutley: Mr Saunders?
Mr Saunders: Right; I'm in a slightly different place from Peter on this, partly, I think, because fund managers are not generally involved in the selling process as intimately as life companies are. I think we're not pressing for a savings objective. While it would be nice if the CPMA acted in such a way as to encourage saving, I don't think it is something that's entirely within its gift. I think a lot of the levers for encouraging saving sit with Government. I think the biggest, single step towards encouraging saving that has been taken in the last several decades would be the introduction of auto-enrolment in 2012 and that will make a serious contribution to encouraging people to save for the future. There are probably things one could do around tax relief, although now is not the time to be looking at new tax reliefs given the fiscal situation. I wouldn't see the CPMA as being central in the encouragement of saving.

Q268 David Rutley: Do you think, if the CPMA isn't the body to do it, is it the consumer finance education body? Who is going to chivvy that along? Who's going to push that forward?
Mr Saunders: Ultimately I think people respond to incentives. Clearly, people having a better grasp of the issues would help. On the whole, I think I'm a little bit sceptical about consumer education because people receive when they're motivated to receive. Again, I think that auto-enrolment and NEST will have a positive impact. Once people start receiving a statement a few years down the line saying, "You now have £15,000, or whatever, in your savings account", that will grab their attention in a way that any number of well-meaning consumer leaflets won't.

Q269 David Rutley: You were shaking your head pretty vigorously on that, Mr Vipond.
Mr Vipond: I was sharing perhaps some of Richard's scepticism about consumer education. I think it's entirely laudable, worth while and important but the idea there are going to be short-term and immediate benefits from it in terms of a savings culture, I think we have no evidence to support that. That is why I think the CPMA needs to take saving very seriously and indeed it will inherit the RDR and the RDR is part of the way in which you make it easier for people to get simple advice, get them into basic savings products and get them started and that should be part of the new agenda.

Q270 David Rutley: Thanks. I just wanted to move on to consumers. You also have quite strong views, it would seem, on what the CPMA should do or not do for consumers, saying it's entirely inappropriate for the CPMA to be a consumer champion. Surely the whole point about the CPMA is to provide some sort of protection for customers. So could you explain your comments on that?
Mr Vipond: I think it's the word "champion". As you saw in the previous session, there is this issue of to what degree the CPMA is to be some sort of retrospective advocate in all cases for particular decisions. The CPMA will be judged ultimately by the degree to which: it delivers good outcomes for consumers; they can buy the protection, the general insurance, the life savings, the products they need, the bank accounts that they need; those products are delivered; there is a competitive market on a reasonable basis for consumers; consumers win out on this; and the CPMA comes down heavily on bad practice in the financial services sector, where that is to consumer detriment. We support all of that, but we think it should be done on a principle basis, on a basis where it uses evidence to make decisions and really helps consumers most by making financial services markets work as best they possibly can.

Q271 David Rutley: But not retrospectively a champion?
Mr Vipond: I don't think it is right and I think it would be very seriously damaging to some of our firms; particularly in insurance we've seen it. When the FSA tries to rewrite the rules after the event, it can do a great deal of capital and prudential damage to insurance companies and it can very quickly take out whole areas of product. For example, in the first part of this century, with-profit savings were a great savings product for this country and were used by many consumers. Some of them had problems; some of them were far from perfect. But FSA regulation has meant that we now sell a tiny part of those products. Similarly with PPI in 2009, I don't know if you have seen the figures but payment protection insurance collapsed in 2009. We now sell less than half of what was sold at the beginning of the year. Now, there were some bad practices in the selling of those products by banks and those had to be addressed but, at the end of the day, consumers benefit most by modern, efficient markets and financial services.

Q272 Mr Rutley: Any thoughts on that?
Mr Saunders: I agree on the consumer champion point but I think, in a sense, there is a slightly false argument because when you look at the proposed statutory objective that is in the Treasury paper, which is an objective of "ensuring confidence in financial services in markets with particular focus on protecting consumers and ensuring market integrity", I think that captures extremely well what the role of the regulator should be. I think that the use of the word "champion" has created a bit of a false debate. I think the statutory objective is what matters.

Q273 David Rutley: Moving on to competition, it's not exactly clear as we look at the new structures as

to who's going to be responsible for monitoring or encouraging competition—should it be the PRA, should it be the CPMA—and especially with the news today that the Competition Commission will consult with the OFT about the merger of their functions. Any thoughts on that, because obviously that's going to be quite important particularly perhaps in banking, so in your sector?

Mr Vipond: I think it is very important and I think we would want to see both the PRA and the CPMA having a remit to look at competition and the competitiveness of the sector. I think that's part of the competition debate. It's to make sure that markets work but that the UK financial services industry is competitive in global terms; something in the past, frankly, the regulators have not done, have not addressed. I think that's important because if they're competitive within the UK as a sector and globally, then that again is going to be a real win for consumers and indeed for shareholders.

Mr Saunders: The CPMA and the PRA are not competition regulators, that is a function that remains with the successor to the Competition Commission, but they need to have regard to competition because of its importance as we've already discussed.

Chair: I just note in passing that Equitable Life wasn't the best advertisement for with-profit schemes and I will leave it at that. You did say one other very interesting thing, among a number of interesting things. You said that there was a huge compliance cost to the sale of savings. We're very interested, in the Committee, in trying to establish what the real compliance cost is of regulation. That is the full cost, not just the cost of running the bodies that do the regulating, or just the cost of running the compliance departments within firms, but the cost of the work generated by those compliance cost departments within those firms as well; all the phone calls and the activities that take place. Much of this, perhaps all of it, is justified. It would be hugely helpful if, on behalf of your respective industries, you could examine in detail what you think the full compliance cost is of existing regulation at this time of turbulence in the regulatory structure, which would help inform us about what structure is most suitable in the years ahead.

Thank you very much for coming to see us today. If you have further thoughts, please come back to us.

Tuesday 19 October 2010

Members present:

Mr Andrew Tyrie (Chair)

Michael Fallon
Mark Garnier
Andrea Leadsom
Mr George Mudie
Jesse Norman
David Rutley
John Thurso

Examination of Witness

Witness: **Mr Martin Lewis**, moneysavingexpert.com, gave evidence.

Q274 Chair: Thank you very much for coming to give evidence to us this morning, Mr Lewis. Could you tell us whether you agree that the new CPMA should be a consumer champion?

Mr Lewis: I certainly think it should be pro-consumer and I'm delighted to hear that it has a pro-consumer remit. I have wrestled with the concept of it being a consumer champion as I think, certainly, from my own perspective, having lobbied over consumer issues and pro-consumer issues over years, there are some things I know I can say that, no matter how much freedom of remit the CPMA will have, it will never be able to rant and tirade in quite the way that sometimes consumers need.

Whether it should be a full-on consumer champion, which for me is not balanced—I'm very lucky I don't have any intrinsic need to be particularly balanced in my view. I am, unapologetically, one-sided in the way that I work. I think the other consumer champion organisations out there: Consumer Focus, which I'm very, very disappointed to see to be going, or Which? or Citizens Advice, are unapologetically pro-consumer, and I think there are some difficulties with the regulator going quite that far. So I wrestle with the point and the term "consumer champion". I'm certainly delighted to see it have a very strong pro-consumer remit and be reacting to the consumer champion bodies that are out there. But whether, in reality, a regulator can truly be "the" consumer champion I find a difficult concept.

Q275 Chair: Do you think that increased competition is likely to be the best consumer champion?

Mr Lewis: I have always been a fan of increased competition, apart from when the action that that competition takes has been to tie up the market, which we've seen in financial services. It's a very limited marketplace and we do know that banks tend to operate in a very similar way. If we take the old example of bank charges for going beyond your overdraft limit, until the recent investigations into bank charge reclaiming, there was no competition in that market. The difficulty with competition, when we talk about the financial sector, is that the competition takes place on the headline rates, so banks will compete over interest rates, over introductory bonuses, over overdraft rates, but often, on the bits that people never think of, the stealth charges, the bits that people don't see, there is no competition in those marketplaces and no way to avoid them. So I think, certainly, competition addresses some of the problem. Competition certainly helps and I genuinely believe that, in this country, we have a relatively competitive financial services sector. There are those who argue that we should have a limited choice of mortgages out there because that would aid people's problem with confusion. I disagree. I think we want as much range and as much choice as possible. But what I would hope to see a regulator do is make sure that there is real choice and real competition, right across the board, in all areas of a product, but there only is in headline rates.

I have two big problems with the way the situation works at the moment. The regulatory system is massively complicated and we have a financially illiterate public, and those two things do not add up. My second point would be that banks and financial institutions, deliberately and maliciously, use the complexity of the system to avoid recompense and redress when they do things wrong. Those two things are very severe problems, in my eyes, that need to be looked at.

Q276 Chair: The first of the two things that you referred to, before you got into that second set of two, was stealth charges. Presumably, what we need from the regulator is pressure to ensure that those charges are not stealthy but are visible and costed out, so that consumers can make informed choices?

Mr Lewis: Yes and no. The problem I have with the way we've dealt with stealth charges in the past—I'm going to use credit cards as an example because it is the easiest to describe. One of the problems for me is that consumer credit isn't part of the remit of this regulation, which I don't understand frankly. I find that a very difficult and confusing issue and I know many consumers do too. But let's take credit cards for a second—

Chair: That is a very difficult case you've moved straight on to, perhaps one of the most difficult for establishing clarity of charge, but anyway.

Mr Lewis: But I'm going to use it as—

Chair: There are easier examples than that.

Mr Lewis: Can I give the example of the problem with how we regulate over stealth charges because I think this will make more sense than using an easier example? We introduced a few years ago—after much lobbying, which I wasn't a part of—credit card summary boxes. Now that was because there was a demand that you must know the information, and the detailed information, about a product.

I gave a talk at a university I'm a governor of the London School of Economics. With regard to the Lloyds advance card, I asked the students what it meant when it says in the summary box for the interest free period—"None". Nobody knew. A few of them stabbed, as many consumers think, that it meant that there wasn't a 0% period for six months or for a year. What it means is, even if you pay the card off in full at the end of the month you will pay interest on it. I asked the same about repayment hierarchies, nobody understood what that meant. I asked the same about credit card loading.

My problem with making stealth charges less stealthy is we need explanation, not information. One of the great excuses the industry has given over the last 10 years, of how it has improved, is it has given more information. But with no financial education—I'm a great believer in compulsory financial education in schools; an issue for another day—and a financially illiterate public, giving information doesn't do the job because people haven't got a bloody clue what it means.

My problem with saying what a regulator should do is make sure they're not stealthy and that companies have to publish them, well what we end up doing is publishing a massive range of charges. We tell people what they are but people don't look at them and don't understand. It's a more difficult problem than just providing the information.

I read the submission from the head of the BBA when she was talking to you, I think it was last week, and she talked about needing to provide information. This is the great excuse of the industry: we give them all the information. But I'm afraid if you were interviewing real members of the public and you asked them even basic questions about financial products, they wouldn't understand them. Information is not good enough. It is not good enough.

Chair: Just to summarise your overall view: the regulation is far too complicated and, therefore, not achieving its purpose, and the industry is hiding behind complexity, part of which is a result of the massive amount of regulation, in order to rip off customers.

Mr Lewis: Let me make the second point very plainly. Perhaps the biggest scandal in—

Chair: Do I have that right?

Mr Lewis: Yes, bang on.

Chair: All right. Carry on. Make the second point in the way that you would like.

Mr Lewis: PPI reclaiming is a campaign I've been involved in since 2007. One million template letters have been downloaded from the website on this one. I will explain it to you in the same way that I tell the public when I'm on television or radio, because my job is to try and bring this down to its ultimate nub. I say, "Here are some of the reasons you may have been mis-sold. They told you it was compulsory; it isn't. They didn't tell you, you have the product. That's a classic mis-selling. They didn't ask you whether you had a pre-existing medical condition. They didn't check whether you were self-employed so the policy doesn't cover you. If any of those applies you may well have been mis-sold. This is what you do: you write to your bank, you explain why you've been mis-sold and your bank will tell you to get lost. Expect it to tell you to get lost. The fact it tells you to get lost has no bearing on whether you have a case or not. It will almost certainly tell you to get lost. It will do that with a large letter in legalese telling you why you have absolutely no case. That is part of the dance. You then take that letter to the Financial Ombudsman where you have an 81% chance of winning; a four to one chance of getting resolution in your favour". Those are the stats from the Ombudsman in payment protection insurance. Every one of those 81% have been rejected by their bank with a letter telling them, "You don't have a case".

Well that is absolutely ridiculous. There is an eight-week period you have to wait and it is a deliberate policy of attrition of the public, so that they cannot get justice by using a devious form of rejection to try and stop people claiming. Claims-handling industries have grown up on the back of this, when all you need to do is go to the Ombudsman. They charge 25% of the £3,000 or £4,000 that people are owed. They have already been ripped off once. They are taking their money yet again, because the system is too complicated and financial institutions are allowed deliberately to use confusion to stop people getting redress. The very simple solution for me is: any sector where the Ombudsman upholds over 30% of cases should automatically be reviewed—I would do it by the Ombudsman because I think they're in the best position—and all that sector needs to be looked at. We need to stop putting people through the mill of this. Everybody knows that while payment protection insurance can be a good product but the ones sold by banks are a rip-off. It's a pure and simple rip-off sold by the banks. It has been a rip-off for years. I love the fact I'm allowed to say that freely in here. It's been an absolute rip-off and it should have been stopped. What we should have done is come down, and instead of people having to complain about it, when this is ill-informed members of the public who have absolutely no way of fighting their corner—I'm going to say one more thing and then I'll stop my rant. My template letters, I have been told—

Chair: I don't know what you have for breakfast but—

Mr Lewis: I've been up doing telly already. I've been going for hours. This is why I get upset about this: on the template letters we send, people are asked to put in their names and address and their financial details. I've been told that about 5% to 10% of people, where it says "your name", "your address", leave the "your name", "your address" in, and where it says "put in your account" they leave "put in your account". They just send the letter without adding their personal details. Now you can laugh at that, but for me that means there are people in this country so desperate and so trusting, and—whether it's due to mental handicap, whether it's due to mental capacity issues—so unable to deal with their own financial issues that they just send a template letter without putting any details in, in the hope that they will get redress.

For me, those are the people we should be protecting, and the only way we can protect those people is by a proactive stance so that when we can see obvious

systemic abuse, as we can—just look at the Ombudsman's stats for complaints upheld; it shows systemic abuse; it shows lots of cases where people have been rejected, then over 50% of the cases are upheld by the Ombudsman—there needs to be some form of automatic investigation and ease of redress for people. Payment protection insurance could be up to £10 billion mis-sold and we have not handled it. It's a disgrace.
Chair: So we have to point this legalistic pirouette with the banks, which they're engaging in, in order to minimise payouts and engage in attrition with the consumer?
Mr Lewis: It's a tactic. It's a pure and simple tactic.
Chair: That is basically a summary of what you've said..

Q277 Jesse Norman: I would like to just ask you about the FSA and the retail distribution review that's been done. That's a review which has caused, I think it is fair to say, a great deal of concern in this Committee and among other Members of the House. Could you just give me your view of whether you think it's a sensible piece of regulation and whether you think IFAs have been fairly treated by it?
Mr Lewis: I'm rather worried. Funnily enough, many financial journalists are very pro-fees, when it comes to IFAs, and think that IFAs should charge fees. Probably, by the nature of what I do, I deal with a wide spread of the public. The websites have 10 million unique users a month. It's a very wide range of people. I worry that if you ask people to pay for financial advice they will not pay. Now, I'm not the greatest fan of IFAs, but I certainly think they're far better than tied agents and are well worth people going to on issues like protection, pension and investments especially for somebody who doesn't have a clue. I sometimes worry about which is the worst evil: having some IFAs who are paid commission and who have limited levels of commission bias, which should be regulated very stringently to try and reduce the commission bias, or not having people go at all.
So I'm not 100% convinced of the idea that fees solve everything. I think, to an extent, what we're going to end up having is tied agents who are getting commission, going in selling hard. It's very difficult for the public to understand the concept of tied agents—multi-tied IFAs—going in selling hard. People go into their bank and think the salesperson, who is commission incentivised, selling them payment protection insurance, is a financial adviser. That's difficult enough. To tie IFAs' hands by not allowing commission, certainly in environments where people would prefer them, seems to be a problem for me. I understand there are some solutions to that, in that they can keep the commission, but they tell how much it is and rebate if it's over a fee level. It's not my strongest area. It's not what I look at because, basically, in the areas that IFAs look at, I tend not to because that's not my job, if you know what I mean. But I'm not convinced fully.

Q278 Jesse Norman: Let me put the question a different way: do you think there is a segment of the investing public that would be disadvantaged by the threat to IFAs from a loss of commission income?
Mr Lewis: I need to be honest with you: I don't cover investment. I don't. So I don't think it would be fair for me to give you an answer because I'm not well enough informed on it.

Q279 David Rutley: We had a conversation with Peter Vipond from the ABI recently, and he felt very strongly that the CPMA should have a statutory duty to encourage savings, and Mark Hoban is absolutely opposed to the idea. Based on what you have been saying about the importance of education, where do you think things should fall?
Mr Lewis: I think we should first encourage people to pay off their debts, and I think that's one of the great dangers that we have going on right now. I did a talk at the Building Society conference a few years ago, and I asked there, "How many of you are savings managers?"—this is mutuals—and they put their hands up. I said, "How many are remunerated by how much savings you bring in?" They put their hands up. I said, "How many of you tell your staff that if customers come in, the first question they should ask them is, 'Do you have a high interest rate credit card, and have you considered paying that off before you start saving'?" No hands went up. I am very pro people saving—although whether the economy needs it or not is another question; I know the Bank of England doesn't necessarily agree—but they have to pay off their debts first. This is always the problem when we have blunt ideas of how we work things.
So I would first have a debt reduction plan and make sure people are incentivised, first to reduce their debts and only after that to save. If you have debt on an 18% credit card, savings are at 3% after tax, 2% in a high street or even in a top savings account—pay off your credit card. It's the best way you can save. Frankly, going forward, with mortgages now at 5% or 6%, for many people paying off their mortgage, as long as they have an emergency fund, is better than saving. So should it have a statutory remit to encourage people to save? Yes, as long as you count saving in that wider context of reducing debt as being a part of saving. I don't know whether it did or it didn't; you have to forgive me.

Q280 David Rutley: Following on from there, what worked well, in your view, with the FSA, and what should be transferred across to CPMA? You highlighted an interesting theme—I know you've been preaching it for many years—about education. How do you think that can be best picked up? So two questions, really.
Mr Lewis: I'll start with education first, if I may.
David Rutley: Sure.
Mr Lewis: It's very difficult not to go on a polemic on this. I've always found that quite difficult. The fact we don't have compulsory financial education in schools, when we've had student loans in this country for 20 years and we have educated the nation into debt when they go to university, but never educated them about debt, is a national disgrace. We're just about to introduce potentially much bigger student loans with real rates of interest, and we are still not going to have

compulsory financial education of the people who are going to borrow them. We are going to get them to hang the debts around their neck without understanding it. That is wrong in every single system. The main thing we could do to improve your regulations—to stop mis-selling, to have better informed consumers, to have more responsible borrowing, to penalise irresponsible lenders—would be to teach every child in school how finances work. If they started to understand it, all these problems would diminish.

I think the FSA has done some reasonable work on that. It's not for the FSA to put it on the national curriculum. It is for Members, and it's very nice to be talking to you about that. The education system—and I'm probably rent-seeking here. I own the UK's biggest money website; it's important I say that before I say what I'm about to say. The FSA has done things like setting up Moneymadeclear. It's done the classic thing of government, which is you see something that works well and you try and replicate it in your own image. It hasn't worked. It has a very small amount of traffic, compared to my site and other sites. It is this type of idea that Government considers it needs to do itself rather than work with external websites. I would be quite happy—and I suspect many of the other sites would be—if the FSA told us what it thinks we're doing right and doing wrong, and gave us a stamp of approval, rather than spending its own money on replicating what we are doing and it never being read, or not give us the stamp of approval if it doesn't like it.

The way that education has been done, for me, is relatively staid and relatively boring. A word I never use in my public broadcast is "finance", and it's the word that we're here to talk about. Finance isn't interesting. Looking after the pound in your pocket is. Saving money is interesting. Beating the system is interesting. When we talk about education, we have to not do it in a po-faced way. We have to do it in a way that shows that by being educated you can gain. I think the FSA has had some good remits on its education and CFEB, I hope, will help and improve that. But I still do think that, unfortunately, we do it in such a worthy way that it doesn't work well enough, and people don't necessarily trust those institutions. I'll just give you an example. We have the FSA; we have the Ombudsman; we have the FSCS; we have the OFT; we have the Competition Commission. If you ask the public what they do, most people wouldn't know.

If you want your savings to be safe, you have to split them into institutions that aren't linked, but Halifax Bank of Scotland is one institution; RBS and NatWest are two institutions. So you could put £50,000 in each of those and you'd be safe, but only £50,000 in Halifax Bank of Scotland to be safe. If you want to find that list, it doesn't exist on the FSCS website. It exists on the FSA's website, even though you're protected by the FSCS. On the FSA's website, the only way you can look this is up is by looking at the banking registration on this. We have it on our website. We've done it and I have someone who works to keep it up-to-date. That type of completely disjointed thinking that people can't penetrate, unless they work through the system, defeats all forms of education anyway because we're not giving the information out in the first place.

I don't think the people who are doing the education understand how consumers think and need the information to come across to them, and until they do that, the education won't work.

Q281 David Rutley: So are you planning a reality TV show to help make this more accessible?

Mr Lewis: If the television companies would give it to me, I would do it. I did a team cash class three years ago, where I went in and taught 12 15-year-olds of mixed ability how to save money. We sent them home and they saved their parents £5,050 after a day's lesson. That teaches you two things: one, we desperately need compulsory financial education in schools; two, we could do with some compulsory financial education of adults as well. So I would love to do that. Unfortunately, it's the TV channels who have to decide—not me—whether that happens. But yes, that type of thing—the opposite of The Apprentice—trying to teach kids to be money-saving experts. We've made entrepreneurship programmes, and that's great, but we need to make being a good consumer and understanding that important as well. We're just coming out with our own curriculum guide that we've been working with pfeg on to go and help teachers, but all that work could be done.

As for what the FSA has done well, well, it has done some things well. It needs to be proactive; it needs to be spotting flaws before they happen. I think that's one of the great problems that we have at the moment. There is a genuine disconnect between the people at the top of organisations and the people creating products; the FSA isn't necessarily talking to the right people. There is a disconnect between the manufacturers of product and product marketing, which means what the product is set up to do is often not what it is being sold to do. There's a disconnect between the people selling the product, those at the coalface, and what is going on with top management, and I think in many ways the FSA hasn't been quick enough to look at all those different elements and bring its regulation in. It has done it on certain occasions. I thought what it did on mortgage administration fees was a great piece of work. It spotted a problem, it told them they had to change and companies changed it.

But banks and financial institutions are incredibly good at coming up with clever new products, not just in the derivatives market—that I know is another part of what you're looking at and I don't understand, frankly—but in the consumer finance market. We look at these very carefully, and the number of times we see a product that is marketed and we get very excited and think it will be great to tell people about, and then we spot a hole. It comes up all the time. Now, whether we should regulate away from that or whether we should just make sure they communicate what that flaw is, unfortunately doesn't work because no form of regulator is quick enough to spot this. When a new product comes out and the marketing goes in heavily, and they're following the existing regulations, but they've found a new way to make profit and to take

money out of consumers' pockets, I can't see any regulator being quick enough, which goes back to my original point about whether it should be a consumer champion or it should be pro-consumer. We need a way for people to filter into that process. If I spot problems that I think should be changed, I don't know how to do it and I'm one of the biggest gobs out there on the subject. And I don't know how to get something changed, because every time I've tried to do it, it doesn't work, or at least to get something looked at. So how does that happen? There must be a way that people can filter in to get things looked at when there are problems.

Q282 Mark Garnier: You've talked about problems being education, too much information, obfuscation, complex procedures, confusion, all this kind of stuff. Turning more specifically to the products that you list on your website, do you see any common thread coming in when things go wrong amongst the products themselves, as opposed to the overall umbrella?

Mr Lewis: Common? No, and it's very important that the answer to that is no. That's the great difficulty, there isn't a common thread. But there are common confusions that go on out there. One of my little agenda points—while I have my chance to say something—that has to be looked at here is the concept, for example, of FSA registration, as opposed to FSA regulation. We've just had the collapse of Crown Currency Exchange, which many people are very upset about. This was an FSA-registered company, which frankly means nothing. But when you read what people are very upset about, it is that this is a company that had "FSA registered" on its website, which people thought implied something, but means nothing. That type of confusion is a real problem. Frankly, it would be better not to have had that company being FSA registered, for all the good it has done being FSA registered, not to have had the stamp on the website, and therefore to have had no implicit—it's not a recommendation—legitimacy implied by its FSA registration would have been very useful.

When we talk about "product specific", the only thing that they have in common is that it's always very clever. What is done is always very clever. I and my team of nerds, and other people who work at this on different websites, try and spot them and we try and spot what goes on. One of the great problems I have with comparison sites is that people compare on rate. The best way to choose a product is to compare on rate and know how you use the product. Take a very simple example: cash back credit cards—wonderful products. People can make hundreds of pounds a year. I'm a massive fan, provided you, in font 100, say, "Set up a direct debit to repay the card in full every month so there's no interest". Now, choosing the best cash back credit card on rate and not doing that, defeats the whole purpose. That's a simple example. There are many much more complicated examples. I remember years ago Barclaycard set up the 0% for life credit card if you shifted your balance. All you had to do for that 0% for life was to spend £1 a month on it, which, of course, meant repayment hierarchies came into place, so that your expensive debt from spending was paid off last, your cheap debt was paid off first. Most people would spend far more than £1 a month on it. That debt would then get trapped in. Barclaycard would make its profit. We set up a direct debt system to charity for £1 a month to defeat it, and Barclaycard changed that product within three or four weeks, so that you had to spend £50 a month. It was six or seven months later that the regulation came into place that they couldn't use the 0% lifetime marketing on that product. So consumer reaction can be much quicker. But we knew what was going on with the product after day one, in fact before it was launched. I had it embargoed. But there isn't a rule.

The point is that this is a constant battle between new ways of making money come in, new ways of defeating them, and other new ways coming in. But the rule is: how they make money changes, and whatever we try and do now, or whatever the trends are now, will be different in two years' time, and new fees and new charges, and new stealth charges and new ways of manipulating, right across financial services, will come in. I perceive we have an adversarial consumer society; the companies' job is to make money from us, our job is to try and stop them, but we need some regulation to make sure it's a level playing field, which it has not been for a long time.

Mark Garnier: In summary, you are saying that there's an awful lot of pointy-headed boffins sitting in banks, trying to work out ways of getting around whatever—

Mr Lewis: And not enough pointy-headed boffins trying to tell people how to stop them.

Mark Garnier: I think your pointed head is the bigger one.

Mr Lewis: Thank you very much.

Q283 Mark Garnier: Can I just change to a slightly different subject, looking at macro-prudential tools. I think you said you went through Angela Knight's evidence last week. One of the things she talked about was the FPC's toolkit. This could include quite a lot of significant socioeconomic measures. For example, we as MPs may well see a number of constituents complain that they can't get a mortgage, because the FPC has made a decision to take the heat out of the housing bubble. Do you think, as a result of that kind of thing, you're going to see some potential conflicts coming between the FPC, the CPMA, CFEB, and possibly even Parliament?

Mr Lewis: Yes, certainly. If we take that as a very specific example, one of the problems that always happens when we talk about regulation of borrowing is that people start to get protective and say we need to protect people from themselves, from borrowing too much money. Those regulations are then enacted; let's say you put a 70% LTV cap on it, and say you can't go above 70% or 80% on LTVs. Or we put a limit on the amount that you can have on your credit card. What you effectively do, often, by those type of regulations is, you trap people in who already have existing debts. This is what we've seen, time and time again. It's what we're struggling from at the moment. We have a very competitive credit card market right now. We have the best 0% balance transfer deals

we've ever seen on the market right now, for those with fantastic credit scores. But lots of people with existing debts can't use them. So what tends to happen, when you look on a macro level, is rules are made that seem very sensible, but miss the impact on real people and real lives. Certainly, putting caps for people who are desperately trying to get to new borrowing out there, would cause a tremendous strain on the public.

We have a ticking time bomb in the mortgage market, right now. We have people who are at 4% over base on their tracker rates. They think they're getting a cheap deal because they're at 4.5% interest. If base rates go up to 5%, which would not be anomalous—now is the anomaly—they're going to be paying 10%; whereas, in the past, trackers were at 0.5%, 1%, over base rates. So, if and when, and I presume it is when, interest rates rise, whether it's in three years or five years, there's going to be an a absolute nightmare. It costs double on the way up, is an old phrase of mine. If you save £50 on the way down, losing £50 on the way up feels like losing £100. It's always worse the other way around. So when we start looking at FPC trying to control the economy by tools that affect real members of the public, we're going to come into conflict. You can go straight back to the Keynesian paradox of thrift. Over the last few years, when we've had an economic downturn, the work I do has probably been relatively destructive, because my job has been to tell people to pay off their debts and save, and keep your money aside for the bad times. Well, the economy doesn't need that, so how the FPC and the CPMA will conflict in those times, when the FPC wants people to spend and borrow, and the CPMA is saying, "Don't borrow, it's not good for you."—it's going to be a real problem, yes.

Q284 Mark Garnier: My next point, coming on from that, is that you then have, if you like, the MPC as the body that's going to be putting its foot on the accelerator, trying to get more liquidity into the economy and this kind of stuff, and then you have the FPC that is effectively going to be the one that's sitting with its foot on the brake. It's going to be very interesting, I think—I'm very interested in your comments on this—to see how the relationship is going to work, because, if we go back to the time when we started having quantitative easing, nobody knew quite how sensitive this was going to be; whether you needed a lot of foot on the gas, or a little bit, to get things moving. Do you agree that, when you're talking about the FPC using the brakes, that it could be a lot more sensitive than people are imagining, and do you think the FPC might, unwittingly, overly slow things down and cause a crisis, or do you think they might have to be very heavy footed to get the effects they're after?

Mr Lewis: I think there is always the potential for things to be slowed down much more rapidly than they need to be, and the consequences on the individuals who are affected is the real problem. We see already people who are in terrible trouble with their debts because the liquidity has gone from the market. You can read in various newspapers stories that, having the best credit card deals we've seen since before the credit crunch is either a wonderful thing and the market is bouncing back, or it's a terrible thing and banks are doing their old tricks and encouraging people to borrow again. That is the mirror image of the FPC, CPMA remit, going on right there. I worry, certainly now, that—you will have to forgive my lack of knowledge of FPC and MPC interaction—if you put interest rates up now, there's going to be a much closer track. It will be much more effective than it has been in the past, because there are so many people now on trackers, and so many people stuck on standard variable rates, that they weren't on in the past, so that we have more variable rate mortgages, from memory, than we did previously, and more people at high rates. So the reaction to putting interest rates up, certainly, would be felt much more keenly than it has done before.

When the FPC comes forward, in terms of closing down the economy, I do have some great worries of the impact that will have on real people out there. It tends to be those people—I think the political phrase is "the squeezed middle". I'm not quite sure it's the squeezed middle, I think it's the people just a bit below that. It's those who are working and struggling at the bottom end who are going to be squeezed by this; those who get the least amount of help, but have everything on a knife edge. There are so many people out there whose budgets are balanced at 0.5% interest rates, as we have now, and as soon as that goes up, or as soon as any other costs come in, they're not going to be balanced any more. There's no going back. If you continue to spend more than you earn, you're going to be in trouble, because if you can't fix that, you're in a debt spiral.

Mark Garnier: Yes, I see.

Q285 Michael Fallon: The Treasury document on financial regulation concedes that there will be higher costs, both ongoing and transitional, for most of the firms involved. How are those costs going to be passed on?

Mr Lewis: They certainly will be passed on to consumers, because any costs that financial institutions incur are passed on to consumers. That is a simple business model, and one would presume this will be in the form of worse rates or higher charges. From my perspective of the desirability of that, I think those who will whinge and complain are probably those, like me, who play the system personally, and get the very best deals that you can all the time, because they will marginally lose. But the people who will be better off by more stringent regulation are the mass of people who are financially illiterate, and who do need a form of protection out there. So from that perspective, even if it slightly diminishes the very best products, and adds more charges on, the sheer amount of money that people have spent on products, either mis-sold or that they should not have had in the first place and which don't quite fall into the mis-selling category, is many tens of billions of pounds, which is far larger than any increased cost of regulation on the retail financial services sector. I don't know the investment banking sector at all, and I can't discuss that. So I would still say it is worthwhile.

Q286 Michael Fallon: So you are not concerned about any increase in charges by independent advisers that may then be attributed to the changes in regulation?
Mr Lewis: Again, the IFA market isn't particularly the market I look at. I wasn't specifically referring to that. If people get decent advice that comes through, and that advice is correct, I'm less worried about it. It's very obvious and it's probably not very helpful, but ultimately, if the regulation works and protects people, I don't think there's too much of a problem having some form of increased cost to it. The problem will come if the regulation doesn't work and people are paying more. My great worry is the transitional period to a new form of regulation, and exactly how that will work, when people will only see disbenefits, as you always do when there is change, and yet we will see increased costs coming on, on the back end. Certainly, I think there are some brave decisions to be taken, going forward. But the IFA market is just not my market at all.

Q287 Michael Fallon: But generally, with firms, do you not see any opportunity to use regulation now, to reduce the costs incurred by consumers?
Mr Lewis: The interesting point for me is that the costs that consumers pay are generally very cheap, if you know what you're doing. I think this is the friction here, to talk about costs for consumers. Right now, you can have a bank account that pays you £100 to go to it, and 5% interest and a 0% overdraft. We have people getting car insurance for less than £20 a year if they use the right system, people being paid to take out their home insurance. If you're savvy and smart, costs are very low. The problem is, the majority of people are not using those techniques, and if they did, they wouldn't work.

Q288 Michael Fallon: How can we use regulation to reduce costs more generally for consumers, not just the clever ones who use your website?
Mr Lewis: I think you regulate so that products are fairer. It goes back to what I said in the first place: many of the costs don't come in the headline prices; they come in the ancillary costs that are never broken out and that aren't looked at, where there's no competition. They're only put in the small print, and people don't understand. If we go back to my great problem with "treating customers fairly" regulation—this does answer your question—I've always had a problem with treating customers fairly, in that I can set up the most abysmally over-expensive product with stealth charges and, as long as I tell you about it, even if you don't understand it, and I get you to sign on the line, and I follow the procedures, I am treating you fairly, according to the rules. For me, regulation needs to look at the real impact of the product, and product rate, and product charges, not just the procedure of product. So if you want to regulate to bring down costs, I would get regulation to work in a way that looks at what the product actually does, rather than whether the product is procedurally correct. Does that answer your question?
Michael Fallon: Yes, it does. Thank you.

Q289 John Thurso: I wanted to ask you about the Financial Ombudsman Service. Before I do, going back to the comment you made about our adversarial system—the consumer society—and the fact that those selling financial products set out to make as much money as they can, as long as it's sort of legal, it's a pretty predatory and irresponsible lending, and it's largely what has got us where we are. Should we have just a cap on the amount of interest you can charge on things like consumer credit and credit cards, and just say, "You can't go beyond that?"
Mr Lewis: I think on credit cards the argument is relatively simple. Having said that, I was suggesting, a couple of weeks, ago that people get a credit card that had 55% interest. The reason for doing that is, it's the only credit card they can get, and my suggestion was, they get that credit card and they set up a direct debit to pay it off in full every month, so there's no interest, use it for a year, and it will help rebuild their credit score. So there are certain tools out there that I wouldn't want to stop working, as long as people use them correctly. My problem with a cap on interest—I get so many e-mails and messages from people saying, "I've just seen an advert for a company charging 2,300% interest, that's disgusting, it should stop"—is that I did a pet calculation the other day which showed that if I lent you £20 and said, "Pay me back a pint of beer next week; buy me a pint for it," and the pint cost £3, that's 141,000% interest, if you compound it. Yet most people would say, "Buy me a pint and £20, is a pretty reasonable deal." Interest rates are a blunt tool. I'm more concerned about 8% secured loans over 25 years at a variable rate which then get increased up to 15%, 16%, which no interest rate cap would touch, than I am over 2,300% payday loans, where you pay back after one week. The problem with payday loans is they encourage you to keep borrowing, keep borrowing and it snowballs, not the interest rate, per se. So I'm not unsympathetic to the cap on interest rate argument, but I do worry that it is just too blunt a tool to have any real impact. I hope that makes sense.

Q290 John Thurso: Yes. Turning to the FOS, at the moment consumers pay nothing for the service, the charges fall on the industry and ultimately come back to the consumer generally. It has been suggested to us that there ought to be at least a small charge, in order to deter what was called the frivolous calls. What would your view be on that?
Mr Lewis: My view is that if you want to deter frivolous calls, you stop the banks rejecting people who have good cases in the first place. Until the banks stop doing that, they should absolutely—I can't swear in here, but they should get lost. That suggestion is deeply offensive. I encourage people to make so-called frivolous calls on the Ombudsman, because they are only frivolous because the banks pretend they are not valid—81% of people rejected by banks for PPI, then win at the Ombudsman. The banks would say they're frivolous; it's the banks being frivolous, and until they get their house in order, they need to bloody pay for it. First of all, the eight-week rule needs to go, making people wait eight weeks. I have stats that show 40% of people who complain to banks

don't get a final letter that triggers allowing you to go to the Ombudsman. That's the Ombudsman's own stats on investigations. The system is being abused by banks. It's free and it needs to stay free, because we're talking some of the—if you're making a financial hardship claim, and you claim you've been mistreated in financial hardship, to have something that deters you by putting a cost barrier in place, is absolutely, morally wrong.

There is a real disjoint here and finding these figures is very difficult, so please, I apologise if I have them wrong. I would love you to find out what the real answer is, because we've tried. Our researcher who did it is in here and he spent a day and a half and we couldn't work it out. 1.6 million financial complaints in a six-month period: half of them are dealt with by the banks, 800,000 aren't dealt with, 80,000 people go to the Ombudsman. That's wrong. Only 10% of people are getting to the Ombudsman on the complaints. Those stats may be wrong, because they're very difficult to work out, but it's certainly a very low proportion.

What we know is the banks' policy of attrition works. Any barriers put in place to deter claims we should not have. We need to encourage. We need to resource the Ombudsman, encourage it, and as I say, it needs some form of proactive power. The Ombudsman is the best institution of state in a position to spot systemic problems. It is in the right position, because customers know when they're being diddled and they complain and the Ombudsman sees it. The fact that the Ombudsman cannot do anything on a wider scale, on a group scale, it can only be reactive and not proactive, I think is one of the problems in the current system.

Q291 John Thurso: That was going to be my next question. In this mix of change, what would you recommend, bearing in mind of course—and they made this point to us very strongly—that they don't want to be a consumer champion because that detracts from their ability to be an independent adjudicator. So within the role of independent adjudicator, what should we be looking at for them?

Mr Lewis: We currently have a flagging system where they can flag to the FSA issues, but I haven't seen any evidence of that bearing fruit at all. I don't believe it is taken seriously or a priority. On bank charges, regardless of what happened in the Supreme Court, it was two and a half years and 6.5 million template letters before anything was done. Now, 6.5 million is a very big number. A large proportion of society was doing it before any form of institution of state dealt with the issue. They were going through the Ombudsman, as PPI are going through the Ombudsman now, scores and scores of cases, even though there's a claim being put on hold. There is a disjoint. It seems quite obvious to me that the things that people are complaining about are winning and are doing it en masse. You can probably assume that for everybody who complains there are about 10 people who don't complain and who are being dealt with in the same way. It's a very simple system of spotting systemic abuse, but the fact that nothing is done—

Q292 John Thurso: So it would be a duty on them. If they spot something that is defined as systemic, the duty would be for them proactively to take action?

Mr Lewis: There needs to be a duty on someone else to deal with it and deal with it quickly, because the problem with regulation is it is so slow. When peoples' finances are in trouble they can deteriorate within a matter of months. The number of suicidal e-mails I'm receiving from people in bad debt at the moment is horrendous. It is absolutely horrendous. Often when you read it, it has been three months, everything has just gone. It's that dire strait of desperation where people get themselves in trouble.

There is a nine-month queue for PPI claims at the moment—because of resource issues and because people like me have been pushing it very heavily—which is too slow. The Ombudsman does not have the resources and is trying to do other things at the same time. The point is all these cases are the same; they're the same case. They are all resolved in the consumers' favour. I'm not a financial regulator, but why can't someone say, "Look, we have 81% of these cases. These cases are similar to the 4,000 we've had before. Every case you get like this, Mr Bank, instead of rejecting it, deal with it"? Someone needs to be able to say that.

The eight-week wait and the fact that if I send a letter today and I send an identical letter from someone in an identical situation in eight weeks' time, and this first letter has been adjudicated by the Ombudsman in the consumer's favour, the bank will still reject the second letter even if it is identical, in an identical circumstance, can't be right.

John Thurso: Thank you very much.

Q293 Mr Mudie: I am a great admirer of your websites and I send my constituents to you when they raise problems. But I think today it's more important you tell us what you think we should do. The Chairman started off with the first question, "Should the regulator be a consumer champion?" I would answer in this way, that I have not seen any of the regulators being consumer champions in the past few years, not only in finance, but in water, in energy and air traffic, it has always been on the margin. Do you think a regulator can be a consumer champion?

You keep saying, Martin, "I don't know how to get things put right" and it comes back to us. You are representing consumers. We should be responding to genuine difficulties that you cannot solve, that they cannot solve and they're suffering from. It comes back to Government. At the moment, it's the regulators. We pass it to the regulators and the regulators, as I say, have it on the margin. Do you think we can carry on with regulators being seen as the consumer champions?

Mr Lewis: It's a very interesting point. I'm always careful to say I don't represent consumers, because I haven't been elected by anybody. I can only talk from my own opinion—

Mr Mudie: You are articulate.

Mr Lewis: I hope so, but there are many who will disagree with me. I deliberately hedged when you asked me the question in the first place, because what I certainly don't want to see is a pro-consumer remit

taken away. I think it's very important that the CPMA has a pro-consumer remit.
Mr Mudie: No, but let me just—
Mr Lewis: You're right, I don't believe it can be a champion, no.
Mr Mudie: When the Governor of the Bank of England came here on the first hearing, I thought I was pretty marginal myself, because I asked about the position of the CPA and where it was and how it was positioned with the Markets Authority, why it wasn't separate. But the further the discussions have gone on, when you consider what's happening to consumer protection or consumer interests in the last few weeks and months, you see, we could be arguing about a finance consumer champion, but there are consumer champions needed across all government.
Mr Lewis: Absolutely.

Q294 Mr Mudie: I watched what happened to women in the last Government in terms of there being a Women's Minister in the Cabinet Office, with the ear of the Prime Minister, which means that all Departments pay attention if they raise a problem and all pieces of legislation are viewed through the eyes of how this affects women. Do you not think there is a very strong case for a consumer Minister in the Cabinet who is the champion and we don't have this fielding it off to regulators in the separate Departments, where some are better than others, but they're all bloody bad?
Mr Lewis: If you forgive me being cheeky, would they be able to get anything done either? The problem is legislation and getting legislation through is even more tricky than getting—the reason I say regulation is that at least regulation can be monitored.
Mr Mudie: No, no, don't be negative. Come on, don't be negative. This is your chance to tell us how you think we could play a better role than we have. Now, come on, you have to come off the fence and tell us.
Mr Lewis: I think you need both, is the honest answer. I think you need a strong consumer minister there to represent consumers with a very defined role that says they don't have to give a high jot what business thinks. Business is very important; I'm not an enemy of business in any way, but business often has the ear of the Government. I think there should be someone with a role who is very specific, who is deliberately polemic, deliberately on the side of the consumers, who, if someone says to them, "Come on, it might cut the profits and we need to make sure our big businesses are okay," will say, "Well, you know what, talk to someone else. It's not my job, you can argue that with the other people. I'm here to represent consumers."
But the same goes to the regulator as well because there are many things; regulation should be able to be done more quickly than legislation. I think it should work that way. I will give you my litmus test as to whether the CPMA would work. This is the question we can never answer because it's past. When we had bank charges and when the banks had paid back £1 billion and had continually paid out, and a test case went to the court between the OFT and the banks, the FSA decided to put bank charge reclaiming on hold, but it did not put on hold the charging of bank charges. For me, that was a biased decision that favoured the banks against the consumers.
The banks had paid back £1 billion. That reason is pretty decent evidence that they were pretty scared. They lost in two courts and it was only on a technicality in the Supreme Court that it was overturned. It was a very painful day. But my perspective on that is why was the hold put on reclaiming if a hold wasn't put on charging? How is that fair to consumers? How is that balanced? If the CPMA is a real consumer champion, it would have said, "You can't do this, if you're going to put a hold on and stop consumers getting their money back." Even after we'd won in the High Court, even after we'd won in the Court of Appeal, the hold on reclaiming was still on, but banks were still allowed to charge. That was just a nonsense decision. A real regulator, CPMA, pro-consumer regulator, in my perspective, would have put that hold on both. That is a good litmus test to how we go. Even though it lost in the end, it's a good litmus test for fair treatment on both sides. But I think the worry about the economic impact of damaging business is seen as a much stronger worry than damaging consumer interests.

Q295 Chair: You have given us some very interesting and entertaining evidence. There are many people who have cause to be grateful for a lot of the work you do. I want to end by asking who regulates you?
Mr Lewis: Nobody. In that my website has a very minor impact because we tell people to go to comparison sites, it has to be a regulated introducer, so I have FSA status for that, but I am a journalist, and we are not regulated. I could either say, "No one," or I could also answer, "The same people as those who regulate you, sir," which is the general public and my users who would leave me, ditch me and not trust me if I got it wrong. We do get it wrong on occasions. But when we get it wrong, we get it wrong for the right reasons, not the wrong reasons. I am a financial journalist and regulation of the media is an interesting one.
I go back to what I said earlier. Someone spent a lot of money setting up Moneymadeclear. You know what, if they had come to us and said, "We want you to do this, this and this and we'll give you a stamp," I would have been regulated and you would have saved the Government a lot of money.

Q296 Chair: You did, for example, recommend Kaupthing Edge just before it went under, only days I think before it went under, as the lead account.
Mr Lewis: Kaupthing Edge didn't go under. Kaupthing Edge was transferred to ING Direct. A better example would be Icesave. What we said with Icesave was the protection system is £35,000 per person the first £18,000 under the passport scheme, which should be scrapped, is regulated by the Icelandic Government. The Icelandic Government has told us it would be safe. When I interviewed Yvette Cooper, the Minister on this, which was not shown in the TV programme months before, and asked about the system, I was told that whatever happened it would be safe and that money would be safe.

What I said to people, what I still say to people now, is we cannot judge company solvency and we will not look at company solvency. But what we will do is where there is a protection anomaly, we will tell you about it. I was the voice shouting for years before that, for a year after Northern Rock, "Spread your savings. Don't put more than £35,000 in any one account." So yes, we go on best products because I am certainly not qualified to look at company solvency and would never dream of doing so, but we do try, where we can, to tell people how they are protected. But did you know that the Icelandic Government wasn't going to pay up, because that was the only thing that we had slightly wrong. Thankfully, the British Government kept up with its promise and did. Yes, as I say, we make mistakes and I wish I couldn't, but we do sometimes, but we make them for the right reasons.

Q297 Chair: You are offering IFA-like advice though in many ways, aren't you?

Mr Lewis: No, no, not on regulated products, no. We are a website. First of all, we don't ever deal with individuals.[1] We are a website offering articles based on what we believe are products, pros and cons to those products to allow consumers to make a choice. IFAs give specific advice based on personal circumstance. We allow people to come and read and tell them the pros and cons to make their own decisions and no more than *The Guardian* money website section or *Sunday Times* money section do. Hopefully, we think we do it very well and we are more prescriptive.

Just to flick that back at you, we are about to give generic money advice and are setting that up through CFEB. The problem we have is that generic money advice is generic. Nobody has ever asked me, "How do I get a cheap loan?" What people ask me is, "What's the cheapest loan?" No one has ever asked me, "How do I get a cheap credit card?" They ask me, "What's the cheapest credit card?" Now, I do all my couching because I'm scared, because of all the reasons you have just said, of giving the wrong answer. Even if I've done my research, I'm not perfect. We do it to the best of our ability. Generic money advice won't work because it's generic. Regulations penalise people for doing the right thing and trying to help. I will flick this back to you, I would be happy to be regulated if it gave me some protection to give the right answers to people.

Chair: I think it is important you should have an opportunity to put these points on the record.

Mr Lewis: Yes, thank you. I'm not having a go.

Q298 Chair: Who pays you?

Mr Lewis: We won't take adverts on the site, because I don't believe anyone should be able to pay to be on the site. What we do is we have a Chinese wall between our editorial team and the two-man commercial team. Obviously, I get paid by broadcasters and for newspaper columns, but I presume you're talking about the website. We write our articles to the best of our ability, we work out what the best products are when there are products, and a lot of our articles do not have products. And then we go to the commercial money websites, like your Moneysupermarket or your uSwitch, and we take their links. If they have a link through to a card or a product, we use their link and we get a split of the revenue there. But if we can't get a link that pays, then the best product is still the best product, and it just doesn't pay. My only possible way of impacting traffic, and we do do this, and I say this on the website, is we won't direct traffic to products, but we can direct traffic to articles that happen to more remunerative at the time. So if the top savings article has a decent affiliate linked in at the time, we can direct people to top savings more at that moment. But if people want to know top savings at a time when it does not have affiliates in, they can just go to that page themselves. That is the commercial tool. I have 32 staff to pay.

Chair: Thank you very much, Martin Lewis, for coming along. We have enjoyed the evidence you have given us this morning.

Mr Lewis: A pleasure, thank you.

Chair: We will take a three-minute break.

[1] *Note by witness:* IFAs look at giving individuals specific bespoke advice on regulated products and investments. Yet our prime subject areas are the things where there's no advice available—it splits into three categories—first there's guides on debts, savings, bank accounts, utility bills, then we've a deals section for cheap consumer products and discounts, and finally we have a financial justice section for reclaiming issues, consumer rights, and personal financial advocacy. It's important to understand we are a website.

Examination of Witnesses

Witnesses: **Robert Sinclair**, Director, Association of Independent Financial Advisers, AIFA, **Dr Tim May**, Member of the Board, Association of Private Client Investment Managers and Stockbrokers, APCIMS, and **Steve Gazzard**, Operations Director, Institute of Financial Planning, IFP, gave evidence.

Q299 Chair: Shall we begin? Thank you very much for coming to see us this morning. Things have already been livened up by the first session, which I think all of you heard. I think I saw all of you in the room already. Could I begin by asking each of you whether you think that this new system of regulation is going to be cheaper or more expensive to the consumer? Why don't we start with you, Mr Sinclair?

Mr Sinclair: I think our general view is that when you, I suppose, increase the number of entities, it is bound to cost more. Certainly, even within the paper itself, it recognises there is initial transitional cost. But having, I think, more senior sets of management across a range of entities is liable to cause an increased cost in any event. I think the other part in terms of—

Q300 Chair: The transitional cost is the £50 million that is in the impact assessment. Do you agree with that number?

Mr Sinclair: We consider that might be understated, but we have no evidence to underpin that, which I

think is the concern. Our emotional intelligence tells us that in these types of transition, that would tend to be understated, but we wait and see. Part of this will be down to perhaps the IT infrastructure that has to be built to support the various entities. And then I think it comes to part of our view in terms of what might be required in terms of shared services. While there is talk of sharing fee-gathering, then there might opportunities for more shared services. We might get that cost back down, but I think it depends on how that gets played out.

Q301 Chair: So the answer is you don't know, £50 million sounds a floor for transition, and we might have higher long-run costs, because we have two institutions?
Mr Sinclair: More institutions, and I think also a genuine desire for more to be done. I think that more to be done was always an issue, and we always anticipated that as the FSA was changing to its conduct risk strategy we would be running two systems in parallel for a period of time—when they were doing conduct risk, when they were assessing product, and when they were doing conduct of business, when they were still monitoring what had not yet been conduct-risked through the process, so we were anticipating increased costs anyway.

Q302 Chair: We will get on to whether we are getting value for money for this corpus of regulation in a moment. Could I just have a quick answer to the same question from Mr May and Mr Gazzard?
Dr May: I think certainly there is a danger of costs going up. I think the control of regulatory costs is something that there is still an opportunity to look at. Just thinking back, when one went from SROs to FSA, the whole idea was costs were going to go down because we would make savings. That doesn't seem to have been the case, as reported, and going back to what Robert said, I think when you have more than one institution involved, there could be an opportunity to keep the costs reduced by having shared service companies and so on. For instance, even just member authorisation could be put in one entity across the PRA and the CPMA.
Mr Gazzard: Yes, very similar views on that. I think the initial reaction is that if you split between two bodies, you are going to end up with increased costs. It has been our experience in the past that you have ended up with increased costs. It remains to be seen—the devil is in the detail, I guess, in terms of how this will affect, in particular, our members. I think we would be pleasantly surprised if it turned out to be £50 million.
Chair: As you have probably noticed in a number of other sessions, I have asked those representing institutions to tell the Committee what the full compliance cost is to their firms, and therefore ultimately to their customer, of the regulation. So far, no one has been able to answer that accurately, and unless you have come armed with that number today, I would be very grateful—because we are taking this very seriously—if you could go away and give this considerable thought with your respective members. This needs to include not just the cost of the amount that is paid to the FSA to create the FSA, but also the amount that is required to run a compliance department within firms, plus of course all the time spent by people within that firm who are answering queries from the compliance department. So it is a full cost to the consumer of the regulation, not necessarily because we think that regulation is wrong, but because we need to know what that costs the consumer, if we are going to do a proper analysis of the corpus of regulation.

Q303 Jesse Norman: You will have heard me ask a question earlier about the retail distribution. I would like to leave that question to my colleague, Mr Garnier, and open by asking a question briefly to all of you about the Bank of England. Obviously, in the new arrangements with the CPMA and the PRA, the Bank is going to be predominant. Are you comfortable that it has the expertise required, either as a result of it, or as a result of its existing expertise, to deal with the specific challenges posed in each of your sectors. You could start, Mr Sinclair.
Mr Sinclair: I think the IFA sector is a little different and unique in terms of it operating predominantly through effectively a large number of disparate smaller businesses. Sometimes they are gathered together in very large businesses that are partially-owned subsidiaries of large insurance companies. So it is a very complex mixture that sits in there. Whether the Bank of England has any direct impact in terms of that, I would think it is uncertain. Whether the structures that sit underneath that will get that close to them in terms of the IFA part of the landscape, in terms of life, pensions, investments, I think is much more around how they deal with the providers of those products, rather than the way they are sold directly to through IFAs.
I think across in the other part of the landscape, which is the other half of the area that a large number of IFAs operate, which is the mortgage part of the world, then there is more liable to be direct impact, as was mentioned earlier, which I think comes around to this fact of how we will apply medicine at various points of the journey, particularly where we might have a situation where the Monetary Policy Committee has a view of what they needed to do to move things one way or the other. The PRA might have a view where they have to take action against certain parts of the market, but then the CPMA may also be taking action against firms in that marketplace and product in that marketplace. Therefore, making sure that all of that works in a structured way, where everybody is aware of the interdependencies and of the likely outcomes of the individual actions when they are then threaded together, is one of the major problems that we foresee around some of this—how we get that right level of understanding when those decisions are made.
Dr May: On financial stability, the Bank is extremely well placed, which tends only to affect a particular sector of the market, and we've seen previously those that were very systemic in a financial sense. There is no doubt they're going to have to build up expertise that doesn't now exist at the Bank, to take on all the things that Robert said, and probably a number of other aspects of interrelationship between the FPC, the

PRA and the CPMA. So it's a challenge for one specific aspect, yes, but I think for the rest, it's to be seen how that will build up.

Mr Gazzard: I think in terms of financial planning specifically, we're still building a relationship with the FSA, and building understanding within the FSA. I think there is a general misunderstanding of how financial planning fits within the whole marketplace, including the IFA marketplace. What has not helped in the past is a mix-up of definitions. So you can have financial planners who are tied agents working for a bank, you can have financial planners who are IFAs, you can have financial planners who work for other large organisations. I think there is a lack of understanding in the marketplace. Our concern would be, specifically for financial planning, there would currently be a lack of understanding within the bank, but we would hope that in the transition, where staff were moved over from the FSA to the new entities, that that knowledge and experience would go with it.

Q304 Jesse Norman: Let me push you a little bit further on that question, Mr Sinclair. Are you comfortable that the senior reaches of the Bank know anything about retail financial markets at all?

Mr Sinclair: In the conversations I've had at Deputy Governor level, I am very happy they do have a fairly good understanding of how things work in the lending side of markets. On the investment side of markets, I have not come across anything that helps give me comfort in that area, but I have no reason to have discomfort at the moment. Does that make sense?

Q305 Jesse Norman: It does, thank you. It is slightly unnerving but it makes sense. Finally, Dr May, could you just talk for a second about investment management? How is that going to fit into the new regime? It's not obvious, to me at least, where it sits and perhaps you could just talk a little bit about that.

Dr May: No, it's not obvious. Just so that Members are aware, we at APCIMS represent 125 firms, who are looking after investors who generally are more literate. They generally want to take risk in order to gain growth, which hopefully is important for the economy, particularly in the current environment. As to where they fit, that is a bit of a struggle. It looks as though, and we would hope, large numbers of those firms fit in CPMA. But if a number of them end up going into PRA that extra cost that we talked about earlier, an extra overhead, will certainly be there. So I think it's our hope that they will end up in CPMA with appropriate prudential knowledge coming from FSA, or in some cases the Bank, so that they can cover those firms appropriately. But there's no doubt they were not systemically important. They did not have a systemic issue related to those firms in the recent crisis, but there will be a cost overhead for the new regulation for those systemic problems coming to bear on the marketplace. So we are looking to try and manage that with the powers that be, and also hope that some of the recent FSA changes, where they've been spending more time trying to understand the investment community on the private client side, will go through into the CPMA and the PRA in a knowledge sense. Because the idea of the one-size-fits-all for retail is certainly not what we are putting forward for our community, and I think is an important point we should keep stressing.

Jesse Norman: That is helpful, thank you.

Q306 Mark Garnier: My question, broadly speaking, is directed to Robert Sinclair, but by all means don't feel shy about coming in if you have a comment on this. There is going to be a short debate tomorrow about the FSA's retail distribution review, RDR, and its effect in IFAs. Do you think the FSA has served IFAs well, or do you think the FSA through RDR has let this community down badly?

Mr Sinclair: I wish there was a simple answer to this question. I think one of the challenges is that, if you go right back to when the RDR started from a speech at Gleneagles Conference, some outstanding objectives were set for the project. I think we've lost our way a little through the process. It almost feels as though we've come down from an excellent model that is about dealing with some fundamental economic issues within the industry, and getting more savings and engagement with consumers, to a debate around exams and commission. It is disappointing that we have gone from what were some very laudable objectives to a result that is debating two relatively minor issues.

I understand exactly why a significant proportion of the RD Committee feel aggrieved by the examination issue. They feel as though they had been in the industry doing an excellent job for a very long time and why are they being asked to go through a hoop of a series of what are process-led exams, when they have been serving consumers' welfare for a very long period of time. Therefore, some form of work-based assessment might have been more appropriate if they were prepared to bring that forward—or even if the FSA decided to champion it, which they didn't choose to do.

On the income and commission arena, we've always been supportive of the view that we could move to some form of fee-based adviser charging because—certainly I think the IFP will support this—the better firms have been in that place for some time. We have always had to talk in terms of independence but do you want to pay a fee, or do you want that fee effectively obviated by commission and take commission? We've always had to be in that place for a very long time with consumers. Therefore, all we are now doing is forcing the mechanism to make the explicit cost very clear to the customer and the customer paying it directly, rather than getting it back through a third party. Whether there has been any evidence of product bias or provider bias to that has always been almost lost in the debate. Nobody has ever come up with real tangible evidence that shows there has been either product or provider bias, funnily enough, but we are about to change a whole structure at £1.7 billion cost because of these issues. I'm still not convinced that even the product providers are able to deliver some of the stuff that underpins this within the timescales required.

I think where we are at the moment is that it is right that professional standards are increased, and we

believe that the aspiration to level four is exactly the right level for us to get to. Whether we need this cliff-edge date at the end of 2012, and we need a whole lot of other cliff-edge dates impacting on the industry at this time, I think is perhaps unfortunate, and that's where we feel there is room for manoeuvre.

Q307 Chair: It would be helpful if you come out of code and just tell us what you really think.

Mr Sinclair: As an organisation we have always supported the move to increase professionalism. Do I believe in grandfathering? I don't think we've ever believed in grandfathering. My council has never supported grandfathering. The firms that sit there have not supported grandfathering, but then again they've always wanted to get to a better system of work-based assessment or something other than pure exams.

Mr Mudie: But that does not—

Chair: Sorry, it's my fault for interrupting.

Mark Garnier: No, I was just about to give you the opportunity—

Mr Sinclair: Because this doesn't just impact on our fees, this whole thing impacts on the APCIMS community, it's not just an IFP issue, it has a much wider base.

Q308 Mark Garnier: It does, and one of the things that I am very concerned about with this is that I am not sure that RDR is going to ensure that you have a good and wide range of consumer choice. I think it's going to end up affecting some of these organisations where you're going to have people with a lot of grey hair and a lot of experience in these markets who are just going to turn around and say, "To hell with this; I've lost interest in the whole business. I'm going to leave it". I suspect that that body of knowledge in the retail end of this market is going to be a big loss. You will have read the articles where I have been quoted, no doubt—

Dr May: Grey hair is not a bad thing, obviously, and particularly in the financial marketplace, because you build up experience in all those years of many situations, including the most recent crisis. Thinking of my point about one-size-fits-all, I think the shame for the APCIMS sector is that the FSA has let down our community and others in not explaining what the RDR was supposed to be achieving, particularly if you're more service and relationship led. We tend to have an investor base who is quite happy to pay for advice. They're quite happy to have things explained to them—

Q309 Mark Garnier: Through commission or through a fee?

Dr May: Either. It depends on the client. As long as it's properly explained, it is back to Martin's point; if there is that understanding the clients can go with you on both those points. You do have to make sure everything is properly in place.

Q310 Mark Garnier: There is a very big issue about this—sorry, I am cutting across you. There is a very big issue about this commission versus fee thing. My sense is that I am sympathetic to the role of the IFAs who say that if you sit down and start charging £100 an hour, £200 an hour, you are crossing a boundary into being perceived as being rather like an accountant or a solicitor. Whereas if you are an independent financial adviser who has disclosed but hidden, to a certain extent, having a commission, that is an easy way of doing it. But people are very happy to subscribe to a pension scheme or insurance or whatever it happens to be, safe in the knowledge that there is going to be a fee coming out of it, but they just do not feel like writing a cheque to the provider and then writing another cheque to the IFA.

Dr May: And there's a danger if you're charged, as you say, on the basis of hours or time, that it would send quite a number of consumers away. They may not be willing to sign up to just have a conversation on financial matters.

Mr Gazzard: I think if we're saying, "Are there thousands of consumers out there waiting, if only IFAs were better qualified, were paid for by fees, were to sign ethical—are there thousands of investors out there waiting for that to happen so they'll go along and invest"? No. Are the basic principles of what the RDR is trying to achieve correct in terms of moving the industry forward? Yes, in terms of professionalism. To say that you can go out and you can advise clients with the equivalent of a level three qualification is ridiculous, in our opinion. To have a level four qualification is an absolute minimum. At some point, if the financial planning/advice industry wants to be considered professional, it has to be seen in the same light as accountants and solicitors. We are dealing with the same issues. We are dealing with complex tax affairs. We are dealing with some of the biggest financial situations in life, in terms of pensions and investments. In terms of the qualifications issue it's right that we should set higher standards; it's wrong to say grandfathering those individuals—and a lot of them have been effective IFAs working at level three, but they've been dealing with the issues that are tested in these exams on a day-to-day basis. To revise and take the exams within the timescales, as Mr Sinclair has suggested, is a slight pressure. But they should be able to go through the process and achieve these exams within that timescale.

The ethical component is important, and I think that should be taken forward. I think there's a whole area of regulation that should be looking at the whole ethical aspect of whether the job that's being done for the consumer—I guess that's whether you're in IFA or whether you're a product provider—the right one? Is this in the best interests of the consumer? I think all of these things are.

Finally—if you will let me just finish—the remuneration aspect, yes, what the regulation is saying is let's take away any hint of commission bias in terms of product choice by saying, "Mr Client, when I set this up for you I will charge you X." You can then take that through commission if you so wish, as long as you have explained to the client clearly upfront what the fee is for conducting that particular piece of business.

Dr May: So just to complete this. "Commission" in my terminology for our sector is normally "brokerage commission", which is another reason why people have to be very careful using just generic terms.

Q311 Mark Garnier: Yes, sure. The RDR was originally expected to cost something like £400 million, the cost is now £1.7 billion. That is not exactly a moment of glory for the FSA on cost overruns. These costs are probably going to be borne by the consumer. Do you have an opinion on that?
Mr Sinclair: I certainly believe that's where they will end up, because there isn't anywhere else for them to go. But I think the consumer also suffers at two levels in here. One is there are going to be a large number of consumers who are going to lose access to advice here, which has to be wrong.

Q312 Mark Garnier: As a result of this exercise?
Mr Sinclair: As a result of this exercise. I think that's undoubtedly the case. Or they're basically going to end up with this different advice, or not very good advice, because they're going to get driven away—almost self-help or website-based advice. That's the comfort of sitting down with somebody and having a good piece of analysis done, in order to get the correct solution. And we go back to where we were earlier with Martin. Often a large part of the advice is very much a case of trying to help consumers understand the right things to do in the right order.
I think another part of this, to be clear, is the single premium debate that we keep getting dragged into—i.e. if I have £10,000 to invest, how do we begin to get people to acquire money, the regular saving process, and how does somebody pay a significant fee when we're talking about putting £50, £100, £200 a month into a pension arrangement? That's the much harder piece here that we need to get right, because we don't want to lose sight of that. The cost will be significant. While I don't want to take issue with the professional body here, I think the other part of the cost that comes out of this is—and we will respond formally on the costs, because we have some good figures around the cost of regulation. The cost of this is not just the cost of sitting the exam. It's the number of hours you have to take out to prepare to do the exam, which means you're then not earning. I think when we are talking about—if you start on the structure of those papers—a couple of hundred hours, and if your normal charge-out rate is even £50 an hour, that begins to be a significant opportunity cost lost for most people involved in the industry.

Q313 Mark Garnier: Taking all that into account, because it is very useful stuff, what does the CPMA have to do to ensure that independent advice is going to be available to everybody?
Mr Sinclair: That is a very good question. I think it is changing the whole landscape, because at the moment people are allowed to hide behind something that they call advice that isn't advice. We've always been of the view that, as said, advice should be very clearly advice from somebody who is on your side working on your behalf, i.e. not tied to provider. That is not usually advice. We've always taken a view that independent advice, or advice from the person sitting working for you, is not quite the Holy Grail but certainly—and FSA reversed well away from that as part of this RDR process unfortunately, in our view.
I think the other part is, and I hesitate to say it, it has to be something that people view as an industry they want to get into. And I'm not sure people see it as very sexy at the moment, for some strange reason. I've been involved in this industry, in various parts, for 30 years now and I've always loved and enjoyed it. People don't see it as sexy. People worry about the risks as well. A large part of this is as you are in this industry longer and longer you build up this iceberg of liability potential behind you of all the rack of complaints that could come at you—not all of which might be your fault, but because you give the advice it's wrapped around you. Because you've taken that personal responsibility to say to somebody, "I think this is the right thing for you"—because that's what genuinely independent advice is—you then have to take that and wear that coat for the rest of that customer or product's life. Now most consumers, 70% say that that should stop at some point in the future, 25% roughly in our research, and certain research has been done, say that should stop when the relationship stops, but we have no ability of terminating that at the moment, which is also part of the equation. What would make it more attractive? It would be things like that.
Dr May: I think what I would say is that our firms act as agents for clients, so we give that advice on that basis. It is not for somebody else, so my best advice to the CPMA is listen, talk to us and use the grey hairs, while we still have them, to understand how that can be fed into the industry in a safe way.
Mr Gazzard: Obviously, in the IFA sector, the level of paperwork that needs to be maintained when you give a piece of advice is enormous, and one area to look at would be what ensures the right consumer outcomes in terms of what advisers need to maintain, in terms of the paperwork, to back up the process they've gone through. There's a couple of other points here as well, and going back to the earlier session, certainly one of the first points of advice you would give to any client would be to pay off, certainly, any high-rate debts they have. I think there's a process to be gone through here. One is to try and get clear with people on what their goals and objectives are, because too much of the industry is about, "The solution is a product. Now, what's the question?" and it's all of the advertising, it's all of the regulation, it's all about product. The piece about getting people clear on what they want to achieve in their life is something that's better facilitated face to face, but is possible through using online tools and other tools, and certain organisations have tried to start doing this.
I think then in terms of getting an accurate picture of where people are with their finances, most people would come along with a shoebox full of papers that they've bought this from a bank, they've bought this from a salesman that they met 20 years ago, they bought this from an IFA, they bought this from the mortgage adviser. It's not all pulled together. It's not easy for them to pull it together, so you have to help people pull all that information together and give them tools to be able to do that. And again, that's an important piece of what the IFA does. I think then you need to come up with a plan that says, "Right, based on everything you want to achieve and everything you

have, this is what you need to do," and this is where debt repayment I think comes in, importantly.

Then there may be a place within this whole process to say, "What you need to do is take out an ISA or a pension or some protection". Obviously they're all regulated in slightly different ways, and at the end of that process, you might say to them, if you're an IFA, "And my selection from the marketplace, based on your personal circumstances, are company X, Y and Z". That's the bit that's regulated. It's the company X, Y and Z that's regulated, your selection there. You then go on and say, "Right, we'll come back and review this in a year's time, because we need to check we're still on track". We're focused with regulation on a very small part of the process. It's the part of the process in research—I think it goes back to some Cerulli research that was done in 2002, 2003—that shows it's one of the least valuable parts of the process, as far as consumers are concerned. But that's where regulation is focused, that's where all the cost comes, and I think we need to realign regulation with what the consumers need. I think in doing that, if we looked at that more carefully, then we might be able to bring independent advice to the masses.

Chair: Now, we're just beginning to get to the point. The fact is regulation is in flux. Anecdotally, people working in all three of your areas are telling us that a high proportion of this regulation is a complete waste of time, it doesn't benefit anybody, it costs a packet, it's a box-ticking exercise, often designed to cover the backs of the FSA. What we need from you is candid, independent evidence that can enable us to offer advice on how this area that is now in flux, in regulatory terms, can be redesigned for the better for the consumer. So what I'm asking of you today is to have that in mind as you're giving this evidence, and what else you may decide that you may need to put to us in written form as a consequence of what you've heard.

Q314 Mr Mudie: I just want to go back to where Mark was pushing you on exams. The Chairman, Mr Sinclair, asked you to stop speaking in code on the question of grandfather rights. You started off then saying, "The board of my association and I are against grandfather rights" and then you seemed to say you weren't certain on this examination, but you had the view there were other methods of assessment. What is your position? Now, I'll tell you where I'm coming from. I have a man in his late 50s who's been in the industry 20 years and you've left him abandoned now because he's not passing the exams. What on earth does he do? He's out of a job. Now, tell me in the context of that fellow what you answered to the Chairman.

Mr Sinclair: We've always taken the view that says—and I think we're agreed in terms of this—that level 4 qualification is the appropriate level or standard for people giving personal financial advice to customers, particularly on an independent basis. We have to look across the market and have a good understanding of what's available there. Therefore that's the position we're in.

Q315 Mr Mudie: So you're in favour of that qualification, that examination?

Mr Sinclair: Of that standard of assessment. How you get to that standard of assessment is the difficult bit, because that could be an examination or it could be some form of work-based assessment, or it could be somebody comes and looks at your files, work-based assessment, and says, "On the basis of what I can see, you are at that level, given the type of advice you give". The problem we've had is looking at somebody who's able or wants to do that type of work. We've not been able to find people in the marketplace prepared to do that type of activity, to do that work-based assessment.

Mr Mudie: Oh, to do the assessment.

Mr Sinclair: Do the assessments, to give them that sign off.

Q316 Mr Mudie: But how hard have you looked, because as I say, you're abandoning people and it can't be totally impossible to find assessors. Are you saying it is, Andrea?

Andrea Leadsom: No, I'm saying it's absolutely not totally impossible among their peers.

Mr Mudie: Yes, thank you. That's the first time you've agreed with me.

Mr Sinclair: Among their peers, and I think one of the issues is we've tried to get to a point with the professional bodies and examination bodies who ultimately have to sign this off. There hasn't been the same level of preparedness to have that open door approach to get to that point.

Q317 Mr Mudie: No, but come on, the lad's sitting here, where the hell is he going to get a job in his late 50s? Now, you're an association representing people. They're in a real difficulty about earning a living now, and you say there is a way forward, but there's some difficulties. Are you intent on getting that way forward? Is this just words? Are you intending, is your association working as of now, to set up an assessment board, negotiate with the FSA that they accept that as credible and get these individuals out of this difficulty?

Mr Sinclair: As a trade body, it doesn't sit in our gift. It sits within the gift of other bodies to be able to deliver that.

Q318 Mr Mudie: Which other body then? Are you marking over to Mr Gazzard now?

Mr Sinclair: I think the IFP might be that area, you look in that area. The IFP might be able to work in that area.

Q319 Mr Mudie: Okay, come on, Steve, there you are, but have you not any compassion for a fellow coming to the end of his working life and you've stranded him?

Mr Gazzard: We haven't stranded them. The RDR went through—and one of the things we'd applaud as part of the RDR is the consultation process that it went through.

Mr Mudie: So you're not prepared—no, no, but you're copping out. Come on.

Chair: George, just let Mr Gazzard answer.

Mr Mudie: No, but he's copping out.
Mr Gazzard: One of the things we'd applaud with the RDR was the consultation process that it went through and so we haven't stranded him as a professional body.
Mr Mudie: No, no, but you are copping out.
Mr Gazzard: If he was a member of our professional body and he came to us, we would look into it.
Mr Mudie: No, no.
Mr Gazzard: None of our members have approached us, looking at this. We would be prepared to consider workplace assessments. However, we remain to be convinced that they will test at an adequate level.

Q320 Mr Mudie: Right. But you have a different position from that fine man on your right, Mr Sinclair, because he says, "If we could only find assessors and we're having some difficulty". You don't seem to want that to happen, if I'm not too unkind. Now, tell us straight, is there an effort being made to get an assessment system that will rescue these lads and lasses who have been in this industry for many years and are now stranded, are now not able to work in the future?
Mr Gazzard: I cannot talk to that. It is not an issue that's arisen within our membership.
Andrea Leadsom: Can I say as a general point—
Chair: Rather than pursue this, can we move on to Jesse Norman.

Q321 Jesse Norman: Yes, sorry, just a quick supplementary on the issue of the retail distribution review, I don't think anyone would disagree with you that improving professional standards is important across the financial services market, and especially the retail end, but it is also true that we have small investors to think of when these commission arrangements are tampered with. Now, what you've said between you over the last 45 minutes is that you acknowledge that the RDR has cost four times what it should have cost, the consultation was poor, and the original ideals that it was set up to achieve have fallen away. Does it not strike you therefore that it's frankly a bit of a fiasco, and as far as the retail investor, and particularly the small investor, who might use a commission-based broker, goes, it could do with a rethink?
Chair: Why don't you each answer that question in turn? A quick response. Mr Gazzard? You can try yes, no or maybe.
Dr May: Yes
Mr Gazzard: I think in terms of increasing the professionalism of the industry, it works. I think in terms of increasing the reach of the industry, it doesn't.
Chair: I think frankly it would help hugely if you had begun by clarifying exactly what Jesse Norman began with, because that should be what's at the forefront of what's coming to you from the people you represent, and you're not giving it to us, which is why I said earlier that it would be helpful if you don't talk in code before this Committee. John Thurso.

Q322 John Thurso: Can I pick up the question of the consumer champion? Broadly, your organisations don't engage so much with the consumers who are—I was about to say at the bottom of the structure, but most of the people who you are selling to are people with a certain amount of wealth and are people who are coming for advice, whatever—correct me if I'm wrong on that—but how do we protect the people that Martin Lewis was talking about, that go into a bank or whatever, buy a product because somebody says it's a good thing to have and then find out that they have been stuck with something that's completely irrelevant, if there is not somewhere in the system a proper consumer champion? Mr Gazzard, would you like to crack off?
Mr Gazzard: I think the difficulty of being a consumer champion within CPMA, for example, would be that you're in conflict, because I think to—as Mr Lewis described it—be able to scream and shout and rant on behalf of the consumer is slightly different from the role within the CPMA. However, I would agree that a constant factor within the remit should be, "How will this improve outcomes for consumers?" and I think that needs to be a constant and pre-eminent part of the remit of the CPMA and probably the PRA also.
Going back to a previous point, in terms of improving outcomes for maybe the part of the market that isn't necessarily serviced, I think that you have to look at the availability of money within those areas and, as has already been said, what should be happening is high-rate lending should be being repaid. That comes down to not necessarily a product again, but it comes down to education, and I would absolutely and totally agree with the need for improved education, both in schools and the adult population, and I think, talking to a previous point that's been made in terms of increasing the resources within the industry, if we had better education in schools in terms of what financial advice and financial planning is about and the differences it can make to people, I think you would get a lot more people selecting financial services related degrees and coming into the industry.

Q323 John Thurso: We have heard evidence from a wide range of people. You have a Treasury document that says, "The consumer champion role will be within the regulator" and it uses the words "consumer champion". Virtually everybody who has come before us has said that you cannot be a consumer champion and a regulator. The work that the consumer champion does, the advocacy that's required, has to be somebody with no regard to anything but to be completely for the consumer. Is this as big a problem as is being made out, because there's not one person who has come before us to give evidence to say, "The structure that the Treasury have suggested is good in that one respect of the consumer champion"? Do you agree with all the other witnesses on that?
Dr May: I think pretty much yes. I think it is the word "champion" that has probably caused all the emotion.
John Thurso: Yes.
Dr May: I think going back to something George Mudie said, where there is a need to have the voice of the consumer much more prevalent—whether it be in Government or in the regulator—that is important. As you said, not necessarily for the communities we may represent but for the consumer at large. Whether

you use that "champion" word, I think has people sadly thinking, "This is somebody out there as a flag bearer up the front and regulation or some other things come behind it", which they plainly can't. It will be a balance, particularly, in our market sector and also in product sectors. It will always be a balance. So I think consumer at the forefront and a balance, yes, but perhaps, having put in the word "champion" has given play to a lot of emotion, that we need to now get back out of the system but get a balance for consumers to give a—

Q324 John Thurso: Obviously, there is the matter of semantics, but do you believe there should be a champion, that there's a good role to be consumer-focused within the regulator, but there is an additional need for a champion, or that we don't need a champion at all, as long as the regulator is reasonably consumer-focused that will do the job?
Mr Sinclair: I believe, at the moment, there is quite a good consumer champion within the structure of the FSA, in terms of the consumer panel. Adam Phillips, who chairs that now, I think has been doing a very good job developing that panel, particularly over the last year. That panel could be given more power, and more influence, alongside the other statutory panel. The intention to increase the power of the Small Business Practitioner Panel, which is in this paper, is critical to this because—I think this goes back to previous issues—it would give the consumer panel the right status and influence, in order to direct what the regulator does, not just have a voice on a board meeting, the practitioner panels similarly, who should have that influence as well, directing the regulator to where they needed to work. Because it is the people who work in the industry, and the people who take the products and services for our industry, who should know what needs to be done by the regulator. The regulator appears to have its own way of working, and these panels don't appear to influence enough, in my view, in terms of what goes on there.

Q325 John Thurso: Can I move on to what is linked in with consumer issues, and perhaps come back to you, Mr Sinclair, because you've called for a complete review of the role of the Financial Ombudsman Service. What are your concerns about the way it works that made you call for that complete review?
Mr Sinclair: I think we're always in danger in the UK of running things slightly differently. Alternate dispute resolution schemes, in most of the rest of Europe, and the framework they operate under, tend to be structures where two disagreeing parties are brought to a compromise. That's more commonly how they operate. Within the UK we have been concerned, for some time, that that was where the Ombudsman was, but it had become much more a judicial body making decisions of right and wrong, and without any right of appeal. Because what happens is that an adjudicator has an opinion, and the only person you can appeal that to is the Ombudsman, for whom that adjudicator works. So that's a very strange process. For us to appeal anything out of there, on either side—whether that's consumer or industry—is very difficult, and there is no independent right of looking at an individual case or a systemic issue.
I was interested this morning to hear the issue about the Ombudsman. The Ombudsman has always had the right to take issues of wider implication to the FSA, and does so on a periodic basis. The interesting part is what happens when that is done. Because at the moment all we ever see is that it drops into the FSA and very little is done, and there is a turf war—almost embarrassment that it's happened this far after the fact without the FSA having seen it. That is one of the concerns that we have. Therefore, that is one of the reasons we want to see that review.

Q326 John Thurso: But there's a huge difference between a resolution process that brings two people to a compromise.
Mr Sinclair: Yes.
John Thurso: It's the difference between arbitration and mediation, which is that one seeks to judge who was right, and judge accordingly, the other does not seek to judge who was right but it will arrive at something that both parties can live with. If you have these multi-billion pound banks flogging dud products, which is what Martin Lewis told us they were doing, and 81% of the cases brought are upheld, why on earth should we think the banks would not want anything, other than to water down being told they're right and wrong, and simply arrive at a midpoint where they escape their responsibilities for their actions? What you are suggesting is a serious dilution of the consumer's ability to get some redress in this unequal struggle against these financial titans.
Mr Sinclair: Is 81% the right number? Maybe it should be more?
John Thurso: Absolutely.
Chair: Yes, but what is the answer to the question?
Mr Sinclair: I don't think it is dilution. I think it's about fear of what their purpose is because at the moment—I don't mind them being quasi-judicial, but what I have a problem with is there is no right of appeal outside of that process, and that's where there is difficulty.

Q327 John Thurso: Which is a fair point, the point you're making: you don't mind the process, it is the fact that if you do think you've been shafted you don't have a comeback?
Mr Sinclair: You have no comeback at all, on either side.

Q328 Chair: Have you written down, and given in evidence, what you want as an alternative to the current system?
Mr Sinclair: It's in our submission.
Chair: All right. Good.
Dr May: Just one point I would add as well. I think, as we move to the twin peaks, that there is a need to ensure consumer panels and some of the other aspects that came from the original FSMA do exist in both parts. It's not necessarily only the case that you need it in CPMA. Going back, I think, to the point you made, there could be some decisions taken in the prudential side that have a massive impact on consumers for a period of time, and if there is no

ability to finesse such impacts across the two, this could be a problem—we don't want duplication, as the Chairman has been saying, and costs going up, but there has to be a way of balancing that across in this new world.

Q329 David Rutley: Dr May, you've made a big point about the problems of the "one-size-fits-all" mentality, and you just led on to talk about the twin peaks structure. But don't you think that's just another "one-size-fits-all" with two peaks rather than three?
Dr May: Firstly, I didn't come up with the idea of it. It's not my idea to go to the twin peaks, but I don't necessarily think it's a "one size fits all", but I think there has to be good consultation and the ability to work across the twin peaks. There has been a decision taken to have the twin peaks. I think the key thing now is to find the most cost effective way to get that constructive working and co-ordination across those twin peaks.

Q330 David Rutley: Yes, but I think the point you were trying to make in your comment was: it's all about the banks and not enough about what you are doing. Isn't that just going to be the same in the new structure?
Dr May: Well, no, not necessarily about the banks because, for instance, between Robert's community and my own there is a difference, in some cases, with advice for the market side versus advice for products. It's that sort of "one-size-fits-all" but, certainly in our case, the sector that looks after market activities for private individuals, as opposed to wholesale, has almost a foot in both camps, the prudential and the CPMA, and it's finding that balance. Not that we should have special treatment, but there is a community there that is serving 4 million portfolios; £400 billion of assets. It's a large community that, unfortunately, a lot of the regulation that has come out, more recently, has just had a retail size to it, not necessarily banking, and it's getting that clearer.

Q331 David Rutley: Any thoughts from you, Mr Sinclair, or Mr Gazzard?
Mr Sinclair: I tend to agree with what has been said there.
Mr Gazzard: Yes.

Q332 Andrea Leadsom: This whole discussion this morning brings out my worst fears, which is that trade bodies never say what they think. What they do is they take what is a given and then they fiddle with it at the edges. It does concern me that what we're doing here is, potentially, solving the very real problem of systemic risk in the banking system by changing the regulatory environment, but what we're creating is potentially the unintended consequences that far fewer people trust the pensions and savings industry in future; that the cost of getting into it becomes so exorbitant, because of the additional costs that are being passed on to the consumer, and that what we end up with is the completely unintended consequence that people no longer save for their own retirement. Is there any truth in that fear?
Mr Sinclair: I think there's enormous truth in that fear and I think the FSA didn't do us well, early in the RDR, by junking the gap between advice and selling. We were trying to say to them, "Look, some people are sales people, some people give advice. Can you not make that demarcation absolutely clear, so people understand that and when they walk through the room they know what they're getting?"
I share your fears with regard to what we're about to do, in terms of driving the cost of advice upwards, because it will become very obvious and transparent to people, to a point where they will opt out. I agree there is significant market research coming out now that says that will be the case. Yes, we share your concerns. But these are the points we've been making to our regulator for the last four years, and they've been falling on deaf ears.

Q333 Andrea Leadsom: But this is the interesting point, isn't it? I've been in finance for 25 years, and trade bodies are always terribly nice. They don't turn round and say, "This will not work", and take the appropriate steps to get enough media coverage and media on their side to make it happen. I think this goes back to what George was saying earlier, which is that you have a problem with some of these things but your message isn't being heard, and this is your chance to tell us what needs to be different, so that we, as the Back-Bench voice of Parliament, can go and tell the Front Bench, "This isn't going to work because these are the unintended consequences". So this is your chance, and I just wonder whether you are taking it.
Chair: To say that you are giving us evidence in a muted form—
Mr Sinclair: We're not.
Chair: You could understate the length of the pause there. That was just silence.
Dr May: Well, I was waiting for Robert, to be honest.
Mr Sinclair: I think the challenge is that we have, within the IFA community, almost three camps, in that we have what I would call the wholehearted endorsers of the change. There is a group of people who think, "This needs to happen. In fact it happened five years—we did this five years ago—why won't people not come with us?" There's a group in the middle who are going, "We can see the benefits, we might as well get on with it, and, yes, we'll just get it done". Then there's another group who are saying, "Up with this we will not put, and it is wrong". Now, the proportions of these could be 30/40/30. So therefore, 70% are saying, "Yes, we can go along with this"; 30% are saying, "Up with this I will not put". Is that 30% big enough for us to be genuinely concerned that this will break things? Given that there is 30% of people who are giving advice to people, and might well be the people who are giving advice to people at the middle end of the marketplace, yes, that could be exceptionally damaging. I agree, it could well be.

Q334 Andrea Leadsom: But if you look now at someone taking out a pension in the Netherlands, for example, the same pension that they take out in the UK will pay them up to a third less by the time they retire—I am generalising here—but the costs

throughout the lifetime of taking out a pension in this country are already exorbitant. We don't have enough people saving for their retirement. What are we going to do about it? Should we be having a catchall lifetime savings account that incorporates ISAs and pensions? What are the trade bodies doing to propose an alternative that will be cheaper to consumers, that will give them the protection, that will defend competition in the industry because, from what you're saying about the RDR, we will have a real problem in this country, as well, with lesser competition, fewer people in the industry and therefore less competition for that. So, from what I can glean, you're saying this is all potentially disastrous, versus our desire to get more people saving for their retirement.
Mr Gazzard: I seem to get the feeling what you're saying is we, as a relatively small professional body, should be competing against the multi-million pound PR and lobbying budgets of the banks and insurance companies, that had a major impact on the outcomes of RDR. While I would love to be able to put across my case in the same manner that they would, I think it's just impossible. We fed back into RDR what we wanted. Mr Sinclair has already mentioned about the fact that we said—I think we were both the same—there should be a difference between identifying a sales environment, whereby you're going in to buy a product, and I've already talked about the fact that at the moment legislation covers the product end, not the advice giving process. It only covers one small part.
But we talked in our feedback about the fact that you should be covering separately. What is a sales environment where it tends to be a bank or an insurance company and they're going to sell you a product, versus when you were getting into an advice relationship, whereby they will take your full details, they will talk to you about your hopes and aspirations; they will put together a complete plan that will involve debt repayment, that will involve protection, that will involve a range of other products.
We talked about trying to help the market understand that better and, while the attempts of depolarisation to expand the marketplace have failed, we have consistently failed, in what has been produced, to give the consumers very clear indications of what to expect, purely within the nomenclature used within the marketplace. So you can go and see a financial adviser; they could be working for a bank or they could be independent. You can go and see a financial planner; they could be anybody selling anything. So, while I would have loved to made a mark with our feedback, unfortunately, the way the system works it goes against the smaller professional bodies.

Q335 Andrea Leadsom: But to be in front of the Treasury Select Committee is surely where you make your mark?
Dr May: Can I say two things, a slightly different community to the two on my either side, but we have not given up on RDR yet. We think parts of it are just unacceptable, and so we are still fighting those pieces. We've responded—and it hasn't come to you yet, but it's gone to the Treasury—on what's called "a new approach to financial regulation", which, for very good reason, is solving a crisis issue of stability and has come out with ideas. At this point, as a community, we're trying to assess how those ideas—from what we have as information already—are going to affect us and the wider consumer community. When we see that we are going to start shouting even more, but some of those pieces are still becoming clearer, almost as we talk.

Q336 Andrea Leadsom: But surely, should you not be putting forward your own plan for, for example, peer review of people who can't be grandfathered but need to be able to evidence that they've reached the required standard? Should you not be putting forward your own plans for that?
Mr Sinclair: We have been roundly criticised by some people for developing a qualification in conjunction with the Chartered Institute of Bankers of Scotland. We only reached that point because we spent almost a year trying to work with a whole range of agencies to produce this work-based assessment process. That's what we spent over a year doing, trying to get to that point. The only thing that was deliverable, at the backend of all that exercise, was another exam process, because that's all the people who are in that side of the world wanted to deliver up to us. Now whether that's right or wrong—I believe it's fundamentally wrong. How do I get somebody to do something they don't want to do? It's difficult sometimes to get people to do things they don't want to do.

Q337 Andrea Leadsom: Going to a slightly different topic, what about the structure of savings in this country? Do you think that the ISA pension, the multitude of products, do you think that confuses the consumer and makes even more barriers to entry? Should we be looking at a different structure, some kind of lifetime savings account that's tax advantaged to the consumer?
Mr Sinclair: We do. We agree with you. One of the interesting challenges that we've always had in this country is that most of our products are derived out of our tax rules, not out of anything else. We keep changing the tax rules and, therefore, we have all this legacy product structure that we never quite get our heads round, and when we change it we don't allow it—only recently when we changed things around PEPs and ISAs did we roll stuff back together. One of the biggest issues we have is this continual flux and change, whether it's in taxation or regulation, which leaves us, as an industry, with the legacy of stuff, to have knowledge about but then how to deal with. If we can develop a lifetime product, which is a simple savings programme with the right tax wrappers around it, the right tax incentives to save, and whether you give tax advantage on the way in or whether you give them during the life of the product or you give the advantage on the way out, is a choice. There are three places where you can do that, and picking which of those are the most advantageous to induce people to start doing the right thing, is not my judgment but certainly something we would fully support. Rolling together ISA and pension allowances is something that we're debating internally, as to whether we think that's a good thing to happen. It's certainly something

we debate internally quite a lot of the time. We think that lifetime structure that allows limited access, so that people do have a pot at the end that they can access in order to fund their retirement, is important because people shouldn't be relying on their property in retirement. That's absolutely fundamental. So there are all these kinds of things, but these are fundamental social changes for us that while I might have ideas the solutions don't sit here, they sit within the corridors of Whitehall and over the road.

Dr May: Perhaps also—what you said—if there was somebody at the table, when tax issues are being talked about, saying, "What about the consumer?" there might be a balance that comes in from a Government point of view, because there's no doubt tax issues that come in do affect it. One other point I would share with you, to give you an example of the lobbying that's going on in Europe at the moment, particularly for our financial community—which hasn't come up in any of this session or the first session but is not to be underestimated—we have spent weeks just recently trying to explain that an investment trust is a company, to the European powers that be.

It's not the trust that they think it is, so they should put it in AIFM as a directive or something else. We haven't finished. We haven't given up. We are not in the newspaper because, sadly, as Martin said at the beginning, most people wouldn't know what we're talking about, but it is vital for our communities to get some of these things on the table and say to people—even in Europe, "Don't keep coming out with rules that are affecting us. We don't wish to be special because we're British. We wish to be special because we have the richest financial system in the world and we want to protect it". That's vital for this country.

Mr Gazzard: If I could just add, I think again, coming back to one of my previous points, it's naïve to think a product will make people come and buy it; build the product and they will come. It will not happen. People don't recognise the need to save. They're confused by the amount of benefits they will get, whether they will suffer with future benefits because they've saved. The overall marketplace is very confusing for that mass marketplace, in terms of whether they should save or not and how they should save. A product isn't the answer. Better education is the answer, and reassuring people that they won't suffer if they save is the answer, and then you can go through the market through to mass affluence and the wealthy, but it's not a product.

Q338 Andrea Leadsom: Can I ask Dr May a completely off-the-wall question, with your Euroclear hat on: with 10.4 quadrillion of derivatives around the world, do you think that putting derivatives that are currently off balance sheets, through exchanges, like Euroclear, is going to make any difference whatsoever to the systemic risk issues? That is a completely off-the-wall question, I realise that.

Dr May: It's completely off the wall but sadly, again, education has an impact here. No disrespect to yourself, Andrea, but Euroclear doesn't run any exchanges.

Andrea Leadsom: No, indeed, yes.

Dr May: It doesn't run clearing houses either. It runs settlement systems. You're quite right, there is this talk of putting as many derivatives as possible through a clearing type system.

One question that comes up straightaway: does that mean they have to go through an on exchange type process to get there, or can they be off exchange and still get directed there? Nobody can seemingly answer that easily, but that's quite a key point first. Let's assume they're still off exchange but they go into a clearer; for those that are more standard, definitely there is a case for making sure they go through a clearing system. Why? Because you can potentially net liabilities, as you can with the markets, a bought against a sold, in effect. As soon as the contracts get into a colour that's different, no, there is absolutely no benefit. So I think, sadly, because it is difficult to assess the size of those that are standard versus the more complex—

Q339 Andrea Leadsom: So it's about half off balance sheet and half—

Dr May: Yes, it's probably half and half. But then, the last part of that, finding a player or set of players who, in the current market, will stand behind the risk that needs to then be put up against that clearing house, I'd say good luck at the moment.

Andrea Leadsom: Yes, thank you.

Chair: Well we've learned quite a bit today. We're here to represent voters and consumers, and you've sensed some frustration round the table, that we haven't had it quite as forcefully as we would like. Maybe we need more regulation, maybe we need less, but what we need with regulation in flux is very clear advice, from the people you represent, on what has been wrong with the system. We've all heard it ourselves, time and again, from the people you represent. They moan incessantly about the FSA. It seems as if a long shadow of the FSA is cast over here, muting your concerns and criticisms. So if you have further thoughts, in the light of this evidence session, will you please come to us and will you also give thought to what we're getting for the money we're paying for the regulation, and whether that regulation should be structured differently, or whether we can do without some of it. Thank you very much for coming.

Tuesday 26 October 2010

Members present:

Mr Andrew Tyrie (Chair)

Michael Fallon
Mark Garnier
Stewart Hosie
John Mann
Mr George Mudie
Jesse Norman
David Rutley
John Thurso

Examination of Witnesses

Witnesses: **Jacques Aigrain**, Chairman, LCH.Clearnet and **Xavier Rolet**, Chief Executive, London Stock Exchange, gave evidence.

Q340 Chair: Thank you both very much for coming to see us this morning. This is an absolutely crucial industry for the UK and it's absolutely vital that we sustain and build on the success story that we have had over the past 30 years in this field. First of all, could you give a general statement about your view of our future competitiveness and what is required by regulators to underpin it? Could I first turn to you, Mr Rolet, and then I'll turn to Mr—is it Aigrain?
Mr Aigrain: That's correct.
Mr Rolet: Thank you, Chairman, and thank you for having both of us here this morning. I would preface our ulterior comments by saying that clearly we are in a difficult period that has been induced by our collective, as financial services institutions and regulators, inability to properly manage leverage. But as we consider the future shape of our regulatory framework, it is critically important that we consider not only the reforms that are suitable but also their potential impact. As we saw in the period 2006 and 2007, fairly minute changes brought about to bear to equities markets in the United States with Regulation ATS and Regulation NMS and here in Europe with regulation MiFID have had a very substantive impact, including severe unintended consequences. So we feel it's very important to review not only the future framework but also the potential impact of what those new regulations may be because we are really looking and considering here wholesale transformation of about every single aspect of financial services regulation, from prudential to behavioural.
The second point I would like to make is, whether we consider it desirable or not, we operate and live in a world that is increasingly interconnected and in particular here in the UK, which represents approximately two-thirds of the financial services industry in Europe. We are now part—again, whether we like it or not—of a pan-European regulatory framework and we at the London Stock Exchange, given our international reach in stature, believe it is very important that whatever we do here in the UK be also looked at in the context of whether that new future framework will be effective as regards European regulatory institutions that today, particularly in the case of behavioural regulation, i.e. conducts—the new so-called European Securities and Markets Authority—will have binding powers.

Q341 Chair: You said a moment ago "whether we like it or not" we are bound into Europe. Could you say whether you do like it or not?
Mr Rolet: Again, we are an international institution and we are of a non-political nature in essence. So we live within the framework—

Q342 Chair: I wasn't asking you a political question. I was asking whether Britain is going to be able to benefit from this net; whether this was a mistake that we have entangled ourselves so deeply in continental European regulation or whether it is an opportunity overall? Clearly there will be bits of both.
Mr Rolet: I think it can be an opportunity, sir. This is the opportunity to tap into a much wider capital pool than the one available to UK industry in the UK alone. Let's also keep in mind that what financial services is about is directing capital from where it is to where it's needed, i.e. the pockets and hands of entrepreneurs, industrialists and business people, particularly small and mid-cap enterprises. This is what we're here to do. But in that context there is a big opportunity in Europe and, in that sense, if I may—this is based on 28 years of experience in the European and international financial services industry—I think what Europe needs is more than UK involvement, and I have said it sometimes, but it's UK leadership.

Q343 Chair: Do the Europeans know they need our leadership?
Mr Rolet: Well, I think it's up to us to make the case that there are, on occasion, instincts to promote state control in the form of dirigisme, which is not always compatible with the efficient market. It's not the only way to go. And, in that context, the point I would make is it seems to us—a critical point—that, whatever we do here, we put ourselves in a position to fight our corner in Brussels; the delegates, the representatives of UK regulatory institutions appointed to represent not just London but the UK. It's not just about London. In our junior market, for example AIM, 50% of companies listed are not London-based.[1] So it does affect UK industry at large. But the representatives of our regulatory institutions, once sent to Brussels or Paris or Frankfurt—depending on the regulatory institutions you're considering—should be empowered and have the depth of competence and experience to represent our

[1] *Note by witness:* The statistic is marginally higher—57% of UK companies on AIM are not based in London.

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interests. That is very, very important and it is an opportunity at this critical inflection point.

Q344 Chair: But the way you're framing that question, Mr Rolet, suggests that you don't think we do have it at the moment and it would be very helpful if you don't speak in code and be extremely direct and tell us whether you think we've got problems in this area that need urgent redress.

Mr Rolet: Well, I think Europe itself is an inflection point. The whole regulatory construct there is changing. So regardless of whether we had it right in the past or not, we now have an opportunity to go in and influence the process in a fashion that will be beneficial to the UK and to the city and to the financial services industry. So that would be my answer to you, sir. It may be that in the past we weren't always doing it in a fashion that perhaps was the most effective. We now have an opportunity to do it right, at a time when many of the European politicians and institutions and regulatory institutions are asking themselves the question as to what the way forward should be. So it's a critical inflection point.

Q345 Chair: The atmosphere is pregnant with what is left unsaid there. Could I ask Mr Aigrain to say whether he agrees with everything he has heard? There is no need to repeat it if he does, but if there is something he disagrees with or wants to add briefly he could. I have one other question for him before I'll pass the questioning over to colleagues.

Mr Aigrain: Well, substantially I join with Mr Rolet's statements. First of all, thank you very much for asking me to come and respond to your queries in person. With regards to this European framework versus the UK direct regulatory environment, I do observe that the EU Commission staff in general are clearly focused on balanced interests between the different countries involved. There is no denying that during the recent past the issue of Eurozone versus non-Eurozone has become quite significant in many recent events and we see it very specifically in the field of clearing, which I know tends to be a little bit more esoteric and less known than, of course, Mr Rolet's activities. But our role, of course, is to facilitate the post trade once the transaction has been done by the stock exchanges or between the banks or the different investors' community.

Our role is to effectively make the different members in the system, in the financial market, safe if one of them unfortunately defaults, as was the case for Lehman. Within that framework we observe, with the type of activities that we have and the scale of the activities that we have, this notion of global reach that Mr Rolet underlined is absolutely critical. None of the markets can be looked at on an individual basis. That would be potentially attractive from a political perspective but practically we don't see how it works. I'll give you just one data. At this stage LCH.Clearnet, which has already been active for the last ten years in the field of OTC derivative clearing—which is jargon that is now prevailing in many of the regulatory and legislative discussions—is having an activity of the order of $230 trillion in 14 different currencies. None of that can be effectively viewed or exclusively regulated from one single point but we certainly are based and proud to be based and extremely comfortable to be based in London as our primary point of actions. That is where our users, members, are most actively involved in the process that we provide them as a service.

Chair: Okay. We're going to come back to both those questions later on but I'm going to pass the questioning to Mark Garnier.

Q346 Mark Garnier: Thank you, Chairman. My comments will be mainly directed to you, Mr Rolet, but I will come back to you in a minute, Mr Aigrain. I want to cast your mind back to May with the flash crash in America prompted by this 4.1 billion sale of stock index and how London is prepared for that. Mr Rolet, do you think that the UK stock market could suffer in the same way that the US stock market suffered from a flash crash like this?

Mr Rolet: That's an excellent question, sir, and one that I often get in many parts of the world, including in the United States. First of all, and this is the point that I referred to earlier, this situation in the United States stemmed directly from regulatory change. Unintended consequences were not fully considered at the time of their introduction, namely Reg ATS and Reg NMS; the event of extreme fragmentation, the loss of price formation qualities of the core reference stock exchange, namely the NYSE and Nasdaq who today handle barely 20% of the securities that they trade—the rest is basically a hyper-fragmented environment—in an environment of market stress. Let's remind ourselves what the week of May 6 was about: major correction in the Chinese market induced by fears linked to their real estate market, the Greek crisis in Europe. So you had an unusual amount of fear and stress in the market.

In an environment where fragmentation had exploded—atomisation of markets, and the opacity of markets had substantially increased—a large single point amount of orders entered the market. The stock exchange—in fact it came through the futures market, in the E-mini contract of the CME—was unable to handle this flow without a severe impact on the securities price. So the New York Stock Exchange and Nasdaq went into what's called an auction mode, i.e. they stopped trading and they dissembled the market. But because of the way the United States market is fragmented in the way it works, automatically the flow was routed to many other venues who peg their prices on the central market but do not themselves provide liquidity. So we saw a purely mathematical reaction. A lot of selling, no net liquidity, no buying and some securities went to zero.

In the UK we have a different situation. First of all our circuit-breakers have been in place for a number of years. Secondly, they operate in a different fashion. There is no automatic routing of our flow to the various venues, the so-called multilateral trading facilities that have today contributed to the promotion of fragmentation on the back of MiFID legislation. So when we go into slow auction mode our circuit-breakers effectively disseminate the information, but the other venues stop trading because we remain with

a market share of approximately 65% in the UK order book, the central price formation venue.
So if we go in slow auction mode, the other venues cannot trade and that gives time, effectively, to disseminate information. It gives time to institutions and investors to take in the information, and effectively taking action with a view to re-inject liquidity into the market. In fact, in the last six months we've had two instances of incidents, so-called "Fat Fingers" incidents, where an electronic order was mishandled—unusual size—and it was absorbed very well in our market. It can never be 100% but I can say with a relatively high degree of confidence that our micro-structure, what we call the design of our markets, and the fact that today we remain the central price formation venue, puts us in a very different situation from the United States.

Q347 Mark Garnier: It's quite an interesting point because what you're effectively saying, to bring it back to layman's terms, is that as long as the UK stock exchange is anti-competition from other trading platforms then you do not have a problem. Is that a fair summary of that?
Mr Rolet: Well, it points at a mathematical contradiction, which is that, of course, competition promotes efficiencies, promotes improvements and promotes low fees. But on the flip side, we are an infrastructure company and the mathematical point is if you do fragment liquidity you are going to get an environment where behaviours, particularly of securities and investors, are going to be altered. In particular, I think everybody understands that if you fragment liquidity you can have less of it unless—and this is, I think, the point that underpins the current controversy about high-frequency trading—forms of electronic arbitrage are designed and provided that keep synchronicity between the markets. I think this is the whole point about high-frequency trading; they are the necessary outcome of regulatory change.

Q348 Mark Garnier: Can I just pick you up on high-frequency trading because it strikes me there is slight confusion about what it is. On the one hand you've got algorithmic trading, which is where you're trying to facilitate VWAP and TWAP and Iceberg orders and that kind of stuff, which is a way of trading.
Mr Rolet: Yes.

Q349 Mark Garnier: But on the other hand you have these so-called Bayesian-model black boxes being run by hedge fund managers, which are putting on huge huge volumes of trades at any given time; many of which aren't executed but they're still in the marketplace. Now, there's a lot of talk about how we can regulate high-frequency trading and what bothers me with a lot of this is that people talk about this generic high-frequency trading. But how would you address the fact that you've got algorithmic trading as a service to customers and high-frequency black-box trading as a form of asset management by hedge fund managers?
Mr Rolet: That's a very good question and it's a live debate not only here but also in the United States. High-frequency trading and algorithmic trading are different things. Algorithmic trading is a way of trading that uses, obviously, algorithms and electronic support. High-frequency trading is a form of trading that has effectively been created by regulators, indirectly; by the SEC and also here by the national regulators in—

Q350 Mark Garnier: Can you enlarge on that? Because I'm not entirely clear why you think that's the case.
Mr Rolet: One can understand it if you go from a central monopolistic venue to multiple fragmented trading venues. Unless you have a mechanism, an electronic way through arbitrage, to keep the central spread—let's speak of an example; if Glaxo is traded in ten venues and its venues are not interconnected electronically, the central spread, the price, could start diverging to a point where some investors might be paying a price that is too high versus another market, or might be selling the security at a price which is way too low versus the bid that is provided in another venue.

Q351 Mark Garnier: So this is trading on a backwardation?
Mr Rolet: Exactly, backwardation; dislocation in a central spread. High-frequency trading is a normal mathematical consequence of the introduction of fragmentation. What high-frequency trading does is that it's superfast—hence the exposure or the emphasis on low latencies—almost tending towards riskless arbitrage trading activity that keeps those central spreads in sync by arbitraging minute differences that might appear. That's all it does. It's neither good nor bad. It's the normal consequence of introducing fragmentation and it keeps synchronicity between the various markets, otherwise you could have completely dysfunctional behaviours.
Algorithmic trading is just a means to an end. It could be used by hedge funds, it could be used by traditional loan funds and many other forms of investors. Today in the UK market, the high-frequency trading form of algorithmic trading represents approximately 50% of the total volume. So that's a result of fragmentation. It's also a result of the cyclical trend in which long-term investors such as insurance companies and pension funds have massively deserted the equity markets. It's a sort of temporary seasonal circumstance. In the United States high-frequency trading represents in the region of 70% of total volumes. So it is a very, very significant portion of today's activity.

Q352 Mark Garnier: It is, and the EU is consulting on reforms for MiFID. What would you do? Would you advise them to emphasise stability rather than competition between markets? And if so, how?
Mr Rolet: Again, it's a mathematical contradiction. The Greeks used to call it aporism. Competition has been good for us, the London Stock Exchange. It's given us an incentive to work closely in partnership with our clients, to modernise our technology, reduce our cost, think of more innovative ways of the contribution we make to the market. The stimulus of

competition is always a good thing. Again, for infrastructure, fragmentation of a central price formation venue can have unintended consequences. So we think the solution—and this is just one approach that is promoted by the London Stock Exchange, not all exchanges accept it—is putting back in sync or re-harmonising our governance.

If our shareholders were to become our clients—this is the situation that Jacques' business is in—through re-aligning our core interests we would be able to solve that conundrum. But that is, of course, a commercial decision. We are a listed company and open to allcomers. In the context of the MiFID review, what we are arguing for is more transparency so that if there is fragmentation both the post-trade and the pre-trade in terms of disclosure of information should be highlighted and improved. We also think that some form of consolidated tape—in terms of articulating or creating a network with the activities on all these venues that is somehow connected in an electronic and efficient fashion—should also be developed.

Lastly, we think that the contribution that infrastructure companies make to the global economy and the economy at large and particularly the financing of small and mid-size enterprise should be recognised by a special status. We're not banks. We're not leverage companies. What we do is just transfer and funnel capital to put it in the hands of entrepreneurs and companies. We think, as part of MiFID and the overall European framework, that status—and I think the same applies to clearing houses—should be recognised and should be regulated in a different fashion.

Q353 Mark Garnier: On the competition side of things, obviously competition, in theory, drives down prices but you also make reference to the fact that the London Stock Exchange trading platform is now the fastest trading platform. Do you think that's going to be where competition is going to be driven from in the future and, therefore, it's investment in infrastructure that is going to make the difference, rather than prices themselves?

Mr Rolet: Yes. That's a very good point. Given the importance of high-frequency trading and how sensitive they are to low latencies, for high-frequency traders the quicker the execution and in fact the smaller the size of the average execution—hence the trend towards atomisation of markets—the smaller their risk, since their business tends towards riskless arbitrage. So the pressure towards ever-decreasing latencies, as long as fragmented markets are in operation, will remain.

To give you a sense, in terms of metrics, our current trading engine operates in nanoseconds, which is a billionth of a second. It takes about 200 milliseconds for the bat of an eyelid. So we're at levels of operation, and we believe and have ample evidence that our new technology currently is the fastest in the world, but in a competitive environment we're going to have to keep on improving it. The trend is effectively towards ever-reducing latencies and at the moment, while our matching engine trades in nanoseconds, what we call our gateway-to-gateway—i.e. client orders through our matching engine back to the client engine—operates at less than 100 microseconds.

Q354 Mark Garnier: Mr Aigrain, just one last question. How confident are you that were there a flash crash in the UK you could deal with that in terms of clearance?

Mr Aigrain: Well, the rule of the clearing house or CCPs is slightly different. In effect the flash crash creates circumstances of increased volatility. The consequence of that is for the clearer to require an increase in the margin or collaterals required from the various users. So it adds supplementary cost to the system. It does not, as such, create a particular burden. We are facing two types of transactions; on one side, very, very high-volume transactions when it comes to the listed products—say the London Stock Exchange or the Euronext.liffe markets—versus, on the other side, in the case of the OTC markets, extremely high value but small number of transactions. The problematic is a little bit different. In one case, the electronic characteristic, the technology platform, is absolutely critical and what is very important in our case, by contrast maybe to the London Stock Exchange, is not so much that we can reduce the time per transaction treatment but effectively that the safety of that transaction in terms of its recording is as perfect as possible. You can never have a "no fail" system but you want to be as close as possible.

If you allow me, sir, to come back to one of the points that was discussed with Mr Rolet a minute ago. On this overall issue of competition, what comes to my mind and our mind at LCH.Clearnet in general, by definition competition is good in terms of the overall working of the economy. However, and linked to the regulatory framework across all of Europe, it looks to us that what we need is to make sure that it is a level playing field; that in the regulation which applies in different countries within Europe and to different types of operating platforms across a value chain—so whether it is the trading platform for the London Stock Exchange or whether it is the clearing or settlement activities for a company like LCH—the same principle of regulation should apply and the same demand and burden of regulation should apply.

Q355 Chair: You've presumably been making that point to the Bank of England, seeing as they're going to be your new regulator. Do you think they have the expertise to be able to regulate your sector?

Mr Aigrain: Generally speaking, we think that it is quite sensible for the CCPs—which, as mentioned in the early remarks, are effectively at the centre of the notion of systemic stability in the system—to be regulated by the Bank of England. We believe that there are one or two other elements of the regulatory reforms that require some attention to the potential unintended consequences, to use Xavier's words.

Q356 Chair: But what about the quality and the expertise?

Mr Aigrain: We believe that in terms of the systemic risk they clearly have the expertise. In terms of the overall staffing, by definition any of the regulatory reforms that are suggested right now will require a

reallocation of staff, either between the FSA and the bank or in terms of higher amount of staff.

Q357 Chair: Are they on the case and are the right people going to leave the FSA and join the bank to do this?
Mr Aigrain: It's really difficult—
Chair: Just be frank. Just be straight. Are you confident about this or are you worried about it?
Mr Aigrain: We are slightly more worried about the risk of unclear overlaps between the responsibility of the CPMA, in our case, in terms of the conduct of the infrastructures, versus the role of a bank as our lead regulator suggested by the suggested regulation. We believe that if there is clarity as to who is doing what then the allocation of staff is probably something that both the bank and the FSA's leaders are quite focused on. I obviously am not in the knowledge of exactly which way they will handle it.
Chair: Okay. John Mann?

Q358 John Mann: I hear what you say but is the split between the Bank of England and the CPMA, is that the right structure, Mr Rolet?
Mr Rolet: Yes. Even when the concept of prudential regulation reporting into the Bank of England was not popular, we have publicly articulated our strong support for all forms of prudential activities to be regulated by the central bank. That is very important for two reasons; number one, because this is where the expertise lies, to respond your questions, Chairman. If you manage yourself the balance sheet of the nation you are likely to be better positioned to manage and control leverage. In fact, one of the features of the financial crisis is we've seen the greatest numbers of prudential supervision-related failures in areas where prudential companies were regulated by securities markets regulators rather than central banks. That's true for the United States as well.
But the second point is that we feel—it goes for the risk kitchen the same as it goes for the regulatory kitchen—if you have too many cooks you end up in a muddle and we strongly support, as I mentioned, the migration of prudential regulation under the bank because that's where the expertise is; and also the ability to intervene very quickly if something goes wrong. But also it seems to us that a very strong regulator, a unified regulator, concentrating on both primary and secondary securities market regulation is very important as regards conduct and behaviour.
Going beyond that stage, fragmenting further—to go back to some sort of more or less well-defined tripartite or worse, regulatory environment—probably sows the seeds for the next crisis for two reasons. Number one, because of the allocation of responsibility; things can fall through the cracks. But, secondly and perhaps equally importantly, we now have a regulatory framework in Europe that will make decisions on the basis of majority voting, binding decisions on all the 27 member nations, including the UK. We have a limited number of such representations. ESMA, for example, will only take one representative from the UK. We will have 8% of the vote at ESMA even though we represent two thirds, more or less, of the financial services industry. So it's very, very important that whoever represents the UK there, not only from a UK perspective, has the full spectrum of responsibilities to match that of their European colleagues sitting at the table. But also from their perspective, from the European perspective, this person will be in charge with a set of responsibilities that effectively will provide a very, very strong image and impression of competence and responsibilities across all the various areas for which ESMA will be responsible. The match between what European colleagues' responsibilities are locally and the UK representative is very, very important going forward.

Q359 John Mann: That strong language sows the seeds of the next crisis. Politicians are prone to spend most of their time talking about bankers, bonuses and a little bit about big banks and whether banks should be split up. Are politicians rather missing the point? Isn't this the key issue, considering this is where the crisis originated?
Mr Rolet: Well, we're not a bank. We're not leveraged like a bank. So it's difficult for me to comment about banks.

Q360 John Mann: No, but you can comment about the financial crisis we're going through and the origins.
Mr Rolet: Yes, certainly. If one looks at the last 100 years of financial history, every single crisis—whether you look at the late 1920s, early 1930s or even after World War II, whether you look at the 1970s or look at the Latin American crisis, savings and loans crisis, the Mexican crisis, the real estate crisis of 1990, the Asian crisis of 1997, the Russian crisis of 1998 and even the internet boom implosion—all these crises have one thing in common: excessive leverage. It is about regulation, the proper monitoring of leverage at three levels: corporate governance; regulatory and supervision; but also macro-policy, because leverage doesn't appear when interest rates are high—when the real cost of money is high—it only appears when money is cheap and it's always been the same thing.
So we believe that the regulatory response, rather than a sort of blanket analysis of the financial services industry as a whole, as we see for example when we hear talk about financial transaction tax or punishing a particular constituency like private equity or hedge funds through the so-called European AIFM directive. That's not the right response. The right response, in our humble opinion, needs to focus on the origins of excessive leverage and the right way to regulate. Leverage is good. Leverage helps you create something out of nothing and if you articulate that on the basis of bank balance sheets it's basically a way to create capital that can then be lent to companies. But excessive leverage is what always gets us in trouble and this is, in our opinion, what we need to focus on.

Q361 John Mann: Well, let me ask then about transparency in two questions. Is there enough transparency in OTC trades and, secondly, wouldn't it be better to trade standardised securities through exchanges?

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Mr Rolet: I think it's a question that both Jacques and I could answer. If you will allow me, Jacques, I'll take a crack. One of the points that Jacques made earlier is critical. While the total amount, globally, of OTC derivatives is huge—it dwarfs all listed securities by far, we're talking about $700 trillion at a minimum; some people are saying it is $1.4 quadrillion, and no one really knows for sure but regulators have a better idea—their turnover velocity is extremely limited. Listed instruments trade, on average, 28 times more than OTC derivatives. This is an area where we're a bit different from any other exchanges. We're not arguing for a wholesale transfer of OTC derivatives on two exchanges.

We think there is room, particularly in the standardised end, for more of these instruments to trade on exchanges provided—and this is for Jacques to step in—they are centrally cleared because central clearing is very efficient. It allows for risk compression, it allows for systemic risk reduction, and it allows for better visibility, not only by the clearing houses but also by regulators. But one thing we've always been very passionate about—passionate is the right word—is we believe that the way to avoid the next systemic crisis is to ensure that all clearing houses are regulated by the domestic central bank, because we're talking about massive notional exposure. It's efficiently managed—much more efficiently, of course, than bilateral holding of OTC derivatives by a number of banks—but it does require regulatory relationships and a reporting line going to central banks, in our humble opinion.

Q362 John Mann: Mr Aigrain, anything to add?

Mr Aigrain: I certainly join, of course, Xavier's statements. I believe that we should keep in mind that OTC derivatives are not products which have been entirely given up for strictly financial strategy. A gigantic part of the activities in the real industry, or the activities for the consumer in terms of their own financing, would be very difficult to achieve without the presence in particular of interest rate swaps, which is by far the largest part of the OTC derivative market, or obviously before any exchange OTC activities. So I think it is quite important to avoid putting the OTC derivative under a blanket statement of being a strictly banking instrument with no connections to the real economy.

Secondly, as underlined by Xavier, the critical part is to create the appropriate level of transparency so that the regulators in the central banks and the authorities in general can have access to the data, can follow the pattern of tradings, and can use it for appropriate information flow for their monetary policies and their financial policy activities. Clearing and repository activities should provide the service in an appropriate fashion. Some parts of the OTC derivative markets can take the form of traded activities. It's very difficult to say which percentages are at the margin, and I think the market over time will decide. It is quite clear that you will probably see even some of the banks move more of their own trading activities to a format which is market traded through exchanges of one sort or another and have a little bit less OTC format. But that will be a natural evolution based upon the characteristic of more systemically emerging standardised product versus those which are more tailor-made.

Q363 John Mann: I suppose my question is should we, as the politicians, be giving them a push in that direction?

Mr Aigrain: I would be somewhat cautious. Again, with the observation and experience of having been exposed as a director in some industrial companies, many of the requirements of the real economy have to be served by products that do not exist on the traded platforms and are unlikely to exist on the traded platforms. So there is a real value-added that the OTC format can provide. It's basically tailored services to the clients and when those clients are relatively large clients, industries, or if it is a community of consumers within the framework of specific transactions, it becomes a very useful tool to make the economy work better.

Q364 John Mann: But when it works badly we all suffer the consequences.

Mr Aigrain: Hopefully the clearing will be part of the solution. One of the reasons clearing has become so popular in regulatory language during the last two years is that at the time of the Lehman default the clearing houses in general—LCH.Clearnet as the largest European one in particular—performed extremely well and anything that was cleared was being effectively solved, unwound and satisfied to the various counterparties within a week. That, of course, has not been the case for the activities that were not cleared and that, in part, are still the matter of court reviews and decisions. So that's one part of a solution. The second thing is there is a tendency to believe that the OTC derivative activities have been the cause of a crisis. I join Xavier in suggesting that most of the crisis was coming from excessive leverage on and off balance sheet from a variety of instruments that we have all learned after the fact, as well as a number of activities that are not part of the present debate about OTC derivatives—CDO structures and some of the most sophisticated second-degree derivatives, which in substance have disappeared from the market and were probably a little too imaginative for the good of the financial system.

Q365 Chair: Whatever the contribution of the OTC market to the crisis, whether it's big or small, the market still carries systemic risk and, therefore, that needs to be weighed against the upside; the contribution that the OTC market makes to the global economy. Have you tried to measure, in fractions of a per cent of global GDP, what your contribution is?

Mr Aigrain: Certainly we would not have a qualified answer, I'm afraid.

Q366 Chair: Don't you think it's a good idea to try and find out?

Mr Aigrain: It could be an interesting idea. I would suggest that it probably belongs more to the IMF or the Financial Stability Board to try to find it on a global basis. It would be very difficult for one single private sector actor to find the answer.

Chair: It's worth giving some thought to. John Thurso?

Q367 John Thurso: Thank you. Mr Rolet, can I come to you first of all? Both in public and in your evidence to us you've stated pretty strongly your opposition to the concept of merging UKLA with the FRC. Can you tell us why you have that strong opposition?
Mr Rolet: Yes, sir. At the risk of paraphrasing our written submission, we feel this is, first of all, not compatible with the basic concept of having twin peaks-based regulation. It leads potentially to an additional fragmentation of a regulatory universe, going back to three poles: the corporate regulatory pole, the securities markets, and the separation of some of the regulatory activities there. The concept of separating primary from secondary also to us, as far as core regulatory activities goes, makes no sense. I know you're going to hear the opposite view at the next presentation of evidence.
John Thurso: So make a strong case.
Mr Rolet: Whatever perspective you come from, everybody feels they have a strong case. We just lead on those issues. UKLA's activity, only up to 6% of the securities registers, deals with the regulation of corporate equities. The rest is bonds, gilts and many other things. We think also it creates an issue in terms of Europe, and that is a very, very substantial point, I think, that has also been articulated in a recent letter by Sharon Bowles who runs the Economic and Monetary Affairs Committee in the parliament in Brussels and has a real insider's knowledge of these issues. The new European Securities and Markets Authority is going to make the rules, essentially; the bulk of the rules.
It is very important that whoever we appoint there be responsible for these issues, together with all the other issues linked to the regulation of wholesale activities. We already know that the representative who will be nominated there is going to be the CPMA representative. So it's very, very important that whoever that person is, as part of their portfolio—not only in terms of what they're going to negotiate and the points that they're going to argue but also in terms of the respect they will enjoy from their European colleagues at ESMA—that they're able to really fight our corner.
This is really important, and I want particularly to highlight what the consequence of going the other way, as suggested by the initial consultation document, is likely to be; particularly for our junior market, so the so-called AIM market. AIM has been 15 years in existence. There's nothing like it. I know the press sometimes go over some of these frailties and imperfections; the high cost of listing in AIM—which, by the way, is nothing to do with our listing fees—which at £5,000 are only a tiny fraction of the total cost of listing in AIM. AIM is the only such example of a successful small and mid-size capital-raising market, not only in Europe but in most of the rest of the world; of course, with the exception of the United States and Canada, who have a long tradition of financing SMEs. It's in excess of 570,000 jobs, £22 billion of annual contribution to the economy. We have raised £5 billion so far this year for AIM companies. I can tell you that the AIM regulatory construct is unlikely to survive if we don't have someone in Paris at the European Securities and Markets Authority who understands the importance of AIM and the reasons for its success. This will be wiped away. For many, many years, a number of our fellow regulators in Europe have been shooting at AIM, and have been arguing that what makes our listing regime unique—and, by the way, not just for AIM but also for the blue chips—should be harmonised down to the European levels. We're very, very worried about that. We're very, very committed and passionate about the financing of small and mid-caps, and we think the current proposal, as articulated, exposes the regulation of our listing regime in the UK to unacceptable risks.

Q368 John Thurso: Where we are at the moment is that we all agree that sweating balance sheets and having too much debt has proved to be wrong and that we need more equity in the system. That means getting equity into companies at all levels, not just FTSE 100 but right the way through the chain.
Mr Rolet: Correct.

Q369 John Thurso: AIM is clearly an important player in that. There is, in your view, a real and substantial danger that the European regulation will take AIM out of the equation, which would seriously weaken the ability to raise capital and you think that not having this merger is a key part of preventing that?
Mr Rolet: Absolutely. The Europeans do not understand what has made our listing regime so successful. They probably are a bit jealous of its success but they do not understand what has made AIM successful. Not all of it is the current listing regime. There are other factors, particularly the commitments of broker/dealers who make market in the securities, provide research and distribution. But let me put this in another perspective, because you also mentioned, sir, mid-caps and also FTSEs. At the end of the day, this is about jobs. We all know that the public sector is not going to create jobs in the next two or three years and it's not just in the UK; it's most other western world countries.
In the years of rising corporate earnings growth—2005, 2006 and 2007—blue chips in the UK, France and Germany, the three leading economies of Europe, did not create any new jobs. If you look at the job creation performance of companies listed on the FTSE 100, DAX and CAC Index in Germany and France respectively, their net job performance statistics were negative 0.4%. That points to the small and mid-cap sector as the only potential source of net job creation for the foreseeable future. There are 4.8 million SMEs in the UK. It's going to be a lot easier for 4.8 million SMEs to each create a single new job than for 100 FTSE companies to create 48,000 each, particularly given the fact that—even in good years faced with globalisation, competitive pressures and all the things that we know—they've not been able to create jobs. So it is really fundamental and the London Stock Exchange Group, I guess this is my pitch minute,

since Northern Rock has raised £161 billion of equity. That's almost as much as the Bank of England's quantitative easing. The healing powers of equity in an environment where you're suffering from a debt overhang are quite exemplary.

Q370 John Thurso: There is nothing in what you say I would disagree with. In fact raising equities is an absolutely vital part of going forward. But just to be absolutely clear, because we're going to get one crack at this regulation, you are saying that not merging with the FRC is of such high importance that it is critical to that whole argument you've made about equity? It is that big a deal to you?
Mr Rolet: It's a very big deal and in fact not just the London Stock Exchange. I mean whenever we say something we're always accused that those are self-serving arguments and many other things. Let me hasten to say that in the last five years the revenue from listing, on average, has represented less than 6% of our total revenues. So if it's self-serving, it's self-serving in a very small way. But it is critical and—

Q371 Jesse Norman: How much is that? What amount of money is that?
Mr Rolet: Our total revenue is about £600 million a year.

Q372 Jesse Norman: Right. So it's about, what, £36 million?
Mr Rolet: It's less than £35 million a year.
Jesse Norman: Thank you very much.
Mr Rolet: But this is for the group as a whole; that includes our partner company in Italy and so we have other interests. In the UK, it's less than £12 million.
Jesse Norman: Thank you.

Q373 Chair: Why are those boys in Paris such wreckers, apart from jealousy? It can't just be jealousy.
Mr Rolet: Is this a question for Jacques?
Chair: No. I'm using the language that you've used yourself, Xavier.
Mr Rolet: Thank you, sir. Let's be honest and frank. There's a long-standing rivalry between the two financial centres, Paris and London.

Q374 Chair: But this should not be zero sum. This should be a rivalry where both can gain.
Mr Rolet: Well, London has been successful—
Chair: Why is this competitiveness so negative with respect to these two capitals?
Mr Rolet: London has been successful over the decades. It has grown into a preeminent global financial centre.

Q375 Chair: And so they're nursing a grudge?
Mr Rolet: I wouldn't describe it necessarily as a grudge, but I can tell you that some people there see an opportunity through the regulatory harmonisation process to claw back some business. There's one point I want to highlight that is quite relevant to Jacques' business. This is a point that I've discussed with Commissioner Barnier many times and I'm pleased to say so far he has come out on the right side of the argument. There is clearly a desire articulated, I think essentially in Paris and Frankfurt, to mandate the access to central bank liquidity as regards CCPs and clearing houses, and from a systemic perspective this an eminently supportable argument. But this comes with a twist.
And this is just to give you an example, sir, of why the regulatory process is so important in Europe and we've got to be very, very careful. We have to have specialists there who understand those businesses. I think it's fair to say that both Berlin and Paris would very much like to attach to this requirement for CCPs to be regulated by a central bank and have access to central bank liquidity the requirement that those clearing houses that carry out euro-denominated business and, therefore, must have a reporting line to the ECB or access to ECB liquidity, should be physically based within the Eurozone. That's a great threat against London because obviously a lot of Jacques' business or other clearing houses' business, as far as they're euro-denominated business, would have to physically migrate to one such area.
So I think the general point is there is rivalry. There is competition. We need to ensure that whoever represents us, either in Brussels or Paris, at ESMA, really understands the technical details of our securities business in order to fight our corner. But I think the end result can be positive for London because we've already won. We've got two thirds of the business. So it's about keeping it and ensuring that the European pie as a whole keeps growing.

Q376 Chair: Still, it's not a very optimistic picture, short-term, you're painting.
Mr Rolet: I think we're facing many, many challenges and Europe is just one of them.
Chair: Let's talk about it a little bit more.

Q377 Stewart Hosie: You've said many times the UK has two thirds of Europe's financial services business and 60% to 80% of EU securities trading. You've also spoken about the threat to AIM and, most recently, the threat of migration of those companies doing a euro-denominated clearing. So within ESMA, with our 8% vote, what is it we should be doing? How should it be structured? What are the other risks associated with not having the voice that compares with the size of the market share?
Mr Rolet: That's a very good question because, regardless of who's there, that person still has to deliver. That points to the way in which Brussels and European institutions work. A lot of it is technical, granular committee work. The importance, expertise and stature of your representative, determined by the regulatory envelope that they control in their domestic market, is very, very important. A lot of it is committee work also with the parliament; so working with the parliament. A lot of it is very, very tedious work indeed. It's about pushing forward technical arguments and supporting it with an example of success. One thing I can say—it holds true as regards the Commission and Commissioner Barnier in particular—they are starting to get the point about why Europe for so long has lagged in its organic

economic growth performance and the under-development of the SME segment in the SME sector. So I think there is an opportunity for us to make the case that something has worked here and maybe Europe should listen to us and look at it with a view to adopting some of the better features of our regulatory design. But the rest of it is about building coalitions—you know, when you've got 8% of the vote you've got to work with other members of a committee—and it's about working with a number of nations that share the same interest. It's not just about western Europe. It's about eastern Europe as well, working with the Poles, the Czechs and many others, who have a vested interest in growing particularly their SME segment. So you can build alliances but you have to be extremely credible in terms of the technical argument that you're putting forward.

Q378 Stewart Hosie: Are you convinced we have the right people from the tripartite negotiating just now?

Mr Rolet: Well, we look at the regulatory framework here as moving towards twin peaks, which is a model we're obviously very, very comfortable with. I think at the end of the day those decisions are for you, ladies and gentlemen, to make, as well as the Government. We are one of the many players in financial infrastructure. But if I look at the calibre of people associated with regulation in this country and I compare it with the calibre that's on offer let's say in the United States or in Europe, we have nothing to be afraid of. It's just getting the right people in the right seat. But we do have the talent and the expertise.

Q379 Stewart Hosie: Given that our reforms here won't be completed until the back end of 2012, are you concerned that the authorities here are going to take their eye off the ball in terms of what's going on in Europe; in terms of negotiations; in terms of structure and shape?

Mr Rolet: As one of the city participants, it's our job also—through supporting evidence and through our own activities, together with many other financial institutions in the city—to keep articulating the points; that at the end of the day it is about the granular decisions, it is about the technical implementation of regulation which is so important. Financial services can react to minute changes in regulation in a deep and long-lasting way. So a lot of it is just technical granular debate. But we certainly believe that perhaps, unlike any other city in the world, London has the depth of talent and expertise to contribute to the debate. So we are very positive about that.

Q380 Stewart Hosie: If this all goes ahead and some of these fears are realised, what is the biggest single argument that the UK simply can't afford to lose inside ESMA?

Mr Rolet: I think for the European perspective, if we go in the wrong direction the business may end up leaving London over time—this never happens overnight but it could be a combination, for example, of inadequate reform around OTC derivatives or of risk intermediation, that bespoke talent, going somewhere else. From a European perspective—and that is a point we always make to the commissioners and the MEPs—it is unlikely to migrate to Frankfurt or Milan or Paris or Madrid. It is going to go to Asia. A little bit will go to Switzerland, but not very much. Just on the infrastructure capabilities—and I speak under the control of my friend Jacques here—Switzerland has infrastructure capabilities but not on par with the UK. So a lot of that expertise will migrate. Where, we can speculate and I'm happy to give you a few names.

Q381 Chair: Mr Aigrain, have you got anything you want to add to that?

Mr Aigrain: First of all, on all the previous points I join Xavier very forcefully with regards to the importance of the co-ordination and presence at ESMA, as it is the case for other new European authorities that will be set up. As you know, they will work in college for some of the critical decisions. But, of course, with regards to the infrastructure world of the stock exchanges or the CCPs, ESMA is the relevant authority. That is one of the points on which, while we are generally supportive of the suggested legislative changes, we have put on the table this question of the interactions between the bank itself and the CPMA. We are concerned about the way in which the CPMA will represent the interests of all the relevant parties, in our case market infrastructures and ESMA. ESMA, of course, by nature is a body which is more aligned to the regulatory participant aspect of a central bank so there is a kind of natural tension there, and even the language is not automatically the same between parties.

The one piece good news that we would suggest has to be built on is the fact that EU is speaking of new legislation and a new regulatory framework which will apply in an homogenous fashion across all of Europe. So the stated concerns regarding the political agenda of Paris and Berlin, in a way, can be somewhat monitored or tuned based on this broad application to 27 countries in exactly the same fashion. The fact that we are speaking about EU legislation which is developing and not a directive is rather helpful from that perspective. So to the extent that it is drafted in a way which is not against the interests of the UK, and which again is a level playing field for various actors, it is potentially up to Berlin—or Frankfurt in that case—and Paris to develop their own positive momentum in terms of financial markets, rather than to try to grab a share by various regulatory changes.

It is clear, as mentioned by Xavier, that there are some fairly delicate issues which are being talked about—the matter of liquidity and the Eurozone, as I mentioned previously, and it is very relevant indeed on the part of Xavier to call your attention to it. We should continually remember that we work in a very global world. There is a certain tendency following the crisis to have parochial interests coming to the fore, which at the end of the day would be dangerous for any part of Europe. So we have to clearly continue to focus on the notion that Europe works, based upon the true free movements of trade, of financial activities and of the people. In that spirit, I think that the UK can use ESMA, if it is well represented at ESMA, as a body that can provide positive momentum rather

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than a negative one. But I join Xavier's concern that it has to be taken very seriously in terms of representation.

Q382 Chair: We have spotted that one piece of good news you have mentioned, which sounds like a silver lining on a fairly dark cloud. Is there anything else you want to add?
Mr Rolet: No, I'm fine.

Q383 Jesse Norman: Could I just very quickly follow up on that last line of thought and ask whether there are any areas where you have future concerns that competitors may try to exploit EU regulation against your activities or against this country? You have mentioned two already, obviously one is ESMA and the second is the CCP. So I wonder if there are any others that you might like to just touch on.
Mr Aigrain: It is not absolutely obvious to jump to a conclusion, I must admit. It is a competitive world, so you can count on America to try to find a way to get some benefits to itself. It has always been extremely talented at looking at its self-interest, and I say that in a positive sense. So there is clearly some potential here and there, and the regulatory environment is limiting the fluidity of the system. If financial market activities become more burdensome in London then some business will flow back, should I say, to New York, which over the last 20 years, as I told you, has grown slightly less than London in relative terms. Clearly, Asia will develop on its own and the question mark is only how much can London benefit from Asian growth or how much does Asian growth stay entirely in Asia. During the last 15 years, it has been beneficial to London. Again, the attractiveness through, in part, the regulatory framework of London can play a very large role in keeping a very large part of that very attractive growth business in Asia.
Mr Rolet: If I may add a couple of comments. First, very briefly on the CCP point and access to liquidity which Jacques and I have mentioned. The relatively good news is that Commissioner Barnier, in the meetings I have had with him, has made a commitment from the start so that, whatever directive comes out, he will insist that it be non-discriminatory towards London. But here again we have a principle: we now have to make sure that through its migration through committees to Parliament we do not see granular regulation attached to it that would negate that principle.

Q384 Chair: The fact that he needs to say that doesn't sound very optimistic either.
Mr Rolet: It is good that he did say it. He might have taken the other view, Mr Chairman, but it is about following that particular piece of legislation through. You asked if there were other areas where we have concerns. I would mention a few of them. It is non-exhaustive and I would be happy, if that is acceptable, Chairman, to send a document, a separate submission, to this committee.
Chair: That would be very helpful.
Mr Rolet: But I will mention some of them very briefly. First, financial transaction tax. We have a leverage-induced crisis and now we need retribution so we are going to punish absolutely everybody, including investors, including savers, including corporations, through taxation—and we have our own financial transaction tax here in the UK called stamp duty, which is one of the reasons why the liquidity of UK equity markets is one third that of our equivalent markets in Europe. This will penalise companies in particular, increase the long term cost of raising capital and, of course, penalise savers, pensioners and so on. So we are worried about that. The instinct of senior European policymakers is, whether you describe it as a moral instinct or personal preference, very much to support that particular tax. I think they are starting to understand that if Europe does it on its own it is going to be a disaster, an economic disaster, as the business will definitely move elsewhere.
We continue to be very concerned about the so-called AIFM, alternative investment fund management directive. Approximately 75% to 80% of the hedge fund industry is based in London, so particularly the passporting issue I think is an area which requires substantial attention. We are worried about that because it would hurt London, to the benefit in a minor way of Switzerland and potentially also Asia, the Gulf and other parts. We are also quite worried about the so-called short selling directive or regulation that might be introduced. It is described as seeking to outlaw what is described as naked and abusive short selling. I would like somebody to give me a definition of what abusive short selling is. It is like the debate about short-term versus long-term. So we have a number of concerns coming out of Europe, that seem to us more about retribution than sensible policy making.

Q385 Jesse Norman: Thank you very much. Monsieur Rolet, could you just comment for a second on one thing? You mentioned the high costs of listing and how your own fees were a small percentage of that. I would like you to comment on that and also on the costs of capital raising in the markets, and what you think about those and where you think the trends are going?
Mr Rolet: Yes, I mentioned that because I know that there are sometimes arguments about this enormous pot of gold that we are seeking to protect which is listing. First of all the listing market is a competitive one today at the junior end as well as at the senior end. Our competition on the senior end are exchanges like Hong Kong, New York, NASDAQ, NYSE Euronext, Paris, Frankfurt, Deutsche Börse.

Q386 Jesse Norman: Yes, I should say I am less concerned with your costs than I am with all the other costs that this imposes on the market.
Mr Rolet: I understand. I will refocus my answer. Apologies. But at the junior end for AIM stocks, I mentioned that our listing fees that start at £5,000. At the junior end, the cost of maintaining a listing, with all the other related expenses, particularly as regards disclosure and so on, are in the region of about £150,000 per year. So if you're a small company, £5 or £10 million of cap, and you are looking to raise £2 or £3 million this is completely unappealing. We launched a few months ago a corporate retail bond

market for small and mid-sized companies. I am pleased to say we have about 154 companies and other issuers listed there, so there is also the debt side which can be facilitated. But the discussions we have had with both regulators and authorities here and in Brussels show that we need to look at ways of streamlining the regulatory burden on these small companies to help them reduce the cost. It is not just a listing fee or maintaining a listing fee, it is all the other ancillary expenses. We can think of ways, perhaps, of restricting if we feel there is an undue systemic risk, for example, access to retail investors, but it is not going to change the investment case for the large institutions. So it is the total cost of maintaining that listing that is a real hurdle.
Another point is that Europe as a whole, and that include the UK regrettably, doesn't have a fully funded chain of investors throughout the lifecycle of small companies, from inception all the way to the time when they are a mid-cap and they can survive on their own. There are a lot of gaps in the finance chains. When you hit one of these gaps, very often entrepreneurs sell the company so that the Genetex and Googles of tomorrow are subsumed by giants, and in many cases you end up with a sub-optimised result. So we think that, to answer your question, part of the solution is looking at the burden that is put on these small companies which, from a regulatory point is very close to the burden that is put on the very, very large companies to seek to ease their particular problem.

Q387 Jesse Norman: What are the costs of raising capital? I speak as someone who, having worked in these markets, witnessed the transformation from a market in which you could raise fees via placements at 2%, to fees in which you had book-built offerings at 4%. Talk to me about that? Is that a worthwhile development? Does that benefit the market particularly? Is it a deterrent to new entrants? Is it hurting the cost of capital of the country?
Mr Rolet: As long as you have competitive tensions, as long as you have enough underwriters, they can compete on the basis of service and fees. But I want to also describe the unique service that these underwriters are providing, particularly to the SME segment. This is a segment where few large investors dare to venture, so you really need expertise. I know when you look at spreads or fees sometimes the comment is, "Oh, this is really excessive, it's 2% or 1%," but if you look at what broker dealers do—most of them tend to be small to mid-sized broker dealers, not the giant global investment banks—you see that they provide research and specialist distribution. It's about secondary market liquidity. They provide capital. Let's not forget that one of the things that has made AIM successful is the fact that even in bad times, you have a group of market makers that are going to quote a two-way market. This is another thing that doesn't exist in many other countries.
That capital, the cost of providing that research, the cost of paying that distribution, has to be remunerated. The only point of remuneration is the spread of the original listing fee. I think one needs to look at the cost versus the full chain of services, and this is a particular expertise that is provided by City of London financial services companies.

Q388 Jesse Norman: Thank you. It seems to be a consequence of your view that if you could be sure there was enough competitive tension in the market, then capital fees of 10% might be acceptable?
Mr Rolet: I don't think if competitive tensions were there you would see these sorts of fees. I think, by definition, if these were the returns you would attract a lot of competition and if you look at the current competitive environment in the city, particularly the mid-cap stockbroker dealers, it's quite an intensively competitive environment, with dozens of firms involved. But, again, one has to look at the fees charged versus the lifecycle of services provided. You have paid a—I won't mention any names—mid-sized broker dealer fees to list securities, in an environment, for example, where you have the credit crunch and liquidity deserts. If you look at liquidity in equity markets in Europe, it has gone from about €1.5 trillion per month in December of last year to less than €650 billion in August of this year. The liquidity is half in Europe. But if you're a small-cap company and you've issued your stock in AIM using the so-called nominated advisers and broker dealers, there's still someone making it to market new security today, even at a time when liquidity has disappeared. That is a valuable service for us.

Q389 John Thurso: If I could just ask one very quick question. You talked about the need to get equity right throughout the chain and the importance of the SME, and you will know of the ideas to look at, particularly the fact that the Government are now thinking of doing regional stock exchanges. Is it important therefore that in looking at this regulation they bear in mind potential developments at that end and make sure that we don't over-regulate them out of possibility?
Mr Rolet: I think if there's a need and demand for a regional stock exchange, for example, this is certainly not something we would oppose. We don't look at this as a competitive inflection point because we are already in a widely competitive market, so it would, from our own perspective, not change much but if there is a need, if there is demand, if you have local pools of capital, then I think in that sense the UK has also an historical tradition of regional pools of capital. I often travel to places like Liverpool, Manchester, to Scotland, particularly Edinburgh, and other parts of the country where we have a significant number of SME clients as well as investors. So if those pools of capital are well represented and a local company feels that they would rather sell their equity or their bonds to local investors because of an affinity or knowledge of their business, whatever the relationship and its strengths, this is fine. If there is a need it will be serviced.
John Thurso: Thank you.
Chair: Thank you very much, both of you, for coming today. I am sure that there are lots of points and issues that have been raised today that you might want to supplement with further written evidence. Please supply that. You've already mentioned one, Mr Rolet.

What you have said has given us a great deal of food for thought and some worry, not least on the European side. We won't be letting matters rest. We'll now take a five minute break and then we will come on to the second part of the evidence session. Thank you.

Examination of Witnesses

Witnesses: **Baroness Sarah Hogg,** Chair, Financial Reporting Council and **Mr Stephen Haddrill**, Chief Executive, Financial Reporting Council, gave evidence.

Q390 Chair: Let's begin again. Thank you very much for coming along. You'll have heard some pretty robust evidence that we managed to encourage out of our previous witnesses. The first question must be, judging by the fact that one aspect of regulation may end up in your hands under the current proposals, should it be in your tender hands, Baroness Hogg?

Baroness Hogg: We've said in our evidence to you and in our response to the Government that we believe there are important synergies between what we do at the FRC in terms of corporate governance, corporate reporting and audit accounting practices—disciplinary and standard setting—and the work of UKLA. For example, UKLA is responsible for ensuring the accuracy of information that companies put to the markets when they raise capital; we are responsible for overseeing the information they give to the markets in their annual accounts. A piece of work we did a year ago suggested, how shall I put it, that there wasn't entirely consonance between—

Chair: Sorry, can you speak up.

Baroness Hogg: There wasn't entirely consonance between these sets of documents. It was an interesting piece of work that we could let the Committee have if they would like.

Q391 Chair: You mean they were confused?

Baroness Hogg: They were on occasions rather different.

Chair: We managed to decode what was being said in the first session, we would like to start—

Baroness Hogg: All right, we will try and be more decoded.

Chair: Yes.

Baroness Hogg: However, I think there is probably more agreement between us and Monsieur Rolet than perhaps he appreciates in that—

Chair: Well, put him right, yes.

Baroness Hogg: No, I just say I agree with him to a considerable extent that one of the key issues here is our representation at ESMA, and just as there are significant weaknesses in how that works at the moment, for example—at the risk, Chairman, of depressing you still further—I was astonished that he didn't mention as one of the risks coming down the track the proposed Green Paper on corporate governance which poses a very serious challenge to our comply or explain regime with respect to the monitoring of corporate governance. This is of enormous importance, not just to financial services companies but to all companies listed in the UK on all sorts of markets and threatens a rules-based procedure, which is very different from what we follow here. We suffer from the frustration that the ESMA seat on issues like that or audit or a number of our other responsibilities, is occupied by somebody not particularly apprised of the issues in that area. So what we have said in our evidence to you and to the Government is that while we do see some synergies in that suggested bringing together of UKLA and the FRC we think it is sub-optimal. We think a better proposal would be to create out of the remains of the markets division of the FSA and the FRC a fully rounded securities regulator, which would get rid of a whole set of boundaries and weaknesses of representation in the existing arrangements without creating the others about which Monsieur Rolet is concerned.

Q392 Chair: Have you discussed that with Mr Rolet?

Baroness Hogg: No, we have raised it with—

Q393 Chair: Why not?

Mr Haddrill: We have discussed it with the stock exchange and some of his staff.

Baroness Hogg: I've discussed with the Chairman too.

Q394 Chair: What do they think?

Mr Haddrill: They were quite interested in the proposition and they felt that that wasn't an option on the table from the Government so they weren't going to put it forward. But I think really they should speak for themselves.

Baroness Hogg: But you'll notice that in their evidence they suggest that the CPMA, in order to keep a distinction between market regulation and consumer protection, should in effect have two chief executives. It doesn't seem to us that's a great way to start off with a new regulatory institution.

Q395 Chair: Is it your view that we've got to get on with this. What you're describing sounds like a bit of a mess—we've got a lot of proposals and no one seems happy with any of them. What you generally want to do then is take stock, spend a bit more time thinking about it and get it right, but everyone is telling us this has to be done quickly, otherwise market confidence is going to get sapped, we're going to lose business abroad. Which is it? The latter?

Baroness Hogg: I think that is absolutely right. I think you're helping to make it—how can I put this?—rather better thought through but that needn't delay the process. I see no reason why at the conclusion of your inquiry Government shouldn't be ready to get on with things. Some things require primary legislation and some don't, of course.

Q396 Chair: Have you got anything else you particularly want to add, before I bring in others, with respect to the evidence you've just heard? Either of you?

Baroness Hogg: Perhaps I might just add that an important emphasis, of which we didn't hear quite so much in the previous session, is on the interests of investors and long-term investors, which is a very important focus of the FRC. If you look at what we've done recently in the revision of the corporate governance code and the introduction of the stewardship code, that is all about trying to make engagement between long-term investors and companies work better. Because it was, after all, those long-term investors who lost a lot of money in the financial crisis, and who did require and deserve a better process of engagement with the companies in which they invest, and we have taken on the role of facilitating that.

Chair: Corporate governance is also something we will be taking a look at.

Q397 Mark Garnier: I am going to stick this FRC-UKLA merger thing because it is quite a big conflict if you like between you and the stock exchange. The other thing it is, as well, is it seems to be slightly confusing as to which department wants to run it. If we look at the document, *A new approach to financial regulation*, and I quote directly from it, "The Government is therefore considering whether UKLA should be merged with the FRC under the Department for Business Innovation Skills or whether it should remain within the CPMA markets division." Do you see this as a possibility for a bit of a dust up going on between government departments trying to take control of listing arrangements?

Baroness Hogg: May I start with the first half of your question because, as I say, there may not be that much disagreement between us and the stock exchange on the need to ensure that we have a very strong voice, ESMA. It is just the range of responsibilities across which that voice is exercised. I wonder—and I promise I will come to the second half on departments—if I might ask Stephen to say a bit more about that.

Mr Haddrill: Is that okay?

Mark Garnier: Yes, go.

Mr Haddrill: Well, at the moment, or up until very recently, where we have had the CSR Committee, the FSA has represented the UK on that committee but there is quite a long list of issues, including some that are pretty important to investors. Sarah has already mentioned governance, there is also the question of the accounting rules that affect the whole of the market, there is a question of audit rules, and more recently the question of investor stewardship. Now, all of those are being discussed in Europe somewhere but particularly in these regulatory committees. The FRC, except on the rarest occasions, is not allowed to take part in those discussions. That is not the fault of the FSA. The FSA has been very strong in trying to get us into the door. The reason is that many other European regulatory authorities that have securities responsibilities, the French in particular, won't allow their audit regulator or their accounting regulator into the room because they don't want to dilute their influence in the committee.

So we have a situation at the moment where there are big responsibilities where the UK has to be represented by the regulatory authority that is not responsible. It doesn't matter really where UKLA ends up, that will continue. If it ends up in the CPMA, we will still have that problem in relation to those matters relating to investors. If it ends up with us then the split that Mr Rolet is worried about arises. That is why we think we really must make sure that everything to do with securities is brought together, both the trading side, which is what Mr Rolet is focused on and, from our perspective, the interest of investors in governance, audit and accounting.

Q398 Mark Garnier: There is a wider point with the governance, though, isn't there? One of the points that Mr Rolet made was that you've got only about 6% of quoted vehicles, if you like, that are equities, which is kind of where you are concentrated. You've then obviously got bonds and derivatives and all the rest of it which make up the rest of it. I got the impression that his point was that your remit doesn't really extend that much into those sort of sub-classes, if you like, of investment opportunity. Can you comment on that?

Mr Haddrill: We take as much interest in the good governance of companies almost wherever they are but we certainly focus, yes, on the main listed market. I would agree with that, because that's where the listing rules apply at the moment. One of the synergies, and I think one of the things we would want to focus on if UKLA was joined with the FRC, is this question of governance, because at the moment the FRC sets the governance rules, if you like, the code—not the rules, I should say the principles—and UKLA, in effect, creates the listing rules that enforce that, and requires companies to follow that subject to the comply or explain principle. So it would be an opportunity really for the FRC and UKLA together to look closely at listing propositions to see whether the governance of the company that is being put forward for listing is sound and solid and meets UK expectations, particularly perhaps for a listing coming from overseas.

Q399 Mark Garnier: I am going to go back to the second part of the question; I am not going to let you off the hook on that one. It is an important point, though, isn't it? If we do move forward to this merged organisation, should it be under CPMA or should it be directly regulated by or looked after BIS?

Baroness Hogg: Perhaps I might answer in a personal capacity. As the FRC at the moment is responsible to BIS it would be better if I answer personally. Is that all right, Chairman?

Chair: Yes.

Baroness Hogg: I could see a good argument, to be frank, for making the consumer protection part responsible to BIS, because the difficult interfaces with the consumer protection regulator in financial services are with the OFT and the Competition Commission, which, as you know both, or maybe just one going forward, are responsible to BIS, then having a market regulator, a securities regulator,

responsible to the Treasury. With all these things I think it is important that both departments are engaged, because I think BIS has a real and powerful interest in some of the issues you were discussing earlier about the chain of capital-raising potential for companies from very small through to FTSE 100 and the gaps in that chain. But then, of course, so does the Treasury, which has an interest in private equity, and in growth capital, which is a very important part of the piece that doesn't follow the description you were given of requiring the company to be sold. It's an investment in a company which is then grown with the original founders still holding the majority of shares and listing on markets in that way. But consumer protection I can see being primarily responsible to BIS and markets to Treasury. But I am giving that to you as a personal view.

Q400 Mark Garnier: But does it not strike you that we start off with this twin peaks model, and then you have one part of the twin peaks model as being having a twin peak kind of reporting line, if you like. We are getting back to some sort of horrible place that we were before with the FSA, where nobody really kind of knew who it was reporting to and it just became too complicated. We've got an opportunity here to have a very simple, very straightforward and a very understandable framework that we can do, and all of these sorts of hypothetical arguments end up with us going in completely the wrong direction. What I want to hear from you really is how you are going to contribute to this argument to make it simple and understandable and not likely to have the same problems we had a couple of years ago?
Baroness Hogg: I absolutely agree with that, and I do not think the CPMA is a simple model. It would suffer from exactly what we saw—and again I must say I'm speaking personally—with the FSA before the crisis, which is that it did not know whether it should be focusing on consumer protection, consumer detriment, information asymmetries and the delivery of product, or whether it should be focusing on market regulation and prudential requirements. It was always swinging between the two, so there is a need to separate consumer protection. Consumer protection in financial services is all about the conduct of business and the character of products in financial services which are complex products for the consumer to understand and should be put with consumer education in a self-standing body.

Q401 Mark Garnier: But the CPMA is about consumer protection.
Baroness Hogg: Then the markets piece, if I may, will be second string and will not have the strength that Monsieur Rolet has described it as requiring.

Q402 Mark Garnier: Sure, but the central counterpart is clearing houses and settlement systems and markets, which are going to be reportable directly to the Bank of England. Is that maybe the answer?
Baroness Hogg: Exactly, but then the markets—the remains of the markets piece—if you put that with UKLA and the FRC and create a securities regulator you would have greater clarity. I should say in this that we're turkeys voting for Christmas because the FRC is a small organisation; we would be put into a bigger organisation. So there's no FRC interest here.

Q403 Mark Garnier: Yes, sure. It is incredibly important to resolve this. How are you proposing to work to get to a conclusion to this and to get to a simple end and a simple outcome?
Baroness Hogg: All we can do is put our views to you.

Q404 David Rutley: Can I just ask a supplementary question? So you are putting forward the view effectively for a new tripartite role, I guess. Is there any enthusiasm from other stakeholders, other key organisations, for your model?
Baroness Hogg: I think they haven't seen it as on the table. I would say that there are three pieces at the moment. There is the FRC, and its role is growing: it has been given new responsibilities over the last couple of years. For example, with the stewardship code and the relationship with the investor community, which is a new and very important piece of the activity. So there are three. It's about restructuring them so that they work best at this point going forward. There's quite a lot of concern, I think, out there about putting together consumer protection in the remains of the markets authority. There are always difficult boundaries wherever you cut this one but there is quite a lot of concern about that, as with the proposal that they need to have two separate chief executives—that sounds odd to us.
Chair: Do you want to add something, Mark?

Q405 Mark Garnier: I was going to talk about where the potential conflicts are going to come from your model. The more I think about it the more I just can't see any other reason apart from there would be lots of conflict. Can you talk about the conflicts and talk about how they are going to be resolved?
Baroness Hogg: The ESMA piece is resolved by having a securities regulator, which brings me to—
Mark Garnier: I am thinking more with the structure of the management, reporting back to BIS, reporting back to the CPMA, the way it works in terms of the regulation within the UK.
Baroness Hogg: I would see the securities regulator reporting to the Treasury, consumer protection reporting to BIS, a lot of interest in that area.

Q406 Mark Garnier: Which gets back to my original point about the power base, if you like, because you've got a conflict of interest there between one department and another, trying to effectively take control of what amounts to the backbone of the financial services industry in the UK.
Baroness Hogg: You have it at the moment of course, because some of the consumer protection piece is with BIS and it's proposed to move it to the Treasury. So you have that going on in this process. So with the proposal put forward by the Government you would have UKLA and FRC reporting to BIS and the markets division and consumer protection reporting to the Treasury.

Q407 Mark Garnier: Yes, but talk about the conflict. Talk about where the problems are with this.
Baroness Hogg: The problems with that lie in the squeezing together of the markets division and consumer protection: with one part of market regulation, that is to say ours or ours plus UKLA, with BIS and the rest of the market division with the Treasury.

Q408 Mark Garnier: So do you think that we're sticking with the problems we had with the FSA?
Baroness Hogg: I'm so sorry, I didn't hear that at all.
Mark Garnier: Sorry, do you think we're staying with the structural problems we had with the FSA or do you think we're moving away from that? It just feels like we're staying with the structural problems.
Baroness Hogg: With the CPMA, we're staying with the structural problems, or one of them. Obviously the prudential piece has been resolved by moving that to the bank but with the CPMA as one piece there's that same looking both ways within the one institution.

Q409 Mark Garnier: So ultimately we're no better off. We're going to all this trouble and we're possibly not addressing the fundamental point.
Baroness Hogg: There is another fundamental point, I think, which is the macro-prudential issue. So putting that aside.

Q410 Mark Garnier: Sure. Yes, yes. But let's look at the nuts and bolts on the regulation.
Baroness Hogg: Yes, on that piece, we haven't solved that problem and have created a new one.
Mark Garnier: Thank you.

Q411 Chair: Not a very strong endorsement of the Government's proposals?
Baroness Hogg: We've said we think that we can make their proposal work and that there are important synergies. But we think there is a better option.

Q412 Chair: That is the polite bit, isn't it?
Baroness Hogg: I've been extremely open, Chairman, I'm allowed occasionally to be polite.
Chair: You wanted to add something?
Mr Haddrill: Just that the model we're talking about matches up to Europe in another respect as well. We mustn't forget that—we've been talking a lot this morning about the regulatory level, the ESMA level, but above that is the political level, the council and the commission. Of course the basic decisions about the framework of a regulation are taken by the council with the commission, with the European Parliament. ESMA is then asked to implement those in detail. It gets its funding from the commission. It is quite responsible to the commission. And at that higher level you do have a separation in Brussels between the internal market team and Commissioner Barnier looking largely at financial services, and consumer protection, including its impact on financial services, handled separately by a separate part of the commission, and often in separate council discussions. So they have, in a sense, recognised the split that we're proposing here.

Q413 Jesse Norman: Baroness Hogg, you have said that you think that the relationship between the FRC and UKLA could be made to work, and the Chairman has noticed it's hardly a ringing endorsement. Could I make a mischievous suggestion, which is that part of this is driven by financial considerations and that the desire is, in part, the UK Listing Authority's revenue stream be used to sustain the FRC. Is that something the Government, you think, might have in the back of its mind? Because it's hard to see many other points of interesting overlap between these two organisations.
Baroness Hogg: No, absolutely not. I wrote to the Secretary of State on his appointment saying that our funding from Government—and this was before any of these proposals—was now down to 5% of our revenue and we were happy to see it go to zero. It is going down to 2.5% next year and will go to zero thereafter.

Q414 Jesse Norman: So you're satisfied that there's no, as it were, bureaucratic reshuffling here.
Baroness Hogg: No, no, our activities are self-sustaining on our revenues.

Q415 Jesse Norman: Good. Thank you very much. In relation to corporate governance, an area in which I have some personal experience, how would you describe the current set up that we have? Because to the untutored eye it might look like a kind of spaghetti junction of overlapping codes going back to Adrian Cadbury, Richard Greenbury, Hicks, various minors—there were various other bits and bobs. And yet our corporate governance system signally failed to inject the kind of accountability that would have prevented the banking system from going bust. I see, with some pleasure, that you've pushed the idea of annual re-election of directors. Can't we go a lot further than this in empowering shareholders? Let me give you an example: in some parts of the US, they have cumulative voting where shareholders can, as it were, in putting votes for ten directors, put ten votes for one director and thus ensure that there's an independent voice on what may be otherwise an extremely intramural arrangement?
Baroness Hogg: Thank you for your support for annual election. We thought it very important to listen to investors on this issue in this consultation on the corporate governance code. As I'm sure you know, UK corporate governance has internationally a good reputation. You don't have to take my word for it—I was impressed last week, for example, to listen to the specialist of the Norwegian Sovereign Wealth Fund, which you know has about 2% on average now of every listed company in Europe, saying that we were—well, I won't say what she said about France—significantly ahead would be the word, if I'm allowed.
Chair: Why not?
Baroness Hogg: You keep trying to get me to be rude. But I don't think any of us can feel that things couldn't have been better and that's why we reviewed the code and listened to the views of investors. We were steering a course between looking at the code and seeing where changes should be made, such as annual election, and ensuring that we didn't impose on non-financial companies burdens of structure that

were appropriate only to systemic financial companies. Therefore on the changes proposed by Sir David Walker, we embedded in the code those we thought to be appropriate to all companies, and the FSA took on the task of regulating specifically financial services companies where they thought they were additional requirements; for example, formal risk committees on every board.

So far as your suggestion on elections, our instinct is to try and keep the model simple. Annual election, as you know but not everybody seems to, is not just one vote for the whole board, but one for each director. We thought that was a simple model that moved things a long way forward. Everything we do is done on a comply or explain basis because we are, if you like, the facilitators of accountability to shareholders, which lies at the heart of our model, and is under threat—this is where I'll worry the Chairman again—from Europe, which doesn't believe that at the end of the day shareholder rights are properly exercised in many countries. Many countries believe that those are rights that should therefore be taken away and embedded in legislative prohibitions and requirements.

Q416 Jesse Norman: Yes, of course that's true. It is also true that it's a very easy way of regarding the whole of capitalism as a model that is essentially broken because of the events of the last two years. It does seem to me, though, however that you could go a lot further in introducing genuine accountability and shareholder strength. We have talked about cumulative voting. You could, for example, sue investors who failed to exercise prudential ownership. You could open up the question of self-reinforcing pay arrangements which we've seen—executive compensation—go through the roof. What about those kinds of things? Those are the areas that I think really demand attention.

Baroness Hogg: Shall we start with investors? I know Stephen is bursting to come in, having spent time at the ABI. You do the investor bit.

Mr Haddrill: I just think that the picture that we heard from the London Stock Exchange about the very powerful capital raising that's gone on and sort of refloated British business post-crisis, or during the crisis as well, is that we have to be very careful about it imposing responsibilities and costs on investors when they have got the choice about how they deliver their money into the market. We think the equity market model is a very powerful and good one for the British economy, but people don't have to put their capital up in that direction. They can lend it and so on, which we think clearly has some advantages in some circumstances, but we would certainly be losing something if we deterred people from being equity holders. That's why what we have done is introduced the stewardship code which is receiving an enormous amount of endorsement. We've now had over 50 major fund managers sign up to it and we will be monitoring very closely what they do, whether they abide by its requirements on engagement with the companies and so on. And we feel that strong nudge to voluntarism is the right way forward at the moment.

Q417 Jesse Norman: It's a very strange argument, though, isn't it, because you've just been telling us how the benchmark of the European investors, the Norwegian fund, has invested in every major company in Europe? The largest investors have no choice but to remain equity investors. Certainly they are not going to start lending into those companies in a way that gets them out of the equity market so it does seem to me the basis absolutely exists from a shareholder standpoint to start to insist on what is, after all, a theme that this Government is making a big issue of elsewhere, which is that ownership carries with it responsibility?

Mr Haddrill: I think I would question your first point. I think they do have a choice and we've seen—perhaps for regulatory reasons more than anything else I accept—the major long-term holders of capital in the UK, particularly the insurance companies, heavily reduce their shareholdings and move into bonds, which means that we have a much larger—I don't object to this, it is a strength in a sense—foreign holding in the London market than we did say 10 or 20 years ago.

Baroness Hogg: May I just add that in relation to that I think you're entirely right. Again, I must say I'm speaking personally, because it's not within our area of responsibility at the moment to press on underwriting fees. I think that has not been a good story recently.

Q418 Jesse Norman: But you would support the view I was hinting at in my earlier line of questioning?

Baroness Hogg: That they were high.

Jesse Norman: Far too high. Thank you.

Q419 Stewart Hosie: Can I just take you back to David and Mark's questions. In a previous answer, you commented on the difficulties of the tripartite in the run up to the banking crisis. But in separating out the markets conduct regulator from the CPMA, are we not recreating, or would you not recreate, the very underlaps, the cracks between the three pillars, that allowed things to fall in the first place, as witnessed by the failure to have an early takeover of Northern Rock, for example, in the first weekend. Would we not go back to gaps within the system if you had your way with that structure?

Baroness Hogg: I don't believe that. Under the Government's present proposal, there is a separation between the PRA and the CPMA. That addresses one gap, between the Bank of England and the FSA, but of course it opens up a new gap between the PRA and the CPMA. What I'm suggesting is that the gap between the FRC and the markets division is closed, and that consumer protection is a separate institution combined with consumer education, because I believe this is enormously important. If it is in a combined institution, which is half about wholesale market regulation, the kind of thing you've been talking about all this morning, either consumer protection will get lost, or it will be a constant diversion of view between the two at the top of the organisation, as we saw with the FSA. It could never work out from one day to another whether it should be most focused on consumer protection or market regulation. I do believe

a strong consumer protection body for financial services is enormously important.

Q420 Stewart Hosie: No, I wouldn't dispute that. Is there not a danger though that this takes us away from the twin peaks model, which appeared to be worked towards, with that separation.
Baroness Hogg: I don't want to get hung up on twin peaks. I think there are three activities: macro-prudential; market regulation; consumer protection. I think clarity of focus amongst the institutions is the best way of avoiding underlap—and indeed overlap, which will also be a danger.

Q421 John Mann: I'm trying to work out what's going on here. We've got an active politician linked to the current Government and we've got a former senior civil servant from the DTI. We've got a dog's breakfast of a proposal according to everybody else. In fact I can't find anybody else at all who thinks that this proposal has got any merit in it, and they're queuing up to say it hasn't. The stock exchange says that this will help sow the seeds of the next crisis. I'd like to start by asking where did this proposal originate? When were you first involved in discussing this proposal with Government?
Mr Haddrill: Once it had published its consultation document.

Q422 John Mann: So you've had no involvement whatsoever in advance?
Mr Haddrill: No, not with the Government.
Baroness Hogg: No, we read what the Government put out before—

Q423 John Mann: So somebody within Government has dreamt this up, obviously not consulting anybody else at all, not even yourselves?
Baroness Hogg: I'm sure it consulted, but it didn't consult us.

Q424 John Mann: No, it can't have consulted others because they're all against it—ABI, CBI, IOD and a string of other acronyms that are less memorable, all against it. So you're saying that you weren't consulted, but this totally and absolutely transforms your organisation. You said yourself, Baroness Hogg, you're a small little organisation and you'll become a much larger one. So no one bothered to consult you about this major transformation in your organisation?
Mr Haddrill: There was a proposal in the work that Lord Sassoon did before the election for the Conservative Party, where he raised the possibility of effectively creating a markets organisation of the kind that we're suggesting, rather than the kind that the Government are suggesting. He suggested bringing us together with the markets division of the FSA and the takeover panel in a—really what we're now much closer to talking about is our proposition as opposed to the Government's. We discussed that with him before the election. It then seemed to disappear. The whole thing disappeared for a while after the election, and the first we saw or discussed of the proposals was when the consultation document came out, because it came out differently from Lord Sassoon's original proposal.
Baroness Hogg: We should be clear that you mean this proposal that I've been describing of a full securities regulator or UKLA and the FRC?

Q425 John Mann: This principle that's there.
Baroness Hogg: Do you mean just the FRC and UKLA or the wider—
John Mann: Yes, I do. Yes.
Baroness Hogg: Oh, okay. Well, we had some conversations with BIS before the paper was published.

Q426 John Mann: You did?
Baroness Hogg: Yes, discussions with BIS.

Q427 John Mann: Well, how long before?
Baroness Hogg: They were talking to us—what, how long before?
Mr Haddrill: Well, almost immediately before, I think.

Q428 John Mann: Just immediately before?
Mr Haddrill: I'm trying to remember.

Q429 Chair: Can you define "immediately before"?
Baroness Hogg: I'm sorry, I thought you meant the securities regulator idea, which, no, that—

Q430 Chair: I am astonished by the answers you've given to John. Are you really saying that you were not in the loop at all?
Baroness Hogg: No, on UKLA and the FRC, BIS consulted us beforehand, absolutely. I misunderstood you, my apologies. I thought you meant—

Q431 John Mann: Well, the securities regulator, you've just thrown that into the equation as part of your backtracking, haven't you?
Baroness Hogg: No, I thought you meant the securities regulator. You said "this, which we have been talking about".

Q432 Chair: Can you just clarify, what did they consult on and what didn't they consult on?
Baroness Hogg: They consulted on the UKLA-FRC combination with us.

Q433 Chair: And what didn't they consult on?
Baroness Hogg: The idea of a wider securities regulator.
Chair: Sorry, John, to interrupt.
Baroness Hogg: Is that clear, John?

Q434 John Mann: It is but I'm still interested to see when they consulted you.
Baroness Hogg: Before the Green Paper.

Q435 John Mann: Do you remember how much before?
Mr Haddrill: In the one or two weeks before. If you recall, immediately after the election, it seemed that the proposal to take a radical view of splitting up the FSA was being dropped and then it reappeared. It was

only after it reappeared, which was quite close to the point where the consultation document came out, that we had some discussion with them.
Baroness Hogg: Is that clear?

Q436 John Mann: So it's not coming from you all at all, and it hasn't done before, even in pre-election discussions?
Baroness Hogg: No.
Mr Haddrill: No.

Q437 John Mann: In any way?
Baroness Hogg: No.

Q438 John Mann: What's the motive for you then? It totally transforms, changes your organisation, what is the motive? There's always a motive in people's actions.
Baroness Hogg: To improve the quality of regulation. I said it's not particularly—

Q439 John Mann: What's the motive for you as an organisation? Is the motive as previously in some way a profit or financial motive or is it a motive of trying to water down scrutiny of your own sector?
Baroness Hogg: To improve the quality of regulation.

Q440 John Mann: That is a very esoteric aim.
Baroness Hogg: I think it's a very important aim.

Q441 John Mann: But that's not a motive for your organisation.
Mr Haddrill: When our board discussed the proposal shortly before the consultation document came out, the board took the view that the best answer for the UK was the creation of a markets authority—a securities regulator. And it recognised when it took that view that it was effectively saying goodbye to the FRC, and we would be supporting the concept of the Government creating a completely new body. So we did put completely on one side any organisational interest in the proposition.

Q442 John Mann: That is very good of you. I'm mystified. This is how organisations in my experience overreact. Your organisation is going to be totally and absolutely transformed—every one else thinks this is a bad idea who has chosen to comment publicly. You've had a week or two of consultation in advance, you've then thrown in a separate proposal of a securities regulator, and my question is what is going on? Because this doesn't all stack up. Where's your vested interest in this?
Baroness Hogg: To improve the quality of regulation.
John Mann: We're all in favour of that, that's not a vested interest
Baroness Hogg: Good.
Mr Haddrill: Well, we don't have a vested interest beyond the job that we've been given. Our job is to be the UK's independent regulator in a large part of the investment interest and that's what we seek to do. If the Government wants to change the framework we have to give our view on how best that can be done.

Q443 John Mann: Because of your knowledge of politicians and civil servants, you're both together uniquely placed. Do you think this proposal has originated from politicians or from civil servants within BIS?
Mr Haddrill: I don't think I feel able to judge that, except to say that the proposal to split up the FSA clearly came from politicians before the election and therefore presumably the leadership was initially a political leadership.

Q444 John Mann: That's one issue, but the question, which is a contentious one of course, is how it's done.
Baroness Hogg: Indeed.
John Mann: That's the critical issue here. That's why you're in front of the Committee.
Mr Haddrill: When we went into the department the officials weren't saying to us, "Well this idea has come out of Ministers but we don't agree with it", and the Ministers weren't saying to us, "This idea has just been cooked up by officials and we don't agree with it". I mean they tended to say the same thing, so I assume that they developed it together. Maybe I'm being naive but that's what I assume.

Q445 John Mann: We're not electing a Pope here. This is my final question. I'm quite astounded I have to say, because everyone else who has bothered to comment is against this. Quite a lot have bothered to comment.
Baroness Hogg: Can I be clear what "this" is?
John Mann: This is the initial proposal of UKLA merging in with yourselves.
Baroness Hogg: Okay, yes.
John Mann: You've thrown in a second proposal as part of your wriggling to get out of the opposition to others, it seems to me. Why is everybody else so wrong and you and a Government Minister so right in terms of—or is it the Government Minister on his own who is responsible for this? Are you distancing yourself—
Baroness Hogg: We haven't said they are wrong, have we? I'm sorry, you—
John Mann: No, you haven't. So in fact now we've just got a Government Minister on his own—I think, Chairman, we need to get this Government Minister in to find out what's been going on.
Chair: All in good time.
Baroness Hogg: But I think to be fair, I think if you read the Green Paper you will see that the Minister himself raises the questions.

Q446 Chair: Well, we've had a good background in this subject this morning and ended on a somewhat lively note. I'm very glad we were able to clear up what looked like quite a misunderstanding about whether you'd been consulted at all, and it seems things are a little less bizarre than I initially thought.
Baroness Hogg: Yes, I'd assumed that as we'd been talking about the securities regulator that's what Mr Mann meant.

Q447 Chair: No, I understand. This area of regulation is now in flux and we'd better get it straightened out sooner rather than later, judging by

your initial remarks about the damage that this could do to UK competitiveness. Is there anything else that either of you want to add now? Otherwise, if there isn't, if you do have supplementary thoughts we'd be very grateful to receive them in writing. Thank you very much for giving evidence this morning.
Baroness Hogg: Thank you, Chairman. Is there anything you want to add, Stephen?
Mr Haddrill: Perhaps just on your last point about sorting it out quickly. The concern for us is also that the staff of UKLA find out pretty soon where they stand because I think the role they have is so important. If they are to continue to do it and do it effectively, that has got to be taken into account.

Q448 Chair: That point has also been made to us. Thank you very much indeed.
Baroness Hogg: Thank you.

Thursday 11 November 2010

Members present:

Mr Andrew Tyrie (Chair)

Michael Fallon
Mark Garnier
Stewart Hosie
Andrea Leadsom
Mr Andrew Love
David Rutley
John Thurso

Examination of Witness

Witness: **Mr Sean McGovern**, Director and General Counsel, Lloyd's of London, gave evidence.

Q449 Chair: Thank you very much for coming before us this morning and for helping us with our inquiry. I would like to get straight into evidence and just begin by asking you why AIG did not happen here.
Mr McGovern: An awful lot has been written about the causes of the collapse of AIG, both here and in the US, and it has also been examined by the UK regulator. There have been various inquiries in the US by Congress, and I think I can best summarise how Ben Bernanke described it—that the AIG collapse was caused by a small but highly volatile division of AIG, which was financial products, which was trading in credit default swaps, but that financial products division was attached to an otherwise stable insurance group. What has become clear is that the insurance operations of the AIG Group were stable in the lead up to the collapse of AIG, and have remained stable throughout. Most of the US operations of AIG are regulated at a state level and those operations have remained solvent; indeed, the UK-regulated company has remained solvent throughout. Could it happen here?

Q450 Chair: Just before we move on, if I may. What you are saying is that AIG was a solid, cash-cow style insurance business, with a small, very high risk trading arm in credit default swaps. So there is at least some theoretical mirroring of the criticism of the banking sector, who argue for narrow banking.
Mr McGovern: Essentially, the problems that were caused to AIG were through its non-bank activities, not its insurance activities. There is a debate over how complex groups should be regulated and there has been commentary that AIG exploited gaps in the regulatory system. The Financial Stability Board and the IMF are spending a lot of time trying to get to grips with these complex global groups and how those gaps in the system can be avoided. I think the other relevant debate, in all of this, is whether or not core insurance business creates systemic risk in the same way that it has been proven that banks create systemic risk. I think there is a growing consensus among regulators around the world, including the FSA, and Lord Turner made a speech recently looking at the issue of systemic risk in insurance. What is clear is that the insurance business model is very different from the business model of the banks. It is a pre-funded business model: we take in premiums. We're not leveraged in the same way. We're not involved in maturity transformation. You can't get a run on a general insurer; an insurer only has liability to the extent that a claim is payable. And it's clear that you can see the failure of an insurance company long before it happens. You don't get a shock loss to an insurer. Also, there is no interconnectedness. There are very tried and tested mechanisms by which an insurance company's activities can be wound down—either on a solvent or an insolvent basis—without causing wider systemic implications into other parts of financial services or, indeed, into the real economy.

Q451 Chair: What about the treatment of long-tail risks?
Mr McGovern: Long-tail risks. There are certainly some questions over life insurance, particularly the impact of financial stability on the balance sheet of life insurers. Lloyd's does a very, very modest amount of life business; we are a general insurer. So I think you're quite right, there are some issues around the impact of changes in volatility in financial markets, as far as life insurers are concerned, and whether or not the actions of the life insurer can amplify a systemic risk that arises through that volatility. As I say, Lloyd's is a general insurer so that is probably straying into areas beyond my experience.

Q452 Chair: What have you changed in response to this crisis and to what happened to AIG?
Mr McGovern: Core insurance does not create systemic risk. Lloyd's is only in the business of insurance and reinsurance. There is no part of what Lloyd's does that is involved in anything that could be remotely described as being exotic. The system of regulation on insurance here in the UK has been very robust and has been world-leading. The Turner review acknowledged that the prudential regulation of insurance in the UK has been stricter than in many other member states. I think the regulatory regime in the UK has helped the insurers navigate their way through this crisis. Speaking for Lloyd's, we have navigated our way through the crisis very well. We've been profitable throughout, our balance sheet has grown throughout, and we have not been negatively impacted by what we've seen. So, a very different experience to our banking sector colleagues.

Q453 Chair: Just to be clear, what is the obstacle to some type of AIG event happening here? Is it self-regulatory, is it formal regulatory? What is our protection?

Mr McGovern: The protection is the debate about how financial conglomerates that contain a mixture of regulated banks, regulated insurers and non-banking activities that are in the shadows of the regulated sector are dealt with. Obviously, that is where there is a very strong focus of attention on how those non-banks can be brought within an integrated regulatory framework.

Q454 Chair: And you are welcoming the regulators' engagement on that issue?
Mr McGovern: Yes. Our concern is to make sure that when regulators are looking at systemic risk more broadly—and obviously it is quite right to look at it across financial services—we don't want simply to be winning the last war. It is crucial that they recognise there are different business models here, and measures that might be necessary to address systemic risk that has arisen within the banking sector are not automatically transferred into an insurance regime where the business model and the risks created are very different.
Chair: John?

Q455 John Thurso: Just following on from that, in your written evidence you have said "There is nothing inevitable about London's current financial success", referring, obviously, to Lloyd's. Is there a real danger that you could be damaged by the collateral effect of a fallout from regulation of banking that would be inappropriate to Lloyd's?
Mr McGovern: I have to say I think that is one of the biggest worries of the insurance industry at present. All of the debate is around: how can we fix the failures in regulation, the failures in the bank business model? There is an assumption that if more capital is required within banking or more regulation is required within banking, that that should somehow be automatically read across into the insurance sector. We're not only seeing it here in the UK but we're also seeing it in Europe, with debates around crisis management, debates around resolution funds. The question starts with: so how do we bring financial services within this regime? Our argument is that we don't need those solutions for insurance.
Our experience of the crisis demonstrates that the insurance business model is very different. It's therefore a bit disappointing that the consultation document—I think it mentions the word "insurance" three or four times—doesn't really recognise the importance of the insurance industry to the UK economy. It is a major provider of employment. We think it employs something in the order of 250,000 people. It contributes about £8 billion-worth in tax revenue, and is obviously a major exporter of services. The London insurance market is the leading insurance market in the world and it is clear that regulation has a big impact on how people perceive where to place their business. Our business is highly capital-intensive. It's at the very specialist end of the insurance and reinsurance market, and that capital is highly mobile. What I would say at the moment is that the FSA regulatory regime on insurance has been a real asset to the insurance industry in the UK. What we would like to ensure is that when we move to a new regime, housed in the PRA under the auspices of the Bank of England, we don't lose the quality of insurance regulation that has served so well.

Q456 John Thurso: It is quite a complicated model, Lloyd's. You have the society; you have members; you have agents; you have corporate members, and all the rest of it. Do you think the Government understands you and your importance to the British economy?
Mr McGovern: I hope they do, but we never cease to remind them at every opportunity and, as you say, the market structure is unique, so it is hardly surprising that the consultation document has a reference to Lloyd's, which is basically, "There is more work to be done." We do look forward to further engagement with Government on exactly how—

Q457 John Thurso: Do you think you are getting to the authorities and putting your points across, or do you feel there is a barrier?
Mr McGovern: I think we are. We have had meetings with the Bank of England and with the Treasury at ministerial level. We have good engagement at the working level, and I do think we are getting our points across, albeit, clearly, that the action is all about the banks, and we have to keep reminding people of the importance of the UK insurance industry.

Q458 John Thurso: How should Lloyd's itself be regulated? Should it simply be the same regulation as other insurance companies, or are there differences that Lloyd's should have because of its unique structure?
Mr McGovern: The structure is unique and our relationship with the FSA is unique, for many different reasons. We believe that our regulation should be focused within the Prudential Regulatory Authority and not dispersed across different agencies, because the unique structure of Lloyd's, and the knowledge that it takes to regulate it effectively, is currently housed within a dedicated team within the FSA. There is something like 14 people within the FSA whom we work with very closely.

Q459 John Thurso: You feel they know what you are about?
Mr McGovern: Yes, absolutely, and we have invested a lot of time in helping them understand us. We co-operate and co-ordinate with them extremely closely. So we think the PRA is the right place for Lloyd's but we do think that it is important for the PRA to be the lead supervisor. I think one of the things that we will be continuing to push for is this concept of lead supervisors, because the most important thing, from a regulatory perspective, in relation to Lloyd's—given the type of business we do, which is predominantly specialist business written for corporate buyers—is prudential solvency, making sure that there is enough capital within the Lloyd's system. So conduct of business regulation is second order, in my view, to the importance of prudential oversight. There are clearly some aspects of the market where we will be required to demonstrate conduct of business priorities, but prudential regulation is the lead.

Q460 John Thurso: Last question, slightly different angle. You operate in more than 200 countries; you are spread right across the world. Has the FSA been effective in working with overseas counterparts on your behalf?
Mr McGovern: The answer is yes. I think the business model of Lloyd's is very important for London. We do write business from 200 countries and territories around the world. The US is our largest market; 40% of Lloyd's business comes from the US, but all of that business is written and all of the economic activity that supports the business is in London. So we don't have lots of subsidiaries around the world with hundreds of people underwriting business. It is all done out of London. So the importance for us—

Q461 John Thurso: So you do not really have a problem with regulators in other countries, because all your activity is here?
Mr McGovern: But crucially, because we have managed to convince the other regulators around the world to rely on the effective regulation that we have here at home. So for an international business like us, it is absolutely critical that we have a credible, robust regulatory regime to avoid duplicative regulation across the globe.
Chair: I think Mark Garnier has a few follow-up questions on regulation.

Q462 Mark Garnier: I was going to say I am very grateful to Mr Thurso for asking all those questions I was going to ask, but it does give me an opportunity to drill down a bit more deeply into these points.
Carrying on from what John was asking, Lloyd's is a marketplace, and obviously there are a lot of different organisations within it: you have underwriters; you have brokers; you have names, agents and all the rest of it. When I look at the proposed regulatory regime that is coming up, there are certain bits that are clearly specific to the retail investor. I am probably using the wrong word, because "investor" is not necessarily the right thing, in terms of looking for buyers of insurance products. But you also have parts of the regulatory regime that are looking at the system, and the PRA is looking at the marketplace as a whole. You have already said that there is a problem with the fact that this consultation document only mentions insurance two or three times, but I suspect that that is looking at insurance companies. This is a very complex organisation that you run. How do you see it mapping out here? Who is going to be regulated by which part of the spider's web that is the proposals?
Mr McGovern: As I say, I think the prudential regulatory authority should be the lead. It is critical that there is proper co-ordination, not only between any CPMA regulation of Lloyd's and the PRA, but also with Lloyd's itself. The organisation I work for is the Society of Lloyd's. It is a not-for-profit statutory corporation, which is charged with running the market and regulating the market. So we have front-line responsibility for making sure that everybody in the market—whether they are members, whether they are the managing agents, whether they are the members' agents—conducts themselves in an appropriate fashion, and that there is adequate capital within the system. We do that under the watchful eye of the FSA. We have an explicit co-operation agreement that was put in place with the FSA when the FSA took over regulation of Lloyd's in 2001. It was recognised that with the FSA, which regulates the Society of Lloyd's—the organisation I work for—managing agents, and members' agents, there was a real risk of regulatory duplication between what we do in overseeing the market and what they do. We have worked very hard with the FSA to make sure that we are clear who does what and how we do it, and we work very effectively. We have this formal co-operation agreement in place; we share information, and we have a very strong understanding about how we perceive risk in the market. Going into the new regime, it is going to be crucially important that those co-operation arrangements continue to exist. There is going to be a challenge with that.

Q463 Mark Garnier: That is with the PRA?
Mr McGovern: Predominantly with the PRA. I will come on to the conduct aspect in a moment. So what we are looking for is the arrangements we have with the FSA in terms of the co-operation that exists—that has worked very effectively for Lloyd's over the last nine or so years of FSA regulation—being carried through into the PRA. Crucially, what that allows the FSA to do is take account of the systems and controls that we have over the market in judging how much regulation they need to conduct of the managing agents and other parts of the market. They don't like to use the word "rely", because they ultimately have regulatory responsibility, but it is true that, in framing the regulation of Lloyd's, they look at the work that we do, and we have a 150 people whose job it is to oversee the management of risk in the market. They take account of that in then determining how much resource and effort they apply to regulating the market. So that co-operation and that reliance, for want of a better word, needs to be carried through into the PRA.
On the conduct side, conduct of business regulation is very important for the limited amount of personal lines business that is written in the market. We do write some personal lines business. Again, it tends to be at the specialist end, so it is the 25-year-olds driving the Ferraris, rather than standard motor policies. So the way in which we work with brokers to sell those products has to be compliant with good conduct of business regulatory principles, as it does now. However, what I think the CPMA's regulation of Lloyd's needs to recognise is that it is a business-to-business market. We don't deal directly with clients. Everything that we do goes through insurance intermediaries.

Q464 Mark Garnier: Although your names can be private individuals, can't they?
Mr McGovern: Yes. The profile of names has changed pretty dramatically. In the late '80s there was something like 34,000 names at Lloyd's. They constituted the entirety of the Lloyd's capital base. They all underwrote on an unlimited liability basis. We now have fewer than 4,000 individuals who are actively underwriting on that basis. They represent 4%

of the market. They aren't consumers, in the traditional sense of the word. We have a system of protections in place for names, because they obviously have interactions with various elements of the Lloyd's structure. There is an ombudsman's scheme and there is a compensation scheme. Those are all part of the FSA regulation of Lloyd's, so we conduct that under the very watchful eye of the FSA. It is adequate; the representative groups that represent names believe they are adequate. So again, it is a case of carrying those sensibly into the new structure.

In terms of what we would like to see, when it comes to dividing issues between PRA and CPMA, with regard to Lloyd's, I do think that there is going to need to be some pragmatic decisions taken. As I said, understanding Lloyd's as a cohesive whole is going to lead to much more effective and efficient regulation of Lloyd's than compartmentalising things, because they appear to fit better into the CPMA. That is what we're encouraging Treasury and the Bank of England to consider. We understand the principles of the division between the PRA and the CPMA, but we may need a sprinkling of pragmatism to make sure that we come out with a regime that achieves the right regulatory outcomes.

Q465 Mark Garnier: I think you mentioned that you have 14 people at the FSA who are specifically dedicated to looking after Lloyd's. Since the Government announced its plan to split up the FSA, have you experienced any difficulties engaging with them? Clearly, you like these people, so are they all staying there? Do you anticipate they will all move across to the new regulatory regime? Indeed, when they do move across—if they do—do you think they are going to go to the right organisation?

Mr McGovern: There has been a lot of staff leaving the FSA at all levels. Some very senior staff have left, which is very unfortunate. We have been very fortunate, in that the dedicated team at Lloyd's has been very stable over quite a long period of time and we haven't seen the rotation of staff that some other organisations have seen. I think that is in part because FSA senior management recognise that continuity of knowledge and understanding of Lloyd's is very important. We are concerned that there is a risk that we will lose that experience and knowledge. We expect that the vast majority of that team—all of them, we hope—will transfer into the PRA.

Q466 Mark Garnier: That is where you want them to go?

Mr McGovern: That is where we want them to go. But what I think is absolutely critical is that the Bank of England do need to recognise that regulating insurance is different from regulating banks. So the structure of the PRA does need to recognise that. At the moment, if you read the consultation document, it's all about how they're going to regulate banks more effectively. Insurance is terribly important. It takes different skills, and they do need to carve out the expertise to be able to do that effectively as well.

Q467 Mark Garnier: One of the things that the LMA—Lloyd's Market Association—has warned about is this triple regulation, which is obviously the PRA, CPMA and Lloyd's itself; that has been talked about. The other element of this proposed regulatory change is the Financial Policy Committee, which is looking at systemic risk. It is, of course, broadly speaking, designed to focus much more on the banking system, the monetary system. But with something like AIG—referring back to the Chairman's earlier questions—clearly there was a systemic risk there. Do you think that not only do you have the existing triple level of regulation but then, on top of that, you might have that further fourth element focusing in on what you are doing? How do you see that causing problems and do you think the LMA are right to be very concerned about this?

Mr McGovern: On the Financial Policy Committee, it is clear that that policy committee is going to have influence, both on macroprudential regulation and microprudential regulation. It is a bit unclear as to exactly what that influence is going to be. As the FPC is going to have that influence, we are concerned that they do need to be properly informed about insurance business so we don't get a complete focus on banking. So we would certainly be encouraging the FPC to have insurance skill as part of that committee structure. We feel the same way about the PRA. Some of the non-execs on the PRA do need to be drawn from an insurance background so that knowledge is in-built, so we don't get gaps in the system and we don't get inappropriate read-across. On the triple regulation, that really does go back to the importance of having a lead supervisor where the skill and regulatory focus is concentrated in the PRA, and also the transfer across into the new structure of the co-operation agreements that currently protect the market from duplication of regulation, which we have, and should help to guard against triple regulation in the new structure.

Q468 Mark Garnier: The cost of having to deal with all those regulators could be a problem.

Mr McGovern: Yes. There is obviously a cost to the market of supporting the infrastructure of the society that is responsible for the oversight of Lloyd's, and what we have to do is make sure that the benefits that the market get from being at Lloyd's, and the other things that come from being a participant in the Lloyd's market, are balanced by the costs of our oversight. But we have significantly invested in our own oversight of the market over the last nine years. There has been significant investment at the FSA and in insurance regulation in general, but also in Lloyd's oversight. That is a cost. I don't think we are so concerned about the cost. We're more concerned about the efficiency of the regulatory framework. I think it's difficult to see how this new regulatory framework can be delivered without an incremental cost and I think there will be a tolerance for a marginal increase in the cost. But what we can't do is end up with a system that is more inefficient from a management perspective, a compliance perspective and a capital perspective.

11 November 2010 Mr Sean McGovern

Q469 Chair: I am asking a lot of witnesses this question: do you know what the full compliance cost really is? You don't have to tell me now.
Mr McGovern: Currently? Not of the new regime. We know what the cost of the FSA currently is.
Chair: Why don't you send us a note with what you think the real cost is, and therefore the average cost per customer? Stewart Hosie.

Q470 Stewart Hosie: In your recent "Insurance Day" editorial, when you were talking about the internal restructuring to establish the shadow PRA and the CPMA, you spoke about constructive engagement and then said, "We should seek to manage the potential damage such a move would cause to the UK's ability to compete for financial services both in the short-term, through a difficult transition, but also in the longer term". So I'm keen to find out what you think these risks and dangers are, and whether it's your view those risks are partly to do with the fact that you believe the insurer supervision has been treated as an afterthought, which was what was put in your response to the Treasury?
Mr McGovern: I think that, unfortunately, insurance supervision has been treated as an afterthought, and we're engaged in a lot of activity to try and get the Treasury and the Bank of England focused on looking at how insurance supervision can be effective in the new regime. In terms of worrying about the implications in the short to long term, I think the implications for us as insurers in the short term are twofold. The first is that there is an awful lot of activity going on in Europe at the moment, and not only in the insurance field. We have major debates going on about insurance guarantee schemes, we have big debates going on about crisis management, and we have big debates going on about resolution funds and resolution authority.
Specifically on insurance, there is a very big change to regulation going on at the moment, which is called Solvency II, which is fundamentally changing the way in which insurance is regulated throughout Europe. We welcome that because it will harmonise regulation. We think the UK is well positioned, and we think it will harmonise and bring the standard of insurance regulation up in the EU as a consequence. But it is the biggest project that we, as Lloyd's, are dealing with, and I suspect that for all insurers in the UK, it is going to be the biggest project that they are dealing with. Between now and the end of 2012, we will have spent something like £200 million on implementing Solvency II. It's the biggest project the FSA is having to deal with. Again, it is interesting that it doesn't get the attention that everything to do with banks seems to get, but the insurance regulatory regime and the implementation of Solvency II is the biggest project the FSA is currently dealing with. There are two consequences to that: one is that we have a situation where the FSA and the industry are somewhat distracted by this debate about the regulatory structure, at a point at which we are all trying to implement the biggest change to insurance regulation that there has been for a generation. That is not good for us.
The second reason why it's not good is that these debates around Solvency II, but also wider debates about the new supervisory architecture and what that ultimately is going to mean, and all of these other issues that are currently on the table in Europe, are very actively being discussed, and the UK needs to be strongly represented in those debates. So it was very alarming to read, in the FSA response to this Committee's request, that one of the transition risks for the FSA was that they were not going to have senior management time to engage as much as they used to in Europe. From our perspective—not having caused the financial crisis, and being rather swept up in the change to the regulatory regime that is a consequence—we are worried that the UK is potentially going to miss some tricks in the EU because the FSA is not as engaged as they ought to be in those debates. So there is a real concern that, in the short term, the transition could damage the insurance sector because the UK agenda in those negotiations may not be being pushed as hard as it could be.

Q471 Stewart Hosie: That is very similar use of language to the stock exchange, where they said, within ESMA, when they got down to the granular regulation negotiation and formulation level, they were concerned to have absolutely the right people with the right skills set, so that nothing was done that caused unnecessary burdens while maintaining protection. Is that fundamentally the same concern you have with FSA people, knowing that there isn't the scrutiny, in what is going on with Solvency II, within the European architecture and regulation generally? Is that the same sort of concern, then?
Mr McGovern: Yes, it is the focus and attention. Clearly, the banking crisis has somewhat distracted senior management's attention at the FSA away from insurance. That is a good thing, in a way, because it demonstrates that we're not a sector that is keeping them awake at night, but there are moves in Europe to change the basis on which insurance is regulated. There are ways in which the insurance sector could be damaged through the implementation of directives within the EU, and we're concerned that there is a lack of focus on the EU aspect of financial regulation. I also think that the consultation document to some extent underestimates the influence that Europe now has over financial services regulation. I think some of the things that are being talked about—a more judgement-led approach to regulation and wanting to reduce the FSA handbook—are all very laudable goals, but I think you have to recognise that we now operate in an EU context, where the UK is required to demonstrate that it has implemented its EU obligations in an effective manner. We also have the new EU supervisory architecture. We were comfortable with where those negotiations ultimately landed, in terms of respecting home state regulation. We think there are certain benefits to be gained from the new architecture. But clearly there are going to be new regulatory authorities in Europe and, once those are established, there are going to be debates around whether EU regulation should go further, and the role of home state supervisors versus these authorities. We

need to make sure that there is adequate focus on those debates at senior levels.

Q472 Stewart Hosie: You have the UK structure and the EU structure, with the potential, perhaps, for conflicting policy direction; overlaid on top of that, of course, is the new macroprudential levers and powers that the FPC will have. What is the combination of all of these things, in terms of risks for Lloyd's?
Mr McGovern: I think the combination can best be summarised by the uncertainty. At the moment it is very difficult to understand what exactly the implications of all of these different measures are going to be. Of course, you have named just a few; there is a significant range of things that could also be done to financial services generally and insurers specifically. So there is a great uncertainty and, as I said, the concern we have is that the debate generally starts from, "We need to do this to financial services." What we need in the debate are informed voices sitting around the table—whether it is here in London or whether it is in Brussels—who can point out the differences between different aspects of financial services, so the right outcomes are reached.

Q473 Stewart Hosie: Given that it is those people whom you need, are you having any difficulty recruiting or retaining people with specific skills, with Solvency II knowledge, with a deep understanding of the potential European framework? Do you have the right people?
Mr McGovern: We do at Lloyd's. Unquestionably, there is a significant strain on talent at the moment in insurance. Solvency II is causing a real problem. There are limited actuaries in the world. There are limited people who understand risk management and how to implement risk management. There is a lot of competition for a very limited amount of resource. Like many organisations, I think the FSA are finding themselves in a position where it's difficult to compete in monetary terms for that talent. But we do need talent within our regulators, not only to regulate firms effectively, but also to influence the debates that are taking place outside the UK.
Chair: Michael Fallon.

Q474 Michael Fallon: Which of the new macroprudential tools that the Financial Policy Committee might deploy would most impact on your market or your members?
Mr McGovern: I think there are some macroprudential tools that could influence us on the balance sheet side, in terms of what happens with interest rates. Having said that, the impact on Lloyd's should be manageable. It should be limited, for this reason: the Lloyd's market doesn't write long-tail business generally; we're much more about covering catastrophic property casualty risk. So our profile, in terms of our investment philosophy, is very conservative. We hold a third in cash, a third in Government bonds, and a third in corporate bonds. So what happens with interest rates, what happens with corporate bond spreads, will impact us just like they impact everybody else, but we believe that we are in a position to be a little bit more nimble on our balance sheet side because we're able to dip in and out of assets much more quickly. We have almost no equities in our portfolio. So I think that side is manageable. The other macroprudential tools that we would want to guard against is, again, the inappropriate application to the insurance sector generally of pro-cyclical capital buffers. I think we have demonstrated that the general insurance industry has navigated the most significant upheaval in financial markets that there has been in living memory. We have sustained some very significant catastrophic losses, going back to 9/11, through to the hurricanes of Katrina, Rita and Wilma. We have withstood all of those and remained profitable, and our financial strength has grown. So I think there are two aspects. One is the activities that are taken to shape financial markets, which I think we can manage. The other is just inappropriate application of capital levers, for example, which is why we need knowledgeable people at the FPC level and the PRA board level, to understand the implications of trying to use those levers on the insurance sector.

Q475 Michael Fallon: Why should you be exempted from pro-cyclical buffers?
Mr McGovern: Because, firstly, we're not in the business of providing credit, so the credit cycle is not something that impacts our business. But the insurance sector has its own cycle, the insurance cycle, which is driven by what is happening in the rating environment. If insurance rates are good, that attracts capital, and that, generally speaking, ultimately leads to a down phase in the cycle, where there is too much capital in the system, which leads to underpricing, and then we go up again in the cycle. But we are not implicated in or affected by the credit cycle, as the recent two or three years have demonstrated.

Q476 Michael Fallon: The Financial Policy Committee is going to have only four external members. How realistic is it for you to lobby that there should be one with a background in the insurance sector?
Mr McGovern: I would hope that we should get at least one person with an insurance background. I believe the consultation document does mention the possibility of somebody being drawn from the insurance sector. It is true that there is representation on the European Systemic Risk Board, so the European systemic infrastructure has seen fit to have an insurance voice around that table.

Q477 Michael Fallon: But the committee is not a representative committee; that is not its purpose.
Mr McGovern: It's not, but again, I think it goes back to the fact that the PRA has been designed with only banking in mind. Clearly, there are going to be implications from what the FPC does, not only for insurance but for other parts of the financial services industry. So we believe that, given the size, depth and importance of the UK insurance industry to the economy, there should be at least one person at that level.

Q478 Michael Fallon: You are effectively arguing for an insurance seat on the Financial Policy Committee.
Mr McGovern: I think we're arguing for having one of the seats that are available appointed or given to somebody who isn't necessarily actively engaged in the insurance industry now but who has had a big chunk of their career in the insurance sector and understands how it relates to the banking industry. I think that can only make the FPC's considerations more meaningful.

Q479 David Rutley: The Chairman expressed a concern around compliance. Clearly, you have expressed a concern about the cost of compliance as well throughout the conversation this morning. In your evidence, you have suggested that the cost of regulation for you has gone up from £1.3 million in 2008 to £2.2 million in 2010–11. Are these direct costs? Are there further indirect costs related to that, and could you explain why they have gone up?
Mr McGovern: The £2.2 million is the cost of the FSA to the whole market. So the cost of the current FSA regulation of the market is £2.2 million. It has gone up significantly recently. That has largely been driven by Solvency II implementation. In effect, the FSA has had to resource up for Solvency II, and naturally they're levying the industry for that cost. So we—like others in the industry—have had to pay our share of the cost of the resources devoted to Solvency II. So it is not so much related to funding the more intrusive regulation; it is more explicitly on Solvency II.

Q480 David Rutley: The other point was that while there are direct costs, are there additional, indirect costs?
Mr McGovern: That is simply the direct cost. It does not take account of the indirect costs of having compliance people at all the different levels in the organisation. The Chairman has asked if we will estimate those costs, and what they might be under the new structure, as best we can.
Chair: What they are now.
Mr McGovern: Now, yes.

Q481 David Rutley: As you look at the challenges of restructuring, with the new regime coming forward, and also the overlays of EU regulation, how much do you think that cost of regulation is going to increase by?
Mr McGovern: I think the ongoing cost of regulation is bound to increase for the insurance sector. As I said, as a market, we are spending £200 million on implementing Solvency II between now and the end of 2012. How much of that cost is going to be an ongoing cost is unclear at the moment, but we are certainly adding significantly to our own resources, and there are new people being brought in at all levels within the market. The FSA is having to increase its level of staff, so I think it is inevitable that that cost will increase. Again, we can try and estimate that as part of an estimate of the current costs and what we think they might be under the new structure.

Chair: We have to find some way of reversing this ratchet, and the first step is to find out the scale of the ratchet, and very few industries really know, so it is important work. Andrew Love.

Q482 Mr Love: Earlier, you touched on changes in EU regulation. One of the things that have come to the fore in our discussions about this whole subject is the misalignment between the new structure in the UK and the EU structure, and you sort of touched on that. How serious is that misalignment?
Mr McGovern: I think it just needs more thought. I'm sure it's capable of being resolved. We are going to have to deal with the new EIOPA, the new regulatory authority that is responsible for insurance and pensions. The consultation document talks about how the primary interface with EIOPA will be the PRA, and it will have the UK representative seat on that authority. But it is true to say that EIOPA will be dealing with conduct of business issues, just as much as it is dealing with prudential issues. So somehow we need to make sure that the two authorities can work out how they're going to ensure those issues are best covered by the people with the right skills at the right level. I'm sure it is capable of being resolved, but I think it just needs a lot more thought.

Q483 Mr Love: Perhaps you could give us your thoughts on how that could happen, from a Lloyd's perspective.
Mr McGovern: From a Lloyd's perspective, it is not so critical an issue for us, for the reasons I explained. The influence on our business in Europe is predominantly on the prudential regulatory side. The adequacy of our UK influence on the conduct of business side is much more of an issue for some of the composite insurers in the UK, who are very focused on conduct of business issues. How can it be resolved? I think it's going to have to come down to practical arrangements between the CPMA and the PRA. There are other systems of twin peak regulation within the EU. We're not the first to have tried to do this. So I think trying to understand how other countries are proposing to tackle it would be a good place to start, too.

Q484 Mr Love: You mentioned earlier on that you would like to keep together the FSA team that deals with Lloyd's, but the implication of the twin peaks system will be that there will be a split. You have obviously expressed a preference for PRA, and I think that will probably occur. But if there is a split, how will you ensure that that part of the CPMA that deals with Lloyd's can feed into the European structure adequately?
Mr McGovern: About 90% of the regulation of Lloyd's is prudential, so the conduct side is very marginal in comparison with the prudential side. As I say, we hope that we will end up with a system where the PRA is where our team—the FSA team that looks after Lloyd's—is housed. On the conduct of business regulation aspect, I think one of the very positive things that we have here in the UK is a very active dialogue with the Treasury and the FSA currently about how the debates are shaping up in Europe. What

we need to make sure is that the Bank of England, the PRA and the CPMA recognise the importance of engagement with the industry here so that when they go into those negotiations and debates, whether it is on prudential issues or conduct issues, that they can understand the potential implications and the viewpoint of the industry.

Q485 Mr Love: We are never going to have a perfect fit, because we have different structures. Is there a danger that, in order to try and paper over the differences—and you mentioned this in your submission to us, about gold-plating—we will throw additional resources and try and set a higher standard as a result of the misalignment?
Mr McGovern: This issue of gold-plating is quite commonly cited, and it is a very real concern for financial services in the UK. From the insurance side, and from Lloyd's perspective, we haven't felt that we have been the victim of gold-plating. As I said, we feel that back in 2005 the UK FSA led the way on insurance regulation. They implemented a new system of regulation; they weren't required by EU directive to do so. The industry welcomed it. It has served the industry extremely well, not only in terms of our experience since 2005, but in preparing for this new regulatory framework that will come in in 2013, Solvency II. We're ahead of the game as a UK industry. So, where appropriate, I think the FSA has taken some very good steps to improve regulation, which have benefitted the industry. In terms of gold-plating, I guess one area that has concerned the industry overall—but again, not Lloyd's so much—is that we have had a very significant amount of time and effort spent by the FSA on its Treating Customers Fairly regime, which has been very burdensome for the industry to cope with, from a compliance perspective. So I think it is more areas around some of the conduct of business regulation where gold-plating has been a problem.
On the banking side, I know there is significant concern that the UK is getting ahead of some of the debates around how banks should be regulated, whether it's looking at liquidity requirements or capital buffers. Those debates are not settled. I think there has been progress in Basel on those recently, but they are certainly not settled in the EU. There is concern that the UK is going to drive an agenda that may not be followed quite so diligently by some of our European colleagues, and certainly won't be followed by all countries around the world, and that could damage the UK sector.

Q486 Mr Love: We have had some discussions in previous sessions about whether or not CPMA should become a consumer champion. I know you don't deal in consumers, but in terms of treating customers fairly, do you think there is a danger that they will be even more prescriptive than the FSA has been?
Mr McGovern: Like others in the industry, we were somewhat alarmed by the expression "consumer champion". I don't think it is appropriate for a regulator to come out and advocate on one side of a financial contract. It is the place of the regulator to set clear expectations for how customers are to be dealt with, but you don't start by being the customer's advocate. There are other mechanisms in place, whether it is the ombudsman's scheme, and so on, that can fulfil that role.

Q487 Mr Love: Let me ask you finally—and you touched on this—about taking our eye off the ball, in European terms, because of the changes that are going on here. How serious a danger do you think that is? What would be the worst thing that could happen as a result of taking our eye off the ball?
Mr McGovern: I do think it is serious. I am a member of a body that has recently been established in the City, called the International Regulatory Strategy Group, which is a cross-sector group of people drawn from financial services, who are looking at all of the things that can affect us from a regulatory perspective. I have to say the agenda is absolutely crammed full of competing priorities, whether that is in the UK or whether it is in the EU. So we have corporate governance reviews here in the UK; we have corporate governance reviews in the EU. We have crisis management proposals here in the UK; we have separate crisis management proposals in the EU. So there is a significant risk of misalignment, which may mean we don't get the regulatory outcome we want but could also put the UK at a disadvantage, versus other jurisdictions.

Q488 Chair: Thank you very much for giving evidence. Before you go, it would be handy if you felt able to supply us, in writing, with something on the "Know your client" initiative, as far as it affected your industry; a cost-benefit analysis of it, for example.
Mr McGovern: I would be very happy to.
Chair: It would also be interesting to have anything on paper that you can provide that lies behind your concern that other countries in the EU might not be as vigorous in applying new rules as we would be in the UK. Thank you very much for your contribution. It has been extremely informative, and we have appreciated it.

Examination of Witness

Witness: **Mr Stephen Sklaroff**, Director General, Finance and Leasing Association, gave evidence.

Q489 Chair: Thank you very much for coming along today. We recognise there is a limit to what can come before us. We are very happy to take further written evidence. Could you begin by giving your view about how consumer credit should be regulated?
Mr Sklaroff: We have a well-developed system already in the UK for regulating consumer credit and it is, as we speak, undergoing a radical revision. We have a new European directive that is due to be implemented; the deadline is next February. That follows very quickly on the heels of a revision to the UK's own Consumer Credit Act. The regime as we currently have it has introduced, just in the last two to three years, a very large number of new features, in particular with regard to conduct of business, and the way that companies providing credit should communicate with their customers—explain prices to their customers, and set out information and the new rights for customers to change their minds if they do not wish to take up the credit that has been offered, and so on.
That regime at the moment is run in the UK by the Office of Fair Trading, and the Government has, of course, indicated that it wishes to consult on the question of whether in future the regime for retail consumer credit should be transferred from the OFT to the new CPMA. Up until several weeks ago, it was saying that its mind was not yet made up on that matter, and that that it would wish to be persuaded that there were very clear and well-defined benefits to be had from making that change before it would wish to do it. It recognised, very fairly, that there were issues of disruption and so on with any kind of regulatory change. However, it seems to me that the announcements made just a few weeks ago concerning the future of the OFT itself—both as a competition authority and in terms of its various responsibilities for consumer protection in the UK—to some extent pre-empt that debate about what should happen to consumer credit. It would seem very odd, if the OFT was losing its other consumer protection responsibilities, for something different to somehow be done with consumer credit. So, as a working hypothesis, we are assuming that consumer credit is at some stage going to be transferred to the new CPMA. That gives rise to a number of concerns. I should perhaps say, first of all, that we have no ideological or principled objection to that change taking place. Our concerns are very much to do with the practicalities, both of the transition and of the nature of any new regime. Despite the fact that there has been a very great deal of change, as I've just said, in the existing UK regime, nothing is perfect and, of course, it is possible to come up with a list of things that one would like to see changed in any new regime. My slight concern is that the regulation of retail consumer credit may be seen—and this is certainly not what anyone has said on the record—by the Government as, in some sense, a residual issue to be dealt with once the rest of the regulatory architecture dealing with prudential issues, and so on, has been set up. I think my strong plea to those concerned is that it not be treated as a residual, and that it be dealt with, as it should be, as a very major task and a very important economic task in its own right. Therefore, the design of any new system needs to begin right now and quite a lot of resource is going to be required to ensure that the transition is successful.

Q490 Chair: What is your preference for that design?
Mr Sklaroff: We think that any new system should be, above all else, clear and predictable, and we would say that one of the problems with the existing system is that it isn't always clear and predictable. By that I mean that because of the way in which the existing regulators interact in the consumer credit market, it is not always possible for companies or customers to predict exactly how the regulatory system will apply in any given case. So I think my top-line plea would be for a system that was clear and predictable.
I think we would also suggest that a new system has to focus very clearly on the important aspects of the market. At the moment, the Office of Fair Trading licenses something like 100,000 entities for credit purposes. Most of those are not providing credit in any normally accepted sense of the expression "credit". Perhaps 4,000 of them are, to some extent or other, in the actual credit business, and even of the 4,000, most of them are not full-scale credit companies. So I think if one is looking at a new regime one would wish to look at that number and say: is there not an argument for focusing more directly on what I think we would all recognise as the provision of credit to the end customer?

Q491 Chair: Before I pass the questioning over to John Thurso, could I ask you one very general question, since you have an interesting and unusual perspective on what is going on in the economy? Could you give us a view about what the market is like for your industry at the moment, because it is a very good barometer of the recovery?
Mr Sklaroff: Yes. We do represent a very wide range of markets—everything from leasing railway rolling stock at one end, to the provision of consumer credit at the other, so I think we are just such a barometer. Certainly in the consumer credit markets, just starting there, we have seen a considerable reduction in the amount of business being written over the last three years in the context of the credit crunch and the recession.

Q492 Chair: Can you put a percentage on it?
Mr Sklaroff: A 25% reduction in new business in our markets—that isn't the whole of the UK credit market, obviously—in consumer credit over that period.

Q493 Chair: And some recovery?
Mr Sklaroff: We have seen some recovery in some areas. In particular, the motor credit market has done relatively rather well over the last year or so, although

there are concerns, looking at the state of the economy going forward. But it's also true that in the asset finance markets we have seen a considerable reduction in the amount of new business being written over the last few years, and in that space—and I know it isn't really the focus of the Committee's inquiry today—our concern is that, particularly in the small business sector, businesses are less able to reinvest in new equipment coming out of the economy than was the case in either of the last two recessions. So we do have a concern there.
Chair: It's a small aspect of a very big picture that we're getting from a lot of people.
Mr Sklaroff: Indeed.
Chair: John Thurso.

Q494 John Thurso: I want to follow up on some of the points you have just made, but first can I ask you about the Financial Ombudsman Service, which currently provides redress for both OFT-regulated and FSA-regulated firms? Do you think the Ombudsman Service role should be reviewed as part of the restructuring and, if you do, what would you like to see?
Mr Sklaroff: I think it should be reviewed as part of the restructuring. I should say I have been encouraged by what the new Chief Ombudsman has been saying, in terms of her approach to the role of the ombudsman, in recent weeks and months. Our view is that the ombudsman needs to focus on being a genuinely impartial complaint-handling organisation, where people can go and get redress if they feel they have a complaint, without straying into the territory of consumer advocacy. The difficulty with straying into that territory, however tempting it may be, is that it begins to undermine impartiality, and I think it's very important for the ombudsman that it is seen as impartial by all parties to any given complaint.
Our concerns with the existing ombudsman regime also relate to the efficiency with which they process cases—and I know, again, this is something the Chief Ombudsman is taking very seriously, and we have had discussions with her about it—and the length of time it takes to process a complaint once it goes to the ombudsman. There are also some issues, certainly historically, concerning the consistency or otherwise with which similar kinds of cases are adjudicated by the ombudsman. All these things are well-known issues, and we are in discussion with the ombudsman about them, but I do think, going back to your question, that it is important, as part of this really quite radical change to the consumer credit regulatory scene that is being talked about, that the role of the ombudsman be looked at in the context I've been describing.

Q495 John Thurso: Thanks. You have touched on this a bit already but I'd like to flesh it out a bit. On the changes—the moves from the OFT to the CPMA—virtually all the written and oral evidence that we have received from organisations has pretty strong support for the move. As you've said, to a certain extent, it is becoming academic because it's a bit difficult to leave something when you've demolished it, kind of thing.
Mr Sklaroff: It's a bit difficult to see how, yes.
John Thurso: You voiced concerns, and you have fleshed those out a little bit, around the practicalities and the nature, and so on. But can I ask you to look at the other side? What do you think could be the benefits of such a move, particularly in your sphere?
Mr Sklaroff: I think the benefits fall in two broad categories. I think the first and perhaps most obvious is that—as has already been said—there are many regulated companies that at the moment are regulated, both by the OFT and by the FSA in the conduct of business space for different aspects of their business. For those companies there is obviously an efficiency gain to be had or to be aimed at from bringing the regulatory regimes together. So I think there is a clear argument there; many others have made that argument. I think the second set of potential benefits are the ones I was talking about earlier, which are to do with: how can we improve the current system? How can we take the opportunity of designing a new system to see whether we can't design out some of the dysfunctions in the existing system? I've mentioned one or two of them already to do with predictability, clarity and focus. Also I think there is an issue about resourcing. I think it is to the credit of the OFT at the moment, it is a relatively—
Chair: Order, order. It is 11.00 o'clock.
Two minutes' silence observed for Armistice Day.
Chair: Thank you, everybody. Do continue.
Mr Sklaroff: I think I was just about to make a comparison of running costs between the OFT and the FSA. At the moment, the OFT's annual running costs are about £50 million per annum. The FSA is about nine times that; it's about £450 million. That is perhaps a misleading comparison to some extent, because they are running different kinds of regimes, but there is an issue about having the right kind of resource in the new regulator in order to deal with the very particular issues arising in the credit markets. While it is a financial service, credit is a fundamentally different kind of financial service from most of the others that the FSA is used to dealing with at the moment in the retail space. We would wish to be reassured that the CPMA, if that is the destination for this regulatory function, is properly equipped with people who will understand the needs of the market, and will be able to interact with the market and take sufficient information from it to regulate it effectively.

Q496 John Thurso: Given when you put your evidence to us, and given that, as you say, over the last couple of years there have been quite a lot of changes, and in light of the fact that we probably already have a decision—we just haven't recognised it yet—if there is anything that you would like to add in writing, then I think that would be very useful.
Mr Sklaroff: I would be very happy to do that.

Q497 John Thurso: Can I move on from that to the question of cost, which you have mentioned already and clearly signalled? The particular question is about compliance costs and whether you think, first of all, there is a danger that these will rise as a result of a move—they never seem to go down when they move. Secondly, do you think there are one-off costs

involved in the changes? Perhaps you could talk a little bit about the costs.
Mr Sklaroff: I'm very happy to. We have an estimate of the cost of introducing the consumer credit directive, which is what we're doing at the moment. That is within the existing structure, and that estimate is somewhere up to £500 million as a one-off cost for the introduction of that new set of rules around the sale of credit.

Q498 Chair: That is pretty large.
Mr Sklaroff: That is a very large sum of money. It is a worryingly large sum of money, but I think it's not a misleading sum of money, because it does show the pre-existing complexity of the regime that sits around consumer credit in the UK. So, for any further change, I would be surprised if the transitional costs were of an order of magnitude different from that, shall we say. So, there is a big concern about transitional costs, plus all the usual problems about regulatory uncertainty. The UK is already seen internationally as a very expensive market in which to do retail credit business, and I think this further change is unlikely to make that a better picture.
In terms of the regulator, and the compliance costs with the new system, as I think the Chairman has discovered in asking this question of previous speakers, there is rather a patchy amount of evidence available for how much things cost at the moment. In recent years, the FSA has done some analysis itself of how much its existing regulatory system costs, and from time to time aspects of the OFT's regime have been looked at. None of them are exactly additive, so it's difficult to say. But picking up your question, my concern is that it has been inevitably the case each time the FSA, as presently constituted, has produced a new rulebook that the regulatory and compliance costs associated with that part of the market have risen. I think one of our other pleas, which we're certainly discussing with the Government, is that it is not assumed that if consumer credit moves into the CPMA, all it will need is its own rulebook. One has seen versions of that statement from time to time.
That would be wrong on two grounds: one is the cost ground, because I think that would be the wrong way to go; the other is that it isn't like the other financial services currently regulated by the FSA and it needs some proper attention. Given that we have—whatever it is—37 years now of statute law governing this in the UK, and given the fact that that statute law is heavily embedded with other statutes dealing with other aspects of consumer protection, I'm afraid that simply writing a new rulebook is not going to turn the trick.
Chair: Mark Garnier.

Q499 Mark Garnier: Thank you, Chairman. A little earlier, in response to the Chairman's question, you talked about the fact that the current economic cycle has resulted in a downturn in consumer credit. But you also said in your written evidence that "the sheer volume of this new regulation has contributed to the shrinkage of the UK consumer credit market". Can you rationalise how much of the shrinkage has been down to regulation and how much has been down just to an economic downturn?
Mr Sklaroff: The honest answer is no. I can't actually say, "X% was this, x% was that." What I do know, from conversations with many companies in this market, is that the increasing regulatory costs have become a more and more important factor. Indeed, comparisons made between the UK market and other European markets by people who are active in both rather reinforce that.

Q500 Mark Garnier: Maybe a way of looking at it that might be more illustrative is: how many participants in the consumer credit market have withdrawn from the market because the costs have become too much for them to bear and they've closed down?
Mr Sklaroff: We continue to see announcements—and there was another one this week—of companies withdrawing from at least some of the consumer credit markets. It is often the case that when you ask them, "Why have you done this?" they will say that of course there are economic circumstances here, and of course there are issues about the nature of the market, but that regulatory costs, of one sort or another, are a major part in their decision and they just cannot operate profitably in some of those markets. My personal concern about this is that some of those markets are precisely those sections of the population most in need of help and support during a difficult economic time, and those markets are becoming thinner and thinner and thinner. Hence my concern—and we have aired this with the Government and publicly—about ideas such as interest rate caps and so on in some of those markets; they risk having precisely the opposite effect from that intended.

Q501 Mark Garnier: I wanted to go on to that, in fact. At the end of the day, the interest rate you charge to customers is ultimately the most determining factor as to whether people take out credit. One of the problems that we see is that the poorer you are, the lower your credit rating, and therefore the higher the interest rate you tend to be charged. I've always had a problem trying to rationalise that in one respect, although my background is in investment banking so I completely understand why it is done. Do you not think that lenders do have a social and moral obligation to make sure that consumers are charged an affordable rate of interest?
Mr Sklaroff: I think there is a moral obligation to ensure that consumers are charged an appropriate rate of interest, and I think the question then becomes: what does one mean by appropriate? "Appropriate", for a company that wishes to remain in business, has to mean, apart from other things, a rate for the risk. The company has to take a prudent view of what the risks are of default in a particular market, and it has to price the products accordingly. Of course, it is physically possible for a Government or a regulator to intervene in markets—and this happens in many

overseas markets—and set caps and control those costs, but what tends to happen is that either other costs in the credit market rise to compensate for the fact that you can't actually price for the risk in the market you're operating in, or people withdraw altogether. It was interesting that that was one of the conclusions drawn by the Office of Fair Trading when they recently looked at the UK short-term credit market. They explored whether interest rate capping in that market would be a socially useful thing to do, and the conclusion they came to was that those markets are, first of all, as an observation, already very thin, in the sense that there are very few commercial participants in them. If you intervened in those markets by capping rates, you might very well drive some of the few companies left out of those markets, meaning that the individuals who used to use the services of those companies would have no recourse other than the illegal market.

Q502 Mark Garnier: It is clear that we were underpricing risk, which led to part of the banking collapse. Do you think we're possibly overpricing it now?
Mr Sklaroff: I think not. I think what has happened is that, during the last three years, companies and individuals have had to take a rational look at what they can afford. From the point of view of a company, as I'm saying, what they can afford means, "Is this market"—whatever the market is—"something in which I can make a reasonable return, while attracting a reasonable number of customers with a reasonably low rate of default? If the answer to that is no, then I may wish to look somewhere else". On the other hand, consumers have clearly, and we see this in our own figures, been rebalancing the extent to which they are using credit products in, on the face of it, a rational way.

Q503 Mark Garnier: Part of the new regulatory regime is going to be the Financial Policy Committee. Martin Lewis, when he gave evidence to us earlier, already said that he sees that that could be a problem for a certain core of people who need credit who may find it more difficult to get to it, because, of course, as soon as you get the FPC intervening in liquidity, that is where it is going to hit first. Do you agree with those views?
Mr Sklaroff: I think there are some concerns, not just on that score, but more generally on possible regulatory interventions in the credit markets having precisely that adverse effect. I think what one has to be clear about is what problem one is trying to solve. For example, if the problem—and it is a very big and difficult problem—is poverty, defined in a certain way, it isn't necessarily the case that the obvious lever to use to address that is a further piece of regulation in the consumer credit markets. Sometimes I feel that when one sees the debates round these issues, they are as much to do with the very real problem of poverty as they are to do with what an appropriate regulatory structure for consumer credit would be. The risk is—and I think Martin Lewis was drawing attention to this—that very well-intentioned regulatory interventions in the consumer credit markets might make things worse for the people that those markets currently serve.
Chair: Stewart Hosie, you wanted to come in quickly before we move to Andy Love.

Q504 Stewart Hosie: A quick question. Mark's first question there was about the balance between the recession and the burden of regulation. Looking at the growth around the fall in new credit, it is going south in every category apart from car finance; that is quite startling. Looking to the future, do you think that this is going to pick up or stay flat, or do you think we'll see further falls? Where do you think it is going?
Mr Sklaroff: I think there has certainly been something of a medium-term resetting of the market. I think that is undoubtedly the case. It depends how far forward you look, obviously. I think there are some markets that are showing no signs of recovery, and it is a matter of sheer speculation as to whether they will. I think as things gradually get better in the economy, it is possible to imagine that new capital will come back into some of those markets. But I think your question encapsulates very well one of our big concerns about all the talk that is going on about a further change in consumer credit regulation. It would be very easy, for very good and praiseworthy reasons, to break the last straw on the camel's back here and entrench a situation that is a much smaller market, a much more highly polarised market, a market in which lower income people find it next to impossible to get legal credit.

Q505 Stewart Hosie: The question I have is—assuming that's not the most positive answer for the near future, I think we can agree that—do you see the pressures on growth, or the suppression of growth, primarily being led by unemployment, wage freezes, tax allowance freezes, inflation and VAT rises, or do you see the suppression primarily being led by new regulation?
Mr Sklaroff: It's both.

Q506 Stewart Hosie: It is a combination of both?
Mr Sklaroff: It is definitely both. It's a combination of both, because all the factors you've listed are exactly the things that my members talk to me about on a regular basis—all of the above. So, people are concerned about what is the short to medium-term prospect for the economy, for unemployment, for consumer spending—all those things—because these are the markets that are very important to my members. But they're also very worried about the implications of these new regulatory plans, not because there is any—as I said earlier—ideological objection to the move from organisation A to organisation B as the lead regulator, but because of what that might mean in terms of uncertainty and costs.
Chair: Andy Love.

Q507 Mr Love: Can I return to the vexed subject you touched upon earlier of interest rate caps? A lot of people think it's a no-brainer, including quite a lot

of Members of the House of Commons. There are early-day motions relating to this topic. Indeed, I think there is even a prospective ten-minute rule Bill relating to this issue.
Mr Sklaroff: There is, yes.

Q508 Mr Love: The OFT earlier on, as you mentioned, decided in terms of short-term credit, where there are very high interest rates, not to introduce that. They were looking at credit cards. Is it a no-brainer that interest rate caps would help the consumer?
Mr Sklaroff: It isn't a no-brainer because the evidence shows that there are unintended consequences that arise in markets where these kinds of caps are put in place. As indeed was said in the debate in Westminster Hall earlier this week, there is quite a lot of evidence from other parts of the world about what happens when you put in these kinds of interest rate caps. Although that shows on the one hand that it is physically possible to put them in place, you then have to look at what the consequences are.
On the consequences, first of all, any cap is often seen by the market as a kind of official rate, so you get a move to the cap. So, perversely, you get the effect of an increase in costs in the market that you're targeting. Secondly, going back to what we were talking about earlier, you get an effect where if a company is unable to cover its risks, if it knows that default rates, for example, in a particular market are simply not going to be covered by the interest rate that it's allowed to charge, it then has two choices. It can either get out of that market altogether, and there is evidence that that happens in some cases.

Q509 Mr Love: Let me just stop you there, because I think that's where the public find it difficult. When you're charging 200%, 250%, 300%—I don't expect that will happen in terms of credit cards, but it certainly happens in terms of home credit and pay-day loans—when you're charging that level of interest, people find it difficult to understand that companies will turn round and say they're not making a profit. Is there evidence to suggest that there is that withdrawal from the marketplace by the companies who are offering these services?
Mr Sklaroff: There is. In fact, there is a certain amount of evidence from some geographically very close European markets about what happens when you put in place these kinds of caps. For example, in the Netherlands, there is now a very scanty market indeed for loans below the level of about €2,500, simply because, under the regulatory structure that exists there, it is very difficult for a company to operate profitably, for the reasons we've just been discussing—that you can't charge an appropriate level of interest for the risks in the market. Of course, you have the choice of moving out of the market, because you can't cover your costs properly. The other choice is you cross-subsidise from somewhere else, which means that prices somewhere else in your market will have to rise to cover that. Obviously, where you come down with that choice will depend upon the size of company you are, and how many different markets you are operating in. But the net effect of all this is often higher prices for a larger number of people and less credit available in the target markets, which seem to us to be perverse consequences from what would otherwise be a well-intentioned regulatory intervention.

Q510 Mr Love: When they looked at this before, they came up with a series of recommendations, the main one of which—and certainly the one that I can remember—was to try and increase competition, particularly in home credit, where there seems to be a distinct lack of competition. There are a couple of companies that dominate the marketplace. Will that help the consumer in these circumstances, and how do your members, since it's mostly your members that are in these marketplaces, look on—
Mr Sklaroff: Just to clarify that, we have very few members in that marketplace. I think we have one member who is in that short-term lending market; most of our members are in other parts of the market. But to answer your question, I think it goes back to the discussion we were just having about the economy. To some extent, the number of people who are willing to enter those markets will depend a little bit upon the state of the economy, whether there is a perception of a growing propensity for people to buy consumer goods using credit, and so on and so forth, and also the issue we're discussing, regulation. Unfortunately, the effect of some of the kinds of regulation currently being debated would, almost inevitably, be that there would be even fewer companies in those markets.

Q511 Mr Love: Finally, because I do think we can only take this so far, I will give you the example of my own constituency. I was invited by an American company, recently arrived in this country, that provides primarily pay-day loans and their standard product charges an interest rate, I think, of 350%. I have several pawnbrokers; I have several people who will take goods in lieu of cash and, again, charge. There doesn't seem to be a lack of competition in the marketplace in my constituency for people who need that short-term money, yet it doesn't seem to have done anything to reduce the interest rate. How do we reduce the very high charges that are currently being experienced by consumers?
Mr Sklaroff: Going back to what I was saying before, we have very few members in those markets. But on your general point, I think, to be honest, there is a problem—and other people have said this too—in using the APR as the way in which you compare credit products. I think Martin Lewis himself made this point when he was giving evidence to the Committee. If you are talking about a short-term loan, the issue for the person taking out the loan is affordability. If I'm borrowing a very small sum of money, £200, and I'm going to pay it back with £20 in four weeks' time, that is a very high APR but, of course, is the annual rate the way of measuring the cost of that loan? So I think there is a problem with the APR. In fact, it's one of the things that we and others are talking to the OFT about at the moment—

whether there is some other way of giving an accurate view of how much this is costing you. That is crucial; it must be open and honest, but on the other hand, we should not get into this territory where you are comparing apples and oranges.

Chair: Thank you very much for giving evidence today. Please feel that this is part of a dialogue, and if there are further points you want to make, please put them on paper, and we will be very interested to take a look at them.

Tuesday 16 November 2010

Members present:

Mr Andrew Tyrie (Chair)

John Cryer
Michael Fallon
Mark Garnier
Stewart Hosie
Andrea Leadsom
Mr Andrew Love
John Mann
Mr George Mudie
Jesse Norman
David Rutley
John Thurso
Mr Chuka Umunna

Examination of Witnesses

Witnesses: **Mike Bowron**, Commissioner, and **Detective Chief Superintendent Steve Head**, Strategic Management Board, City of London Police, gave evidence.

Q512 Chair: Thank you very much for coming to give evidence to us this afternoon. Can I begin with a question about your annual report? In there you say that economic crime overall, has a detection rate of 80%—78.8%. How do you know that?
Mike Bowron: Well, we know the reports we have taken, Chairman, and—as with any other crime—at the end of the year we tally up those that we've detected and those that we have been unable to detect. I think our detection rate has surpassed the 80% at the moment but it's unprecedented.

Q513 Chair: Isn't this an area, though, where quite a lot of it isn't even reported?
Mike Bowron: Well, that has always been an issue as far as economic crime is concerned. We feel over the last two to three years, with the onset of what we've been doing in the Lead Force, but particularly in the National Fraud Intelligence Bureau, we are now finding more reports. People and organisations are more confident in reporting to us and, therefore, we are finding more. So I think it's more a confidence issue, in terms of what is reported to us and, with the onset of and working with the National Fraud Authority and Action Fraud, individuals are now coming to us because they have a means of reporting what they think hitherto would never have been actioned and, to a certain extent, that is true.

Q514 Chair: Can you tell us a bit about the nearly 2 million people who are affected by identity fraud every year, whether that is rising or falling and whether you're confident that is the right number?
Mike Bowron: I'll pass that to Steve Head if I may. He is my Head of Economic Crime Directorate.
Steve Head: I suspect that that number is rising, sir. I think that we've just recently completed a strategic assessment on what we think the most recent threats are in relation to economic crime, and identity fraud featured largely in that. We believe that the figures are as good as they can be with the information we have available at the moment. We believe it's rising. Part of that is the rise in technology and the ability to steal identities in bulk. Technology is a great boon to us all. It certainly has also been a boon to the fraudsters.

Q515 Chair: Who is winning?
Steve Head: An excellent question, sir. I would suggest that, in actual fact, in terms of the unit at the moment, we are beginning to win. That is my stance with you. We are beginning to win that war against fraud; economic crime. There is still an awful long way to go. We still experience difficulties and challenges as we go around the country. Certainly fraud is a huge international crime now. The markets that you see out there represent huge global entities. Fraudsters have mirrored that.
Mike Bowron: If I may, Chairman. Even as national lead for economic crime, my mother was subject to an identity fraud about 18 months ago. She doesn't know the full details, but two men were subsequently arrested by Cheshire Police and it seems that they were given her information by an insider in a bank, who she banked with, and they were raising funds for an organisation somewhere in Africa.
Chair: They picked the wrong woman then.
Mike Bowron: Rather. But that is just a case in point. It can be anyone. It is very difficult to say: is it rising or are we getting better at identifying and dealing with it. We have literally millions of pieces of data in our National Fraud Intelligence Bureau, which is only 13 months old.

Q516 Chair: You may feel this is not your bailiwick to answer, but I've had a number of cases in the constituency of people who have been very badly affected by identity fraud—and I'm getting nods of agreement from around the table from others—some of whom haven't been able to put their lives back together again afterwards, because the programme in place for restitution of a new identity, which is basically what we are talking about here, is still flawed. Have you anything you can say on progress in improving that?
Mike Bowron: In terms of recovering your own identity?
Chair: Yes.
Steve Head: The National Fraud Authority has recently done a piece of work with the police's own Economic Crime Portfolio, and also at the National Fraud Intelligence Bureau, about exactly this problem. I don't believe the report that they've written is available yet. However, I've had early sight of that document and the issues that they raise are exactly those. There is, of course, the issue of preventing

identity fraud but, equally, along with that is the issue of how you can assist people who have been the victims of that fraud to put their lives together again; working with credit agency organisations, and other organisations along those lines, to help people get themselves back on track because quite often, as well as the financial loss that they've incurred, there is the issue of ongoing future credit and things like that. That becomes quite an issue for them. That piece of work is ongoing and the National Fraud Authority do have documentation and plans that they're working with in the Home Office at the moment.
Mike Bowron: But if I may, Chairman, your question touches on this whole issue of victims of fraud. It was always perceived in the past—and the not too distant past—that fraud is a victimless crime. We have identified, as perhaps you saw from our briefing note, tens of thousands of victims, and we work very closely with Victim Support. So you have mass victims of, say, a Ponzi scheme. We bring them in, up to 30 or 40 or 50 at a time, and they are met by Victim Support. We get them in and we say, "You're not stupid. You're not greedy. You're just ordinary folk who have fallen victim to an organised crime group and this is what we're going to do to help you and we will all fill in statements en masse", because it is very much the same sort of questions we will ask them. That has gone down rather well and has been seen as something to be held aloft for others to follow, in terms of dealing with mass victims of any crime in actual fact.

Q517 Mark Garnier: Insider dealing and market abuse: if I remember rightly, the insider dealing rules came about in the 1980s. It was a long time ago. How many instances of people being charged for insider dealing have been brought and what proportion of those has resulted in a successful prosecution?
Mike Bowron: That really isn't our bag because I think that's probably more for the FSA. We do have a MoU in the FSA and I believe we have—
Mark Garnier: MoU?
Mike Bowron: Memorandum of Understanding.
Mark Garnier: Right, sorry.
Mike Bowron: As we also have with OFT and the Serious Fraud Office. We work with them at their behest if they need a policing function to assist them. So if they have an insider trader they want arresting, or a group that they want arresting and bringing into custody, we will work with them to an agreed Memorandum of Understanding and provide that policing function. But in terms of that data, we're not on the regulation side and I'm unable to answer that. I think that is better addressed to the FSA themselves.

Q518 Mark Garnier: I will do that when they come in. I'm rather interested, as there seems, in the last year or so, to have been a significant increase in the number of people who have been charged for insider dealing and market abuse by about 50% or so.
Mike Bowron: I can't verify those questions but there is certainly increased activity, and we know that from the work we do with the FSA. We have a very, very wrong working relationship with them.

Q519 Mark Garnier: Why do you think that is, in the last year in particular?
Mike Bowron: Possibly because those relationships are better; possibly because the FSA are better at finding it; possibly because of the way the market has turned in the last year or two. People are more conscious of that line between criminal activity and—

Q520 Mark Garnier: It's a very interesting thing; having worked in the City for many years, there was a great joke that used to go on that there were only 10 instances of people who had been prosecuted for insider dealing for years and years, then suddenly we start to see a big pick-up in this. The markets are a lot more complicated but, speaking as somebody who has a reasonable amount of knowledge about this, I can't quite see why the change in the market over the last year has made it easier to identify market abuse and insider dealing. It would be helpful if you could explain.
Mike Bowron: Well, as I said to you, sir, that is on the regulatory side. We are police and mainly it is organised criminality we're identifying now. We're monitoring over 600 organised crime groups, working with SOCA and other agencies, of which about 150 we're directly investigating at the moment. That's the crime side. We don't deal with regulation but we provide that policing function to the FSA, should they require it and we will work at their behest. But I don't have that data, sir, and I don't feel qualified to answer anything on insider dealing. It's not my bag.

Q521 Mark Garnier: But market abuse and insider dealing are ultimately criminal charges, are they, or do I have that wrong?
Mike Bowron: They're prosecuted by the FSA.
Steve Head: They are prosecuted by the FSA generally. Obviously they are capable of criminal prosecution and the FSA bring those prosecutions under the present systems. We supply some of the investigative ability alongside it.

Q522 Andrea Leadsom: I would like to talk to you about internet transactions, because there has been a huge increase in internet transactions. I gather "phishing" is the term given to trying to pretend you're a bank to get somebody to give you their bank details. Is that a growing problem?
Mike Bowron: It is indeed. I occasionally get them myself from a bank. It looks a very authentic website and I know immediately it's a phishing attack because I don't bank with them. That's a bit of a tell-tale sign. But we work very closely with the banks and with the Met e-crime Unit, which deals specifically on the technical side of the business, and other agencies. But I believe you have some data on this one, Steve?
Steve Head: Yes, thank you for a little bit of warning on the nature of the questioning there. In terms of online banking fraud losses, in fact at the moment we're seeing a little bit of a fall in terms of the first half-yearly figures. However, in terms of the general picture, that is the picture that is going up. In fact, what may be attributing to that slight dip may be some police activity. It may be that the banks have had some extreme activity, and just because the losses are

dipping doesn't mean the number of attacks has dipped. So generally the trend is up, albeit in the last six months the trend is slightly dipping.

Q523 Andrea Leadsom: Do you think cybercrime is a real threat to our economy? Do you have any idea of what percentage of all crimes it represents?
Mike Bowron: To put a figure on cybercrime: I think you have to separate out this term "cybercrime". There are the very technical attacks that are botnet attacks—robot network attacks, denial of services attacks—and the technical bug attacks, which are the remit of the Met PCeU or the e-crime Unit. Then there are the many frauds—advanced e-frauds, phishing attacks, lonely hearts frauds, where we've seen a massive increase lately—which have a human being on the end of them. I think we need to separate what we mean by "cybercrime".
Then there are all sorts of potential intellectual property crimes and the denials of services. The impact is enormous. If you look at South Korea, about a year ago, the whole country was primarily brought to a standstill, for about a week, from a mass and sustained attack from outside their borders on their infrastructure. So the potential is always there. We work with other agencies but we primarily focus on the fraud side—the pure fraud with a human or an organised crime group on the other end—then try and separate out the technical side for those who are better qualified to deal with that side of the business.
In terms of putting a figure on potential damage to the economy, I couldn't hazard a guess. It is only recently that we've managed to put a figure on reported fraud in this country: fiscal, non-fiscal, public, private. The last time that was done was just about a year ago, in conjunction with the National Fraud Authority and Professor Mike Levi from Cardiff University, and that was £31 billion. The last time Mike Levi did this figure—that was exactly four years ago—it was £14.9 billion. I'm not saying that fraud has doubled in that time but reported fraud had, and that could be a confidence thing as well. But £31 billion will buy you three Olympic Games every year.

Q524 Andrea Leadsom: So what is the detection rate? How many of those losses are you able to recover?
Mike Bowron: We work on the "three Es principle": the first one is education. So if we go back to banking online, I use online banking but I ought to know what is a good site and what is a criminal site. But we want to educate the public and other organisations on what is a potential crime. We then work with banks and other agencies. The second E is engineering—engineering out opportunities for these things to happen. So if we can find a technical solution for people to stop putting false sites on the web we will do that. Thirdly, enforcement, because we simply don't have the numbers to deal with the crimes that are now being reported. We're currently investigating—it has just gone up—£5.3 billion worth of fraud in this country, and I've just told you that it was last assessed at £31 billion. We have picked that up in the last 18 months with a staff of about 200. So that shows you the capability that we can get our teeth into in a short timescale. But to put a whole figure on all of it, you do need academic input on this because it requires that capability.

Q525 Andrea Leadsom: Yes, but how many people are you prosecuting and are you able to recover some of that money?
Mike Bowron: Yes, and our goal—certainly in the City of London Police that I am representing—is to make ourselves at least cost neutral, in terms of what we return to the public and banks and the private sector. Since Lead Force started two years ago, £168 million in pure cash has been returned to bank vaults and individuals. It is very difficult to assess that which we have disrupted, and that is a big focus: disrupting fraud. But in hard cash, £168 million. It was £117 million last year we returned to banks, which is considerably more than our force budget in its entirety. So I'm working on the force—my organisation—recovering more, freezing more, disrupting more, than it costs the taxpayer to run us.

Q526 Chair: Before I pass you over to Michael, what confidence can you give us that we're not going to have a South Korean experience here?
Mike Bowron: I have the confidence that we have fantastic security services in this country, a joined-up policing approach and very good relationships between the security services and the police and other agencies. You can never say "never" but I'm confident that we are in a sound position to defend our e-borders.
Steve Head: Can I just add, sir, very quickly, on a very practical level we work very closely with the security services. The crossover between some of the things that you've seen generally around what is known as "cybercrime" and cyber-enabled fraud, as we see it, are very close, and we certainly share all of our data with those agencies that might need it in those terms. The boss is exactly right—never say "never", but we work as well as we can to recognise the threat and assist those agencies who are best positioned to deal with each particular element of the threat.

Q527 Michael Fallon: Other than saying that you aim to return more than you cost, which seems fairly unsurprising, you didn't really answer the question of what the recovery rate is. Could you do that now?
Mike Bowron: Okay. The data we have, in terms of assets—
Michael Fallon: Can you give me a percentage figure?
Mike Bowron: Well, £168 million in hard cash. We're currently investigating £5.2 billion worth of fraud, of which about £1.5 billion is attempted fraud. So it didn't realise any cash gain at all. I think the biggest one I've ever seen is US$2.25 trillion—
Michael Fallon: That isn't the question. We're trying to measure how successful you are. What I'm looking for is some kind of measurement. What is your recovery rate on this type of fraud?
Mike Bowron: Do you mean a total figure?
Michael Fallon: Is it 5%, 50%, 100%?

Steve Head: It's £168 million, sir, out of £5.3 billion, minus £1.5 billion. If you give me a few seconds to do the math I'll be there.

Q528 Michael Fallon: That sounds very low.
Mike Bowron: But we've only been running as a Lead Force for just under two years. The Intelligence Bureau has only been running for a year. Our funding, sir, started three years ago.
Michael Fallon: All right. But you can't just defend yourself on the basis that that you return slightly more than you cost. We have to have a measure of whether you're winning or losing.
Mike Bowron: That is one of many goals. My original goal, sir, was to get fraud on the agenda.

Q529 Michael Fallon: All right, it's on the agenda now. While we're waiting for the figure could you tell me something else? How safe do you think internet banking is now?
Mike Bowron: I use it, and I'm confident when I use the internet to do my own personal banking.

Q530 Michael Fallon: Is it as safe as mainstream banking?
Mike Bowron: I believe so, provided we educate individuals to know what to look for as far as potential fraud is concerned. It's a confidence thing. I think internet banking is a good thing because it saves us all a great deal of time. I find it personally very convenient. I think most people do.
Michael Fallon: I know it's convenient but that's not the question.
Mike Bowron: Of course, legitimate sites are safe, but it's not knowing if there is a crime before you and, perhaps, if you're elderly and you don't have any advice, and you're not sure what to do, you may succumb to giving or confirming your password to a criminal site.

Q531 Michael Fallon: Do you think it's rational for people to be reluctant to switch to internet banking, because of the fear that their information might be passed to criminals?
Mike Bowron: I can understand why some people would be reluctant to switch, but I suppose it is incumbent on us to help to educate people to have the confidence of knowing what to look for in terms of crime.

Q532 Michael Fallon: Do you think there's enough competition in the internet banking sector to force banks to invest more in their online security systems?
Mike Bowron: I don't think I can answer that one, sir.
Michael Fallon: You don't have a view on that?
Mike Bowron: Well, I do look at the accounts of banks and I see what they invest in terms of security.

Q533 Michael Fallon: Well, are they investing enough?
Mike Bowron: I don't know, sir.

Q534 Michael Fallon: You don't know. Okay. Can we have the figure then?
Steve Head: I think it's about 5%.
Michael Fallon: You're recovering 5%? Thank you very much.
Mike Bowron: But we anticipate that to increase considerably.
Michael Fallon: I understand that.

Q535 Chair: Michael Fallon's question earlier was: is it rational for people to be wary of switching to internet banking. The answer to that must lie in an assessment about whether you expose yourself to a higher risk of fraud.
Mike Bowron: Yes.

Q536 Chair: Is the answer "yes" or "no" to Michael?
Mike Bowron: I suppose, logically, you are when you switch to internet banking because you're transferring your personal details over the ether.

Q537 Chair: So, therefore, traditional banking is safer and we shouldn't get rid of cheques?
Mike Bowron: It's not my area, sir. I'm not a banker.

Q538 Chair: Aren't these the key questions?
Mike Bowron: It does provide a source of work for us in terms crime, of that there is no doubt. There is a great deal of concern in the banking sector to get this right, because there is the potential for damage to their reputations if their sites are being copied and used by organised crime gangs. I can only say I have confidence in my own bank and I use internet banking. I opened up another account two weeks ago and I'm very confident in the system I have, but I guess I would say that because I'm a police officer and I know what to look for.

Q539 Chair: Well, to respond to the question by saying, "I'm all right because I'm an expert in the field", is not just not inspiring confidence, it's telling the public that there's a very considerable risk here. Likewise, the investment levels. In your answer on that, the investment levels that the bank is putting in, surely the investment levels are themselves not particularly relevant, but what matters is the effectiveness of the tools that the investment is purchasing?
Mike Bowron: Yes.
Chair: If I may say so, on the basis of your evidence so far, you don't seem to be measuring that. Is that correct?
Steve Head: If I might, sir? In terms of the relationship that we have with the banks, they are putting considerable resources into fighting the developing issues around cybercrime—as I might call it—or cyber-enabled fraud, which is what we deal with in those sorts of issues. To answer your question, I believe that is a growing threat. That is a threat that we consider to be growing. Cyber-enabled fraud is, in my professional opinion, the largest threat that we face at the moment, because it allows the traditional frauds to happen at a far greater rate than we've previously experienced. Obviously, the banks have to also balance it against the growth that we've seen in regular insider fraud and account takeovers, which are facilitated by people within the organisations.

In terms of what you're asking around the measurement, we obviously measure our overall effectiveness in relation to the investigation of fraud. We measure it in terms of the amount of money that is stolen and how much of it we can return. We're trying to improve on that as we go, because it's important for us to get money back for the victims. We don't take any of that money. We give it back to whoever the victims are in these instances. I think the other thing I would say is that we are looking at the trends in the National Fraud Intelligence Bureau, because it is a complex picture. There are an awful lot of people interacting on these crime figures at the same time. What we're trying to do is to disseminate all of that out and show which of those have been effective in achieving the downward trend, or the upward trend, and which of them are simply just not working.

As Mr Bowron said, the unit has been up for 13 months. It's made a lot of progress in what it has been doing and it has done an awful lot in terms of identifying networks, identifying how they're linked across the country and the world. But what we haven't yet quite succeeded in doing is being able to take out those bits of our work that are completely successful, and showing what are the bits where we're maximising our impact. That is a piece of work that's ongoing. The trend that I spoke about earlier, where we've seen a dip in online banking losses, would perhaps be a good opportunity to say, "Right, there is a moment in time. What changed then?" Disseminate all of the things that are happening from the police, the banks, the public, education, the awareness and say, "What happened there that made a difference?"

Q540 David Rutley: Can I just be clear about what your remit is: is it just about convicting, or is it about detection early on, or does it go back to prevention?

Mike Bowron: It is all of these things.

David Rutley: All of those?

Mike Bowron: Yes.

Q541 David Rutley: The £168 million, given the standing start, probably sounds all right, given the total scale. But obviously from your estimates it sounds like much more work is required.

Mike Bowron: Yes.

David Rutley: Surely there needs to be a lot more work done then on the prevention side?

Mike Bowron: Yes.

Q542 David Rutley: What evidence do you have of the work you've been doing on prevention, particularly working to improve standards with internet banking capability, across companies that work in the City?

Mike Bowron: Steve, do you have an example of work being done to close down banking sites?

Steve Head: We do work with the banks to close down accounts where basically what we see is victims being defrauded of their money. We don't advertise—

Q543 David Rutley: Just to be clear, specific accounts such as the "David Rutley Account"?

Steve Head: Yes. If we identify suspicious activity, or the banks identify suspicious activity in relation to accounts, we do work with the banks to close down those accounts.

Mike Bowron: To prevent someone from carrying on doing that activity. That doesn't necessarily lead to a prosecution, but it will stop them from carrying on opening false accounts.

Q544 David Rutley: So you do specific account-based level closures. What about when you see poor standards being implemented by a bank that could put at risk a whole cohort of customers—a group of customers? Have you taken action on that front? Any evidence of that?

Steve Head: We put out a series of alerts when we recognise any weakness in any of the systems. We put out the alerts through what is now the National Fraud Intelligence Bureau and used to be the old City operation ATFRA. We put out alerts and they're geared in two or three different ways: we will put out an alert to the banking industry where we see a weakness in a process that is being exploited. That isn't necessarily a criticism of the banking industry. It may be that it wasn't a weakness previously but it's become a weakness, because organised crime have looked at it, they've seen an opportunity and they've grabbed it. When we see that we will send that out to the banking industry and we will share that across other industries. We have also sent that out to the public in the past where, in actual fact, we try and educate the public to the issues that are being raised.

Q545 David Rutley: So XYZ Bank has systems that you believe have an alert around them? Do you make that public? Do you alert people that they have an amber rating, for example, or a red rating?

Steve Head: No, we don't.

David Rutley: Should you?

Steve Head: We wouldn't rate a bank in that sense. What we would do is we would alert the bank to that process, the general banking industry to the issue and we would alert the public to a sanitised version of it, where it wouldn't be identified as a particular bank. So we wouldn't, and in the past we haven't seen that as our position to highlight individual banks in that way.

Mike Bowron: But we do share cautionary tales with banks and the insurance sector, in terms of crimes we've identified. We will share the fact that, "You need to be aware that this is how this organised crime group broke into your systems or defrauded your customers". I must say, as Chair of the ACPO Economic Crime Portfolio, in which the banks are represented as well as the insurance industry, they are much more confident among themselves in sharing those cautionary tales.

Q546 David Rutley: I will come back to the cautionary tales in a minute. The other thing that concerns me is not just internet banking issues, which we've talked about, but increasingly I hear of people having their credit card cloned while they're using an ATM at a supermarket. It doesn't have anything to do with internet banking: this is just traditional banking.

Somebody is cloning the card, or whatever language you use.
Mike Bowron: Or putting a device over the card reader.

Q547 David Rutley: So what is going on here? You're nodding your head. I'm sure other people have heard about these tales as well. That is traditional banking, not internet banking, where increasingly people are at risk. How big is that risk and how successful are you at tracking that one down?
Steve Head: I do have some thoughts on that, sir. We have two units that deal with that kind of criminality specifically: one of them is a City-based unit; the other is a joint City unit with the Metropolitan Police and UK Payments staff. I know that UK Payments would have the specific figures for you, but I think you'll find that they have seen a dip in that kind of criminality in this country. There have been some very significant successes in taking out the factories behind creating the mechanisms that go on the systems. In actual fact, quite a lot of those are based overseas. There was an awful lot coming from Sri Lanka for a long period. The money that was raised was going to various causes internationally, and a lot of effort was put into targeting that kind of criminality. I think UK Payments recently published something at the beginning of the year, which might give an indication as to the exact trends on that, but there is considerable work ongoing across forces.

Q548 David Rutley: We know your intentions are very good and you're working very hard in this area, but you can detect some real concerns around this table about the scale of the problem that you're tackling. You talked about cautionary tales, but do you think that what you really need is more teeth to be able to tackle this problem? Do you have the power sufficient to be able tackle it properly? I don't think we're completely convinced on this side of the table.
Mike Bowron: That we have the powers?
David Rutley: Do you have sufficient powers to tackle this?
Mike Bowron: I don't think we've ever had a shortage of powers, and we work with other agencies which have other types of powers, for example the FSA. I certainly don't want to be pushing for more resources. We have what we have and we've done what we've done in the last 18 months. We were set a task three years ago when we succeeded in a bid at the last CSR funding round to create two models, and also, at the same time, the National Fraud Authority was created to prove that this thing works. Fraud, hitherto, had only been a priority for our own force in the City of London, and at that time it was deemed to be a white collar crime. What I think we've proved in that three-year period is that it is organised crime—it's not white collar crime at all, it's organised criminal groups—and that, in a short time scale, we've managed to elevate the subject.
In a way I'm glad you are concerned because we are concerned as well. It's a drum we've been beating for years. We wanted to elevate fraud as the most likely crime that any of us would fall victim to. I probably have 40 attempts at me every year through phishing attacks and similar attacks, which we're all very conscious of and we've discussed this afternoon. It is a serious issue. Is it a question of powers or is it a question of resource? Can we justify that by making ourselves pay for the investment made in us? That's one of our goals. But I share your concerns and, once again, am pleased that you are concerned because this is what we do and we need political support and general interest in the whole subject; whether it's e-crime, banking fraud or boiler rooms or Ponzis, they come in all shapes and sizes.

Q549 Chair: But what we need is more than interest—we need to know whether or not those fighting this sort of crime feel confident that they're on top of it, or not, and at the moment we're getting the message you're not confident.
Mike Bowron: I am confident the subject is now taken seriously—absolutely no question about that at all—and it is elevated up there with other serious forms of crime.

Q550 Chair: Yes, we're taking it seriously now. What we want to know is: are you on top of it or not, with reducing this level of crime, or are you going to be back next year telling us that you—
Mike Bowron: Chairman, perversely, the better we get the more we find, and at some point that has to level out. As I said, if you go from £14.9 billion to £31 billion you could say, "Well, it's increasing beyond your capabilities".

Q551 Chair: So most of it goes undetected?
Mike Bowron: Hitherto it probably has. But now what we are dealing with, we're detecting the vast majority.
Chair: So this is a very worrying area, indeed.
Mike Bowron: Yes.

Q552 Mr Umunna: Can I just go back to the £168 million that you said was the amount returned to individuals and corporations? I wasn't very clear: is that over two years or over three years?
Mike Bowron: The project started three years ago but the funding became available for Lead Force, effectively, two years ago. So it's really two years' worth.
Mr Umunna: So that's two years' worth?
Mike Bowron: Yes.

Q553 Mr Umunna: I think the Detective Chief Superintendent said that was about a 5% recovery rate.
Mike Bowron: Of that, which we're dealing with, yes.

Q554 Mr Umunna: How does that compare with forces covering other financial centres like, say, New York, Paris or Frankfurt? How does it compare with similar units covering fraud detection in those areas?
Mike Bowron: That is interesting because I don't think there are similar units to the one we've created here. We work very closely with the FBI. I suppose they are the most similar unit in the States. We work very closely with ICE—Immigration, Customs and Excise—but there isn't a similar policing unit.

16 November 2010 Mike Bowron and Detective Chief Superintendent Steve Head

Mr Umunna: So you're not able to compare yourselves with others?
Mike Bowron: Not really, because I don't think fraud is seen as a priority internationally.

Q555 Mr Umunna: I think you cost about £100 million last year to run, as a force. Is that right?
Mike Bowron: Covering the entire police capability.

Q556 Mr Umunna: You will probably detect a bit of—how can I put it?—questioning of whether you're producing value for money, given your detection rate. I mean do you think you are giving value for money?
Mike Bowron: Our detection rate is 80%, in excess of 80%, where the national crime detection rate is in the order of about 29% to 30% for all crime. It's unprecedented, in terms of overall crime figures and an 85% conviction rate. We'd like to improve that, but it's as good as it's ever been.

Q557 Mr Umunna: I was quite struck by something that you said a bit earlier—and correct me if I heard this incorrectly—that you don't have the numbers to deal with the volume of crime being reported. Is that right?
Mike Bowron: As a Lead Force we give a lot of advice to other forces, because a lot of this is capable of being investigated by the other 43 forces in England and Wales and, if it is, I have agreed a doctrine with Chief Constables up and down the country that a lot of this is reported, recorded and dealt with locally. But different forces have different priorities.

Q558 Mr Umunna: But do you have the capacity to deal with what is being reported to you in respect of what is happening in your area?
Mike Bowron: We have case acceptance criteria, and perhaps that is an issue for discussion as well if we're talking about Economic Crime Agency or other agencies in the future. My Head of Investigations may have something to say.
Steve Head: To answer the question directly, if we had more resources we would investigate more of the offences.

Q559 Mr Umunna: Right. So you don't have enough resource at the moment to investigate all the offences?
Steve Head: We could investigate a lot more of the offences. We set a case acceptance criterion that is matched to the finite resources that we have; issues like financial investigators, and their availability within an investigation, as you can imagine. But to come back to the point that you raised, perhaps slightly earlier, in the comparison with other organisations. There are other fraud squads around the country. The detection rate for the National Lead Force is, as you've heard, the conviction rate as Mr Bowron has said. That is not replicated around the country. That is not me trying to seem—

Q560 Mr Umunna: Can I just come back to this point because I don't quite feel I have got the straight answer to this? Do you have enough resources to carry out what you need to do in terms of investigating the crimes—the things that have been raised with you—or not? You've said that if you had more resources you could investigate more. But what I'm asking is: do you have enough resource to investigate what you're doing at the moment?
Steve Head: Right. Yes, I take your point, I really do, and I'm not being in any deliberately obtuse. What we do is we set the case acceptance criteria to match the resources that we have. If we had more resources we would accept more cases in relation to the work that we do.

Q561 Mr Umunna: Would you like more resources?
Steve Head: I would like more resources. I'm always asking for more resources and I know that has to be balanced, as you can imagine, nationally across everybody's needs.

Q562 Mr Umunna: You mentioned the national situation. 86% of your funding comes from the Home Office, and I think we're going to see a police funding cut over the next four years of about 14%. How is that going to affect you as a force? That's to the Commissioner.
Mike Bowron: I could give you an easy answer and say, "Yes, if I had double resources I could double the capability or treble the capability", but that's not the world we live in. All Chief Officers are now looking at fairly severe cuts over the next four years and some things are going to have to go; some functions are going to have to go. We don't know our future beyond April of next year. Our funding for Lead Force and the National Fraud Intelligence Bureau runs out in April 2011, and I'm told by the Home Office that we should know our fortune in the next two weeks.
We may not have this function next year—I will know in a fortnight. But we are fortunate in the City, in that this is what we specialise in doing. The whole ethos of the City is to protect the financial engine of this country, both physically and in terms of the fraud and e-crime as well. It is very difficult for me to speak for all Chief Officers. Yes, the Greater Manchester Police were talking about getting 3,000. But, yes, if I had twice the resources I'd probably be able to deal with four times more crime. We are dealing with £5 billion worth of fraud at the moment and I've already told you that, at the last count, it was a £31 billion annual problem.

Q563 Mr Umunna: As a force—I used to work in the City myself, and obviously you've having to deal not only with fraud but the increased terror threat—would you be able to sustain a 14% cut in your funding, in real terms, by 2014–15 without affecting the frontline service that you're providing for your area?
Mike Bowron: We have very significant plans to cut back-office functions. It won't be of any surprise to you that we carried out a very large review of our own force a year ago. We made some savage cuts, we saved some money and we built up a modest contingency to see us through the next 18 months to 24 months. But I can only speak for my own force.
Mr Umunna: I am only asking you about your force.

Mike Bowron: That is what I've done to mitigate the impact of the latest cuts. If the Home Office supports us in the next two weeks, in terms of continued funding for the Lead Force and the National Fraud Intelligence Bureau, I will undertake to continue and funding to 100%, because it is a function, and if I get the money for the function it will get 100% funding and support from the force. Other things may have to be cut and reduced but this subject won't be.

Q564 Mr Umunna: I just want to ask the question again because I didn't get an answer to it: if you have to sustain a cut of 14%, by 2014–2015, would you be able, across the board of your force—given that you're not just dealing with fraud but protection and all the rest of it—to continue to provide frontline services to the extent that you are at the moment at the end of that period, if you're having to sustain that kind of cut and if you're asked to sustain that cut by the Home Office?
Mike Bowron: No. I've already shared with Police Authority that certain things may have to go.
Mr Umunna: So there will be an effect on frontline services?
Mike Bowron: Yes, inevitably.

Q565 Mr Mudie: So if your funding is cut, it is Mr Head's job that is on the line, possibly, in 18 months. It's not you, you will continue with your authority, I presume.
Mike Bowron: Sorry, I didn't quite understand.
Mr Mudie: With your authority—your police authority. You will continue, but it is the work that Mr Head does that could go, depending on other people's decisions in 18 months.
Mike Bowron: We get funding from about eight different sources. So, for example, DFID fund our overseas anti-corruption unit. TfL pay for an additional body of officers for enhancing safety on the bus routes. It's not an easy answer. There's no easy answer to any of these questions. It is very complicated. If I get specific funding for a national function—whether it's the Intelligence Bureau or the National Lead Force, to assist other forces and other agencies—I will commit to whatever I can afford. It won't be his job on the line.

Q566 Mr Mudie: I accept that. But your written evidence and the FSA's evidence, seemed to be slightly hostile to the Economic Crime Agency's formation. You refer to it as possibly compromising some of the work that you've done, and the FSA is stronger. Would you be recommending that the Economic Crime Agency is set up? It is a straight question.
Mike Bowron: I would certainly recommend that if it is set up I would like to work with it.
Mr Mudie: No, that's not the question. The question is: would you be suggesting it is set up? Now, you answer with "if it's set up". The question is: do you think it's a good idea to have an Economic Crime Agency along the way it is heading?
Mike Bowron: To answer your question, sir, I haven't seen any detail of what is being proposed. My understanding—if I have this right—is it would be an amalgam of the investigatory side of the FSA, the OFT and the Serious Fraud Office. If that were the proposal—
Mr Mudie: That saves time. Fair enough, you're not saying, because you don't have enough details.
Mike Bowron: It could provide benefits in terms of smoothing out the landscape and providing common acceptance criteria.

Q567 Mr Mudie: Then I will put the question to you: do you think it should be set up?
Mike Bowron: It could bring benefits, sir, in terms of certain functions, but I'm not here to speak for those organisations, sir. I can only speak for my own.

Q568 Mr Mudie: All right. Just going back gently to online banking, and so on. How many prosecutions have you taken in the last three years on that line of crime?
Steve Head: We don't separate the figures out for online banking or for other kinds of offences, in terms of the figures that we've collated.

Q569 Mr Mudie: Why not? I mean the Chairman and Mr Fallon have been asking you how safe it is, and whether we should already be on top of it? Can you not tell us how many prosecutions you've brought successfully? I get the impression that you've simply identified something. You mentioned Sri Lanka: "It's over there. We close it down, but over there is over there". Do you ever catch anybody for this? Have you successfully prosecuted anyone for online banking fraud?
Steve Head: Yes, sir. We have.

Q570 Mr Mudie: How many in the last three years?
Steve Head: If you give me some time I will supply the panel with some details.
Mr Mudie: You know you've done one?
Steve Head: No, we haven't—
Mr Mudie: Well, I'm just asking you.
Steve Head: We have done them. I don't know the exact figures and to go back to the Sri Lankan issue—

Q571 Mr Mudie: Well, when was your last one?
Steve Head: In terms of the last fraud that we took on—I'm not going to be drawn in terms of a time. I can get you the details.
Mr Mudie: It is up to you. I think you have answered the question.

Q572 Chair: Roughly how many? You don't know the exact number, but roughly?
Steve Head: Of the 600 investigations that we have ongoing at the moment, if you give me an hour I could get you the exact details. Lots of these investigations will be online investigations, with different kinds of cyber aspects to them.
Mike Bowron: There are jurisdictional issues here.
Chair: We're only asking for a rough idea.
Mike Bowron: Most of the perpetrators are overseas and there are jurisdictional issues.

Q573 Mr Mudie: That is what I am seeking to find out: is it simply identified where they are operating

from, and if they're overseas you seek to cut it down, but that is it?
Steve Head: Can I give an example of a case we have done recently where, in actual fact, we identified that what we would call "boiler rooms" were operating from southern Spain. That is the illegal selling of shares over the internet to members of the public in this country. Now, we could have stepped in and just tried to close those down. However, we took an investigation decision. We looked into that job. We identified the organised crime group network that was operating. It was run by a gentleman—and this is potentially sub judice, in the sense that it is a matter going to court but it's our most recent case, sir—and in actual fact, the situation was they were operating out of Sweden, they were operating out of Italy and they were operating out of Spain, but they were targeting UK victims—hundreds and hundreds of UK victims.
What we did with our investigative strategy is we managed to get those parties back into the UK so they could be arrested for their part and those of them we couldn't get back into the UK, we obtained international arrest warrants to pick them up in Sweden. They were part of organised crime groups operating in this country. They were part of a different group operating in Sweden. They will be going to trial soon. That is our most recent case. There is a huge cyber element to it because it couldn't have happened without the internet, because it was happening all around the world. We also took out an international restraint order, and we have recovered hundreds of thousands of pounds of their ill-gotten gains.
Chair: Okay. We have the general picture.

Q574 John Thurso: Sorry to carry on about internet banking. Can I just follow up? You have said you are happy to bank on the internet. I'm not. I've avoided it like the plague and I'm very happy with my chequebooks, and I think there are quite a lot of people who feel the way I do. Therefore, I never suffer from any internet banking fraud because, clearly, anything I get that tells me I should bank on the internet is a load of rubbish because I don't have one. What I think the public want to know is which is safer: the internet or traditional? Should we be getting rid of cheques? Is this precipitous? I know this is policy rather than enforcement, but if you could steer us towards an answer to that question—which is safer, the internet or traditional—I'd be very grateful.
Mike Bowron: I am personally very cautious—

Q575 Chair: Is this the first time that you've thought about this question?
Mike Bowron: No, it's not, sir. It is very difficult to equate these two, because I am always very cautious when I put my card in a machine. I am looking for perhaps a false facia, for example. I nearly fell victim to one in Sevenoaks not that long ago. I saw some drilled holes, went into the bank and, in fact, it had been subject to one of these and it had been removed. It is very difficult to answer, but as technology goes on, more younger people will be coming through and using internet banking and all other forms of new technology, but new technologies provide opportunities for organised criminals. Our thrust is to work with the developers of technology and banks to stop these people exploiting those technologies to their own ends.

Q576 Chair: But there is an objective answer to this question. You're an expert in it and we want your considered view.
Mike Bowron: Which is safer: internet banking or traditional banking?
Chair: Yes.
Steve Head: I have a professional judgment, sir.
Mike Bowron: He investigates these crimes. I'm finding this a very difficult question to answer. but—

Q577 John Thurso: Maybe I will be guilty of leading the witness for a moment. Would it be fair to say that today, at this moment, if you look at the relative safety of the internet versus the relative safety of traditional, traditional is safer? What you are saying is: the internet may be more convenient and, therefore, the job that is required is for those who provide internet banking to get it up to a level where it is as safe as traditional. Would that be fair?
Steve Head: In my professional judgement, it is safer to do traditional banking where you deal with people face to face. That is always going to be safer. That is not a judgement on the convenience or otherwise of how people do their banking. But in terms of the issue of safety, yes it is.

Q578 John Thurso: Okay. Thanks very much for that. One other quick question, which was around the way that the Economic Crime Agency might develop, and so forth. I think the evidence was from the FSA, which was the concern that some activity is civil, and some activity is criminal. The evidence suggested that there were dangers in having two separate bodies—one focusing on the civil prosecution and the other on the criminal prosecution—and there might be duplication. This is between the CPMA and the ECA. Do you think that is a danger at all?
Mike Bowron: Mixing the civil with the criminal?
John Thurso: Well, the fact that you will have some things that are done that would be a civil case and others that would be a criminal case, and the suggestion was that, by completely separating them between the ECA and the CPMA, there might be duplication and problems.
Mike Bowron: I suppose that could always be an issue but, as long as you have an understanding of what is criminal and what is civil, there might be benefits in having the infrastructure behind that in terms of cost benefits.
Steve Head: It hasn't been our experience in our investigations. Obviously, we do deal with the FSA when they are dealing with civil and criminal matters, and we fulfil only the sort of criminal aspects of that with them. The basis of that has to be strong MoUs, or even standard operating procedures to underpin what you do. There could be confusion, but with good processes you should be able to avoid it.
Chair: Thank you very much for giving evidence today. You can tell that there's a great deal of concern about aspects of internet and identity fraud which you

haven't, as you can also tell, fully allayed. If you have further information you think should come before the Committee please do put it in writing and we'll be very grateful to receive it.

Mike Bowron: Thank you.

Chair: We'll be taking a three-minute break now and then resuming straight on and then the next session will finish sharp at 5.20pm.

Examination of Witness

Witness: **André Villeneuve**, Chairman of the City of London's International Regulatory Strategy Group, gave evidence.

Q579 Chair: Thank you very much for coming before us this afternoon. I'd like to begin by quoting to you what Xavier Rolet said when he came to give evidence to us. He told us, "Some people"—by which he meant in Paris—"see an opportunity through the regulatory harmonisation process to claw back some business from London". Do you agree with him?

Mr Villeneuve: I am sure that people are attempting to do this and I think some countries are better organised to do this than we are at defending what we're doing.

Q580 Chair: Can you elaborate a little on our inadequate defences?

Mr Villeneuve: Yes. To take the French, for instance, which I know a bit about and something Xavier obviously knows a great deal about, certainly under Christine Lagarde's—who is the French Finance Minister—reign, they set out very early to have a series of wise men groups that worked on projects to carve out a position for Paris in certain key sectors of the financial services industry. So, for instance, they decided very early on that it was necessary to create more clearing capacity in the Eurozone, particularly over euro instruments, and that Paris was well placed to do this.

So very early on, under the aegis of the French Treasury, they set out a plan of campaign to do more clearing in Paris. It had a financial services dimension and it had a political dimension as well, because using the necessity of doing euro clearing in the Eurozone is not unreasonable politically. It was used as a very good weapon to do this. The interesting thing, Chairman, is that they didn't rely on the industry to get these things going because the industry, in their view, I think, tends to focus on immediate issues. They think strategically for their own companies, but not necessarily strategically for the broad good.

So some of these processes were kick-started by the Treasury itself, by getting this group of wise men to say, "Let's try and get the industry to look a bit beyond what they are doing today and tomorrow, what the clearing activity might look like in five years' time, how Paris would fit into that and how they could benefit from it". We're beginning to see the results of that now.

One of the results, for instance, is that London may be excluded from access to euro liquidity from the European Central Bank. If that happens, the role of clearing in London is seriously under question. The consequence of this is that—to take one example—the New York Stock Exchange, which has traditionally done all its European clearing activity through London, now has to build up a presence in Paris as well as London, because it doesn't know whether the UK is going to have access to euro liquidity from the European Central Bank or not. If it can't, they can't afford to place all their eggs in one basket. I think all this was quite carefully mapped out in the work that was done in the French Treasury—I'm giving you one example—and I'm not sure that we have mechanisms that do the similar sort of work.

Q581 Chair: So we've been outwitted by the énarques?

Mr Villeneuve: You could phrase it that way. Potentially; I think they have a more dirigiste approach to these things. But I think we need to get smarter about it ourselves.

Q582 Chair: Rather than pursue that now, it would be extremely helpful, since we have the man whose task is protecting us from such mischief, Mr Barnier himself, coming to see us—we are very pleased that he has changed his mind and decided to come—perhaps you could give some thought to what we should be asking him, and in due course come back to us. Of course, whatever you give us we'll put into the public domain prior to the meeting.

Mr Villeneuve: With pleasure.

Chair: Because I think it would be right for Mr Barnier to have an opportunity to see it.

Q583 Andrea Leadsom: Rather cheekily, we have Monsieur Barnier, who of course is very influential over regulation in the future for the UK, we have Monsieur Rolet, who is now running our stock exchange, and we have Monsieur Villeneuve. Is there a bit of a conspiracy going on? Is this the mountain coming to Mohammed? Is there some sort of group thing going on here from the French?

Mr Villeneuve: I don't want to bore you with my history, but I was born and brought up in this country and I have a British passport.

Andrea Leadsom: You give a very good impression of having been brought up in this country.

Mr Villeneuve: My parents are French, but they came over here before I was born during the Second World War, thanks to the English, and they stayed.

Chair: They used to be in the Navy, presumably, once?

Mr Villeneuve: Well, I owe my job to the fact that I was hired by Mr Nelson in my first job.

Andrea Leadsom: So there's no conspiracy?

Mr Villeneuve: This is not a French conspiracy.

Andrea Leadsom: Excellent.

Mr Villeneuve: Although I do talk to the French often and I do speak French. If that's held against me, I don't know what to say.

Q584 Andrea Leadsom: Very good. So just looking then at Basel III, which has a very big impact on the success of the British banking industry, and in a way is seen as perhaps being a bit light on British banks and on the banking system in general. Do you think that it goes far enough? Do you think Basel III capital adequacy requirements go far enough to prevent future problems in the banking system?
Mr Villeneuve: I would start by saying I'm not an expert on capital adequacy. I chair a group that covers a whole lot of subjects. There is always a trade-off between regulation and growth, and there needs to be a trade off, and the question is: do they have it about right? me. The view I'm hearing from the banking industry on my group at the moment is that it's probably a bit heavy in its current versions, rather than light, that there will be an impact on growth. They haven't quantified this yet in the way that I would recognise.
Different banks have different models and the original proposal of Basel III didn't recognise that adequately. It is viewed that it recognises it extremely adequately now, because I think the timescale goes up to 2020 for, say, French and German banks to apply it. There is a question mark about whether the Americans are going to apply it. I'll stop, because you don't like long answers.

Q585 Andrea Leadsom: Okay, so just to reiterate, do you think Basel III could contribute to preventing a future crisis,? Do you think it is part of, or a full, solution?
Mr Villeneuve: I am told by people more expert than me that raising capital standards, and looking at liquidity standards and leverage, should help prevent a future crisis. Nobody has told me what the magical point is at which it does. We're talking about 2 percentage points or 3 percentage points. I don't know whether 8 is good or 11 is good. I'm not expert enough to be able to answer it in those terms.

Q586 Andrea Leadsom: Do your UK banks tell you that Basel III will harm their future profitability in a global sense, or help it?
Mr Villeneuve: All the banks that are on my group recognise the need to raise capital standards. All of them also say that raising capital standards will mean they will have less money to lend. So yes, there should be a bit more comfort with higher capital standards. Yes, it will have an impact on the economy.

Q587 Andrea Leadsom: So it is a trade-off between the security of the system and the prospects for lending to companies to enable growth in the domestic economy?
Mr Villeneuve: That is broadly the way it has been put to me, yes.

Q588 Andrea Leadsom: Thank you. Do your banks tell you that the European regulatory changes are compatible with what we're proposing to do in the UK?
Mr Villeneuve: Are you talking about the new supervisory authorities?

Q589 Andrea Leadsom: Exactly, yes—the new supervisory regulatory reforms coming through from Europe. Are they seen by your banks as being compatible with what we're proposing to do with the new—
Mr Villeneuve: We do not mirror what has happened in Europe. In fact, I do wonder whether this paper was written even with Europe in mind, because it was clear when the paper was written what Europe was moving towards. So no, we don't mirror it ,and this has shown up very clearly—as Xavier, I think, pointed out to you as well, if I read his thing correctly—in ESMA, which is the European Securities and Markets Authority. We have a very puzzling situation as to how the UK is going to be represented on ESMA. The proposal, as I understand it, is that the consumer authority will represent the UK on ESMA. Now, you have to bear in mind that the UK is by far and away the biggest international wholesale securities market in the world. So it's really a wholesale market and it is being represented by somebody that is essentially consumer.
So the question then comes: how broad is the remit of the consumer agency here—the CPMA—in as far as it represents the UK in this essentially wholesale set of discussions? Most other European regulators are not as concerned with the consumer as we are, so it won't be a consumer discussion, it will be a wholesale discussion. If the remit of the CPMA is very broad, then the delineation between the CPMA and the prudential regulator becomes challenging again, because where do you draw the line? If it's quite small, then our representation on that group is going to be fairly meaningless, because other regulators may not take very seriously a UK representative that is totally focused on consumer issues in the wholesale equities market discussion.

Q590 Andrea Leadsom: So would your banks then say that we have it wrong, that our proposed regulatory structure in the UK is wrong, or that the proposals in Europe are wrong, or is it just an observation?
Mr Villeneuve: None of my banks say that anything is right or wrong, because they're focused more on outcomes than they are on structures. Every structure has its upside and its downside. You have one tripartite system being replaced by another tripartite system, essentially. It is very difficult to find the perfect model, so I think my members recognise the difficulty in finding the perfect model. The problem then is: what remit do you give these different groups and how do you make sure that they are as effective as possible in fulfilling their duties?

Q591 Mr Umunna: While capital adequacy is extremely important in ensuring that we don't have a repeat of the mistakes that were made over the last two or three years—and it is something that has preoccupied a lot of regulators and those who work

within the financial services sector—the one issue that is brought up, more than anything else, in respect of the banks and the sector by our constituents, is the remuneration of those who work in the Square Mile in particular.

We have the next bonus round about to start in a few weeks. I know the FSA are just completing, I think, their consultation on the new code that they intend to put in place. We've had the Capital Requirements Directive coming out of Europe, which suggests a whole raft of measures. Do you think the new rules, which are being implemented at the moment, will help prevent a repeat of the financial crisis we saw emerge over 2007–08?

Mr Villeneuve: Let me start by saying I'm not a banker and I don't get bonuses and I don't even get paid for what I do, so let's be quite clear on that. In our group, we try and cover issues that cross sectors, but on remuneration, we have left it to the trade bodies to represent their own interests, because they're different. The British Banking Association is putting representations of bankers; the ABI is putting representations of insurers, and so on.

Where we do come in is in the range of institutions that the FSA is proposing to cover, and here it differs from just about every other country that I am familiar with. Most other countries—or all other countries in Europe, anyway—that are dealing with this are focusing on a very narrow range of banks and a very narrow range of people within their banks. The FSA has decided to go ahead of the pack and they want to cover 2,400 institutions, as far as I understand, which includes fund managers, insurance companies, which are not, as I understand it, covered in France or in Germany—certainly not in the US, which isn't even trying to micro-manage remuneration in this way—and this is worrying. The FSA is seen as being too far ahead in this debate of other countries, so the end result is whether the level of remuneration here is appropriate or not. We may end up being very uncompetitive with other countries in what is essentially a global market, and we're an international centre, so we have to be interested in what the global markets are doing.

Q592 Mr Umunna: Following on from that, in April 2009, we had Jacques De Larosière carrying out various reviews of these types of issues, in addition to Lord Turner, whose paper, I think, was tabled at the G20 in April 2009. Given what you say, do you think that the Government have done enough to lead on this issue at a G20 level, and—I happen to think Europe generally is on the right course here—do you think enough is being done to ensure that the standards that we're looking to put in place here are also followed by the SEC and others in the States?

Mr Villeneuve: This is a very important question you raise, because it has broader issues than just remuneration. I think what we have at the moment is a European approach on remuneration. We have a UK approach on remuneration, which looks at this stage to be a lot harsher than the European approach, although that remains to be seen. The American approach is to rely largely on shareholders, and not micro-manage remuneration from the centre, so they're encouraging shareholders to challenge the remuneration committees of banks. The Asian approach is open season.

Now, the issue is then: where does the G20 come in if you're worried about being an international financial centre? The Prime Minister told us last night that he wanted London to be an international financial centre that was as competitive as anyone. So this is a very important issue, because there's no evidence at all that the G20—other than the principles that they laid out very early on, about how much was going to be paid in cash and how much should be paid in deferred stock—are going to be applied universally throughout G20 countries. In fact, there's a lot of evidence that that won't be the case.

Q593 Mr Umunna: But just going back to my question: do you think they need to take more of a lead? I mean, in some respects, they're in the perfect position to do so, simply because of the City of London being here and it being rather unique as a financial centre. Do you not think they're in a good position to lead on this issue and do you think they are providing sufficient leadership on it, given the concerns that you have raised about the UK going it alone, in some senses, with a tougher regime? Not that I'm saying I agree with that, but that's what you seem to be saying.

Mr Villeneuve: I have to say I don't think the UK is taking an adequate lead in the G20 in general about this, because what we're seeing now is fragmentation in the G20 on remuneration and on other issues—which I won't go into now—and therefore we are going to get regulatory arbitrage and remuneration differences, for instance, between the Asian centres and the EU on the one hand, and possibly with the UK at the extreme of the EU on the other. I think that if the UK doesn't take a tougher stance with the G20, or recognises that this can't be managed, which is quite possible, because the Asian countries are looking at very different objectives in all this, we need to draw the consequences of what it means for an international centre which has to live with a world regime, not just a UK or an EU regime.

Q594 Mr Umunna: Can I just ask one last question, and this is something that I suppose has happened quite recently? We saw reports yesterday that the British Bankers Association informally—I know it's denied formally doing this—has sought to reduce the level of bonuses that are due to be paid out in the imminent bonus round. We have seen—which they have said is speculation and nothing more than that—figures of £7 billion being bandied about, and the reports were that they were trying to reduce this to something in the region of £4 billion. Granted that this could involve on their part breaching certain regulations if they're not careful, do you welcome a move collectively by the sector to try and rein in bonuses, as the rest of the country looks to tighten its belt? That doesn't really do justice to what is about to happen.

Mr Villeneuve: I don't think the industry has handled the remuneration issue very well, but I won't make moral judgements to this Committee. It's not my role

and all the rest of it. The real issue is that these people have to deal in a world environment—a lot of them are international banks, or if they're just UK banks, for certain activities they have to fish in the same pond as international banks; fishing for people. So that has to be recognised. Whether that is a good or a bad thing, it has to be recognised. I can tell you that having just come back from 10 days in the US with my colleague at the City of London, who is chairman of the Policy and Resources Committee, we went to see a large range of top banks, fund managers and markets and they are completely mystified by the UK approach, the FSA's approach to remuneration.
Mr Umunna: In what sense?
Mr Villeneuve: They just think it's far too prescriptive, far too micro-managing and they don't think it's appropriate for remuneration levels, beyond what was agreed at the G20, to be set by Government. They think it's much more appropriate that the shareholders should be involved in that.

Q595 Chair: They are getting their shareholders involved, are they, in the US? That would be a first, wouldn't it?
Mr Villeneuve: They're trying to.
Chair: It would be a first.
Mr Villeneuve: Well, I sit on the board of a big US company and I can tell you that shareholders are getting a lot more aggressive in the US than they used to be about these things.

Q596 Mr Umunna: Are you more aggressive? As one of those shareholders, as you were just saying, are you raising questions in the way that the US regulators seem to think you will do?
Mr Villeneuve: As a shareholder? I'm a tiny shareholder of US companies. As a director of a US company—but it's not in financial services and therefore has a very different profile—yes, when I joined this board ten or 11 years ago, the remuneration committee did its work almost in a closed environment and the other board directors were just told what the result was. We are now all involved in discussing the conclusions, at least, of the remuneration committee before they're agreed. So there has been progress in the US.
Mr Umunna: Sounds like a small amount.
John Thurso: I just want to follow up on this question of remuneration, because it seems to me there is a fundamental problem that exists in banking that doesn't exist to the same degree in non-banking companies, which comes from the history post-big bank. The vast bulk of merchant banks, both investment banks in America, and merchant banks in this country, were unlimited liability partnerships, where the entire wealth of the individual was on the line.
In that circumstance, if they took the profit and split it all among themselves, that's fine. There is a direct correlation between risk and reward. These have all either now become, like Goldman Sachs, stock companies with shares, or they have been absorbed into, in the case of most of our big banks, companies with shares, but they took the same rewards as they used to when they had all that risk. They don't have the risk now—we have it, because they are all attached to retail banks and if they go belly-up, we rescue them. It seems to me it's a fundamental flaw in the capitalist model that the reward is no longer following the use of capital, and that has to be wrong and has to be changed. How can that be done unless either the City of London or the FSA, or somebody, steps in says, "Enough is enough"?
Mr Villeneuve: First of all, I recognise and am personally very sympathetic with what you said, and I think the change to that model was very fundamental.
John Thurso: It was Warren Buffett who came up with it first during the Salomon deadline.
Mr Villeneuve: I think if it can be changed by international agreement, that is one thing, but I think that all that will happen if the UK goes it alone, because it can't persuade other major countries to follow its lead on this, is that we will just lose out and I don't think that's good for the City.

Q597 John Thurso: Would we lose out? If you follow that line of argument, then all it takes is one relatively major financial centre somewhere to say, "We're not going down that route" and everybody else can't do it. If America or Singapore or wherever says, "We're going to go on paying at that rate" that argument seems to say that nobody can change unless everybody changes.
Mr Villeneuve: We are talking about major centres here, but I'm afraid all the evidence indicates that the US, to take one example—and we have a big US bank presence in this country—is not going to go this route. Unless you found something I didn't find in the last 10 days, they have no plans, particularly after the results of the mid-term elections, and particularly with the new influence of the Republican Party in Congress, to go this route. So the reality is whatever we do here, we'll be doing it alone if it exceeds that, unless we can negotiate with the Americans to change their view.

Q598 John Thurso: Just so I have got this straight our choice is: follow the Americans or give up being a banking centre?
Mr Villeneuve: I think that's drawing the wrong conclusion from what I said. You mean give up a banking centre, in the sense that we lose people?

Q599 John Thurso: We lose out.
Mr Villeneuve: In that sense, yes. We lose people, and it's simple. By the way, we were told in no uncertain terms that the banks that we saw in America already had their plan Bs worked out, so that's the way it's going.

Q600 Andrea Leadsom: In my past career, I used to write quantitative compensation schemes in a fund management company. It's always seemed to me that that a far more acceptable route is to force, if you like, to legislate for banks to have to have a quantitative compensation scheme. I think when they're making money and the risk is not high, it's a reasonable bet. The problem that I think we have is where people are taking enormous risks and being compensated,

regardless of the risks that they're taking. I wonder if you could comment on that?
Mr Villeneuve: I think the remuneration boards need to do a lot more work on banks. I believe that they are doing more work on banks. That includes the US, by the way, because although they're not as hard-line as we are, the shareholders are beginning to get pretty agitated about some of this. So I don't think the remuneration boards should continue in the old way, I think they should set standards and benchmark properly and not just say, "Because he's paying that, we have to pay that", but look at risk and all sorts of other issues as well.
Chair: Drop us a line with the proposal to galvanise shareholders and we'll be very interested.

Q601 Mark Garnier: I want to keep on with the competitiveness of the City of London. The cost of financial regulation: do you have any estimates at all of what financial regulation is costing the City of London?
Mr Villeneuve: No. You seem to be another Frenchman like I'm a Frenchman, if I've understood your name.
Sorry, I don't. I have been trying to make an assessment of this. The answer is that when the financial crisis hit, the FSA roughly quadrupled the amount of work it was doing in each bank, so the amount of regulatory and back-office staff, that the banks had to take on to be able to respond to this increased substantially already at that point.
What is not clear is whether, as a result of these new proposals, there will be further increases. I am being told in the insurance industry, for instance—I sit on the board of an insurance company—the answer to that question was no, probably not. I have to see the detail, but they don't think it will affect it very much. The banks I have spoken to think they will have to make a few small adjustments. It won't be big, because the big adjustments have already been made, but I think, pending final review of all this, I don't know that we have the final answer. But you should not underestimate the ramp-up that's already taken place as a result of the process.

Q602 Mark Garnier: A four-fold ramp-up sounds quite sort of scary.
Mr Villeneuve: That's what has happened. It's done.

Q603 Mark Garnier: What on earth did they do before that? Was the FSA really that wrong?
Mr Villeneuve: They were more pragmatic in their approach to regulation than they are now. I think the—
Mark Garnier: I bet they regret that, in retrospect.
Mr Villeneuve: Yes. By the way, this is being replicated in other centres.

Q604 Mark Garnier: This is what I am coming to. What I'm particularly interested in is the cost of financial regulation in the city and the changes that are about to come through. Notwithstanding everything else that is going on, are they going to make the City of London less competitive compared with somewhere like Paris or Frankfurt or New York?
Mr Villeneuve: I don't sense this from the people I've talked to. Their concern is, "We are where we are now." They have had to ramp up already. One bank said to me, at a very senior level, "We're prepared to take a small extra cost, as long as the new system is efficient". So the efficiency is the thing they focus on more than the extra cost.

Q605 Mark Garnier: You have, to a certain extent, duplication of the regulatory system and if you're an investment bank, I think you're regulated by both the CPMA and the PRA.
Mr Villeneuve: Yes.
Mark Garnier: Again, that in itself must have an increase in the costs of regulation.
Mr Villeneuve: We need to look at the details of it. I imagine there will be some rate of increase, but how big it will be, in proportion to what has already increased, I don't know. I have to say, of course, that international banks don't just worry about what is happening here. They have increase in regulation all over the world, so if you take their regulatory costs as a whole, they have gone up massively, but I think they just see that as the cost of doing business.

Q606 Mark Garnier: I just want to get an idea of how expensive the cost of regulation is. Would you have any idea of what percentage of a bank's overheads are relevant to regulation, compared with everything else?
Mr Villeneuve: No, but I can try and get a figure for you on that.
Chair: Would you? We would be very interested.
Mr Villeneuve: Yes.
What I will say is this: that in the US, a typical bank—and I had this conversation the other day, actually—deals not with two or three or four, but with 27 different regulators and supervisory authorities, if you include all the exchanges. So they have the CFTC, the SEC, the Fed and the New York Stock Exchange, and so on. I won't go through the list, but there are 27, and the figure is bigger here. Of course, a typical European bank has to deal with regulators all over Europe, of which there are a greater or lesser number in different countries. So the proportion of the UK part of the regulation in all this—and I am not saying it is not insignificant, of course it's very significant—in the context of all the regulators that they have to deal with for an international bank, I'm not sure is that significant.

Q607 Mark Garnier: The gold standard we would be looking for, though, would ultimately be—following on from what you were just saying—a very comprehensive, efficient, but simple regulator: one regulator, one set of contacts, one department that is doing it, that covers everything without duplication or having to pick up 27 different telephone lines to go and talk to someone.
Mr Villeneuve: Yes, that would be nice, but I think the issue the banks have here—and I don't know whether I should go this route—is combining that with monetary policy. As you know very well, our Central Bank is going to be by far and away the most powerful central bank in the civilised world—maybe

not; I don't know how China operates. Certainly in this country, it will be easily the most powerful, because it combines monetary policy with regulation. So in France and in Germany, monetary policy is done by the European Central Bank but here, it's done by them.
Now there is an issue of accountability here. To fire a central bank governor who is independent and responsible for monetary policy, you can do it, but it has a significant impact on sterling, possibly, or on the view of the international markets on the UK's standing. On the other hand, he also has a supervisory role now, so the question I think is: how do you hold him accountable for that supervisory role? Can you fire him without damaging his position as head of the monetary authority? I don't know how that's worked out.

Q608 Mark Garnier: You're opening a fascinating avenue of debate, which I am tempted to follow with the Chairman's permission.
Chair: We are running up against time, so perhaps if you have further thoughts on it, you can come back to us.
Mr Villeneuve: I'll raise the questions. I don't have the answers, but it's an important question which is not answered—
Chair: It is fascinating, I agree. It is curious that we've moved from having one of the weakest central banks in the world, just over a decade ago, to having the strongest.

Q609 John Cryer: The competition in the banking sector, or the lack of it, has been one of the greatest controversies in the last few years. Do you think any of the new bodies should have responsibility for promoting competition in banking and finance?
Mr Villeneuve: Yes, I think they should have responsibility for growth and competitiveness, which includes competition, as well as for financial stability and prudence, and they don't, as far as I know. By the way, I think the individual who is worried about pension funding, or savings or mortgage instruments, would benefit from the banks he goes to being supervised in that way, so that they're not just supervised from a prudential stability point of view, but they're also supervised from the point of view of are they providing the right range of instruments in a simple form to their constituency?

Q610 John Cryer: Do you think if the proposed bodies are purely going to look at what instruments they provide—*[Interruption.]*
Mr Villeneuve: Sorry, could you start that again? That's fine, thank you. Sorry.
John Cryer: Is that a spacecraft going off?
Chair: We still have tea trolleys in the House of Commons.
John Cryer: Yes, we do. Yes, we like things like that. If the proposed bodies are purely concerned with the instruments, then will that be sufficient to promote competition, or does it have to go further than that?
Mr Villeneuve: I haven't seen papers that address this properly. All I have seen are papers that address the financial prudence and stability issues. I haven't seen papers that address the role of these bodies in, say, growth and competitiveness. I don't think I've seen anything that suggests that they do this. Maybe I haven't read all the papers properly but, for instance, just to take it at a very crude level, the Federal Reserve Bank in the US is responsible for growth as well as for financial supervision. The Bank of England absolutely is not. Now, the question is, as a result of this new structure, do you change that? Do you then spread it beyond economic growth responsibilities, to at least take them into consideration, to competitiveness, take that into consideration, and how far do you go down the competition and competitiveness route?

Q611 John Cryer: How would you go down that route?
Mr Villeneuve: I would go down that route. Given the huge remit that this organisation has now, you could have a serious mismatch between an organisation that is totally focused on financial prudence and the impact on economic growth, competitiveness and the range of products that are being provided to the consumer.

Q612 John Cryer: How would you promote competitiveness? It might not be in any of the papers, but how would you do it if you had a free hand?
Mr Villeneuve: Well, I think—this is a long question—if you would prefer, I will try and do a written submission on that. What I'm saying is you should develop criteria to do that. I'm not personally expert enough to tell you off the top of my head what those criteria should be, but I'm saying that, in addition to financial prudence, there should be criteria on economic growth, competitiveness and competition.
John Cryer: I think we'd all be interested to see that, wouldn't we?
Chair: Very much so.

Q613 John Cryer: I'll tell you what springs to mind, and this is relevant. When Northern Rock was rescued, the EU rules meant that the Government had a responsibility to make it less competitive. That was the bottom line. It had to be made less competitive. At the same time, Alistair Darling, while having to make it less competitive according to EU rules, of course had to try and make it a going concern. Now, when you have rules applied like that, it seems to me that is just round the bend. So, I can't see us going down that sort of route.
Mr Villeneuve: I like the first part of your question, if you see what I mean, and I would think that we'd have to look very closely at how we could encourage these things. I think a narrow remit for these bodies is not a good idea. I don't think in the end it would produce the environment you want, and I'm not even sure it would de-risk things, because if you look at financial prudence too narrowly, you don't necessarily end up de-risking everything.

Q614 John Cryer: Do you think British banks are now too big to fail?
Mr Villeneuve: Well, too big to fail is interesting. Was Northern Rock too big to fail?

John Cryer: Apparently.
Mr Villeneuve: Yes. So the answer is "yes".

Q615 John Cryer: Yes, and do you think that is a good thing?
Mr Villeneuve: No. I mean, I think it's an interesting question, because when people talk about "too big to fail", they're talking about the big banks, and when they talk about SIFI—I've forgotten, it's an acronym basically for the big banks—Systemically Important to Financial Institutions, I think it stands for. When we look at SIFIs, we're talking about 50 or 60 banks globally. But effectively, Northern Rock was a SIFI, because it was considered important enough for the Government to step in and rescue the whole thing. So you wouldn't have said that was a systemically important bank, but it turned out to be very much in the UK interest to rescue it.

Q616 John Cryer: I think it was too big to fail, and I think that the Government was right, but the last time there was a run on a bank was, as you probably know, was Overend, Gurney in 1866. That was allowed to just go down the tubes. Now, that could not happen today. It simply couldn't happen.
Mr Villeneuve: When you see queues round the block of branches on television, it becomes too big to fail.

Q617 Mr Mudie: Yes, I was interested in what you said about the bank pay, the bonuses and so on, because I have thought since we started this, that whatever position we took on regulation, in all its aspects, we may have to roll back when we see what our competitors are doing, and you've mentioned American terms of bonuses and even central banks. What other areas do you think we may have to roll back on, in terms of stances we've taken so far?
Mr Villeneuve: On remuneration?
Mr Mudie: No, on general dealing with the crisis and changing the regulatory structure.
Mr Villeneuve: I think we have to look very much at the detail I was talking about earlier, about how we're represented on the European bodies. What I didn't say, of course, is that I think we've done a poor job in making sure that we have the right people in the Commission and on these new bodies, and I have evidence for that. In fact, I brought the figures with me. Just to give you a crude example, Britain has 2.9% of the people who work in the European Commission, Italy has 6.1%, Spain has 3.8% and Germany has 4.6%. More worryingly, if you look at the grades of people coming in—in other words, the new blood that is coming in—we're the lowest by far. We're roughly equivalent to Lithuania in the number of people now coming into the Commission from the UK. The result of this is we don't have the right people in position there. I don't think we've done a good job on this and I think we have to sharpen up our act. That's not in any of the papers that I've seen.

Q618 Mr Mudie: On that, when you were speaking about that first, you said you had set up this group in Paris, and they worked out a strategy, of which this was one particular point which you raised. Is this strategy in writing and are there other areas listed?
Mr Villeneuve: Sorry, I didn't understand the strategy one.
Mr Mudie: You were speaking about how well the French had prepared for it in Paris, and you said they had a strategy; you raised one point and expanded on one point. That wasn't the only one point in the strategy, was it?
Mr Villeneuve: Oh, I see. Well, if you want a letter with more examples, I'm happy to give them.
Mr Mudie: That would be very helpful, thank you.
Chair: Thank you very much for coming before us today. You've been asked to provide a lot of further written information, but it's such a vast area, I hope you understand those demands.
Mr Villeneuve: Of course. We do it with pleasure.
Chair: We're very grateful. Thank you very much indeed.

Thursday 18 November 2010

Members present:

Mr Andrew Tyrie (Chair)

Mark Garnier
Stewart Hosie
Mr Andrew Love
John Mann
Mr George Mudie
Jesse Norman

Examination of Witnesses

Witnesses: **Mr Iain Cornish**, Chairman, Financial Services Practitioner Panel, **Mr Roger Liddell**, Member of the Financial Services Practitioner Panel and Chief Executive of LCH.Clearnet Group Limited, **Mr Guy Matthews**, Chairman, Smaller Businesses Practitioner Panel, and **Mr Adam Phillips**, Chairman, Financial Services Consumer Panel, gave evidence.

Q619 Chair: Good morning, everyone. Thank you very much for coming to see us this morning. We have quite a lot to get through in a relatively short time, as so often on this Committee. What we're going to do is ask questions, which could come to any of you, for about an hour. But I hope, from about 10.45am, most of our questions will be addressed to you, Mr Phillips, and if others want to leave the panel they are most welcome. There will be a brief interval and we aim to start the second panel this morning at about 11.15am—there is another one coming on afterwards. I expect some of you are already aware.
Can I begin by asking anybody who wants to answer the question, have the practitioner panels been achieving much recently?
Mr Cornish: I think, over the last two years in particular, we have tried to press the FSA on a lot of things. We have absolutely encouraged them, in terms of their desire to strengthen supervision, clearly to redress the balance and focus much more on prudential issues, and we've tried to encourage them to prioritise things and really focus their efforts on the things that matter. It's quite difficult, I think, for us to point to specific panel achievements, because the nature of what we do is tend to engage with them at an early stage and we will be one of many inputs. But we have seen things develop in ways that we would hope that they would have done.

Q620 Chair: Many other industries have regulation but they don't have such highly developed practitioner panels. They seem to get by. Why do we really need these practitioner panels?
Mr Cornish: I believe that we do provide a mechanism, particularly in the way we operate, which is very much in a private way; we don't seek publicity, certainly, as practitioners. We do provide a sounding board. I think the nature of our panel is very much that we support effective regulation. None of us have benefited as practitioners from what has happened over the last few years. But I think we do genuinely provide a way where the FSA can sound out some of the practical consequences, some of the unintended issues, and explore those before formulating and consulting publicly on policy. So I think there has been a genuine value there for them.
Mr Phillips: I think I would say—speaking for the Consumer Panel—that most of our attention is focused on the regulator. However, there are issues that come up where it's quite clear that the industry has a different perspective from us, and it is useful to be able to talk to the Practitioner Panel who are in the same sort of envelope that we are. In other words, they're aware of what the FSA is trying to do, which may not be exactly what they've said publicly.

Q621 Chair: Isn't it customary for there to be a completely different perspective? After all—as Adam Smith told us—the practitioners in any industry are never so happy as when they're conspiring against the consumer.
Mr Phillips: That's where we start from. But I think there are issues to do with regulation where both the practitioners and the consumers have an interest in common, one of the issues being to keep the cost of regulation as low as possible and the unintended consequences to a minimum.

Q622 Chair: Which brings me to my last question—unless there is something in particular you want to add on that?
Mr Cornish: Just an observation. I think there is far more that unites the panels than divides them. We have a common interest in there being confidence in the market among consumers, whether it's retail or wholesale.
Chair: I'm not absolutely sure I'm given extra confidence by that thought, but do carry on, Mr Matthews.
Mr Matthews: On the smaller businesses, we have started having a representative from the Consumer Panel on our panel, as part of our discussions, to help us in terms of the balance of discussion. Often the regulator sees it from a big firm perspective and some of the issues are more closely aligned, cost and burden and issues relating to consumer interaction that are closer to the heart of smaller businesses.
Mr Phillips: I attend the Smaller Businesses Practitioner Panel on a regular basis. There is a representative from the Smaller Business Practitioners who attends our meetings. It has done a lot to reduce misunderstandings. When you read the press quite often you get grandstanding, people putting seemingly plausible arguments, which miss a lot of the detail, and by sitting in a meeting you focus more on a constructive discussion. So I think there are some very useful things that we can do when we work together.

Q623 Chair: Changes to the structure of regulation could be put in place that would make the need for such a corporate approach to consultation less necessary. After all, most other industries don't have this. Since the kaleidoscope of regulation is now in flux we have an opportunity to re-examine this structure afresh.

Mr Phillips: I understand where you are going. I think my observation—having been involved now for just over six years with the Consumer Panel—is that this particular sector has the unusual characteristic that the problems that emerge, emerge very late. It can take some years for a product, which doesn't work, to fail. It is, therefore, important that, in constructing the regulation, you think very carefully about the effect of the regulation and the impact it might have. In the past, the major input into the regulator was from the industry and they have a particular view, as you have pointed out. The ability of consumers to get involved in that debate, at a fairly sophisticated level and at an early stage, is a genuine improvement. So I would say that the Consumer Panel has made a considerable contribution, particularly over the last couple of years where we've had a board at the FSA that has been more willing to listen to us.

Mr Cornish: As well, new structures—for example, the FPC—the judgements they will have to make will be very complex, very subjective, I think, or judgement-led in some areas, and will have an immense effect, not just on industry, not just on consumers but in macro-economy. I think it is vital that they have very high levels of accountability. If it is not to be a panel then, in our response to the consultation, we have suggested alternatives, like the equivalent of the Board of Banking Supervision; that sort of thing, where you do have an independent body that does scrutinise the decision-making, provides some challenge, provides some accountability and, clearly, on terms, is a committee like this one, having a formal relationship in relation to the FPC or a very structured relationship. In our view these decisions are vital. While we absolutely support the creation of the FPC, it does result in a concentration of some very major decisions within the Bank of England.

Q624 Mark Garnier: In your written evidence you stated that you were concerned about the accountability mechanisms for effective challenge and consultation of the regulatory regime. What do you think are the dangers for the UK economy and for the financial sector if there is there too little accountability?

Mr Cornish: Fundamentally, the dangers are a judgement is made that has a huge consequence—potentially an unforeseen consequence—and the more scrutiny and the more transparency around some of the decision-making the better. As I say, the Financial Policy Committee, in my view, is much more complex than, for example, the Monetary Policy Committee, which at least has a clearly defined single target and one or two very clearly defined levers.

The Financial Policy Committee will inevitably have much less clarity around what its targets are and much less clarity around the levers, but those levers will have enormous consequence for industry. The FPC could be determining, at any point in time, who is and who isn't going to get a mortgage, that sort of issue. Those judgements are critical and have an enormous impact. So, to me, the danger of not having adequate challenge and scrutiny of their decision-making is that they get something wrong and clearly, to prevent future crises, the role of the FPC is absolutely fundamental. It feels to me it should be one of the bodies in the entire country that is subject to the greatest level of scrutiny and support and challenge.

Q625 Mark Garnier: How would you have that accountability and how would you have that scrutiny?

Mr Cornish: We have said in our submission one option would be to have a Board of Banking Supervision, which used to exist within the Bank, which we think would create some good discipline. As I said as well, I think the role of this Committee, in enforcing transparency and accountability, could equally be strengthened, and we have argued that all the panels should at least have a right of access to the FPC.

Q626 Mark Garnier: One of the things that a previous witness was saying, André Villeneuve who is Chairman of the International Regulatory Strategy Group on the Corporation of the City of London, when he came in—I think it was last week—he started on a line of comments, which was one that, if we had had enough time, I would have liked to have followed up, but I might, if I may, follow it up with you. He suggested that having so much power in the Governor of the Bank of England is potentially quite a big problem. One of the things he suggested—and I'm very interested in your comments on this—is that if there was an instance where the Governor of the Bank of England had a telling off or had to be removed for any reason—and I'm not for a moment suggesting that there is any reason for that now—it could have quite serious effects on the UK economy, in terms of things like sterling and interest rates, and all that sort of thing. Do you think that is a fair comment?

Mr Liddell: Yes, I do. Yes, absolutely. It would undermine confidence in the UK system, which could have a very significant consequence.

Q627 Mark Garnier: So do you think it is a mistake that we're going down this route, to have so much effective economic power vested in one individual?

Mr Phillips: I think—and I will take the consumer point of view—that the stability of the UK financial system is clearly absolutely central to a reasonably comfortable economy for the British citizen. However, some of the decisions that may be taken, if the stability objective is the only thing that this group is focused on, could lead to some very unfortunate unintended consequences. So I think, first of all, we would like to see a secondary objective that has a public interest element in it; issues to do with long-term saving, issues to do with the housing market. There are some very big issues to do with targeting investment into small and medium enterprises.

Mark Garnier: So this is in the FPC, yes?

Mr Phillips: I think the FPC, as a board, needs, therefore, to have a sufficient diversity to be able to

address those issues. As an example, at the moment the proposal is that the Treasury would be represented by an observer. It seems to me that that does put far too much power in the hands of one man.

Q628 Mark Garnier: I am going to ask you a very simple question: do you think the FPC is a good idea?
Mr Cornish: I do and, to your previous question, I don't think there are any easy options here, in a way. Clearly, the previous system did not deliver any responsibility to any, one, clearly defined entity to identify the build-up of systemic risk, let alone start intervening and managing that. So I think the notion of an FPC is very sound and very valid, but clearly it would be damaging then if the Governor had to be given a public telling off. So I think the key is making sure that that becomes a very remote possibility and the more scrutiny and challenge that can exist before the FPC takes its decisions, the less likely it would be that we would end up with a set of circumstances where the public telling off was necessary.
Mark Garnier: I think the public telling off doesn't necessarily have to be anything to do with what he does in the FPC. I think that's the other point. I mean he could be told off for something completely different but it would have an effect on that.
Mr Cornish: Yes.

Q629 Mark Garnier: Yes, that's an interesting point. Can I move to the UK Listing Authority, which now seems to be going on to CPMA. Do you think that's a good idea?
Mr Liddell: I personally don't have a strong view on that. I do know that there are differing views on this and they seem to be quite polarised. But I would be cautious about voicing any strong personal opinion on that.
Mr Cornish: I think the panel view is that we think it is not a good idea for the Listing Authority to be moved to the Financial Reporting Council. We see that separating regulation of primary and secondary markets, where we think there are significant regulatory synergies, would create fragmentation and an unnecessary risk of things falling between cracks. We also see the nature of regulation carried out by the FRC as being something pretty different to what the Listing Authority does and we simply don't think the case has been made. It seems odd that we're moving from a tripartite system to a twin peaks model in every area, apart from markets, where, for some reason, the proposal is to fragment things out to a tripartite system. Our view is that the case for that hasn't been made and it does carry material risks.

Q630 Mark Garnier: So where would you like to see the UK arrangement?
Mr Cornish: We had floated the option of having a single markets authority and that could reside with the Bank of England. However, I think a situation where the CPMA looked after markets, including the Listing Authority, and then the post-trade aspects went to the Bank of England is perfectly workable, and we would support that.

Q631 Mark Garnier: You don't think it should come under the PRA?
Mr Cornish: You can certainly make a case that if it's all within the Bank then you have complete continuity and arguably that is better, but the thing we feel most strongly about is not breaking off the UK Listing Authority.

Q632 John Mann: Mr Phillips, would you see yourself as some kind of consumer champion?
Mr Phillips: Yes. The panel definitely sees itself as representing the consumer. The consumer champion, depending on how you define it, can have different meanings to different people even though it is the same set of words. I think, insofar as we're a consumer champion, we see our job as getting the best result for the British consumer. That, in our view, means good value products that meet consumers' needs, which are sold or provided to them in a way in which they can get easy access and the products that they buy are appropriate to their needs. So, to that extent, that's what we think a champion is about.

Q633 John Mann: Earlier on, in answer to the Chairman, you said one of the objectives was that the cost of regulation should be as cheap as possible.
Mr Phillips: Yes. The consumer ultimately bears the cost of regulation, and one of the challenges is to ensure that the regulation provides what I have just outlined and doesn't cost more than it needs to. There is a cost to consumers if there is over-regulation, and the cost can appear in different ways: it can be a direct cost that is borne by the industry, which is passed on to the consumer, or, in the case of the mortgage market for example, it can be simply that people find they can't afford to buy houses or they are put through a number of difficult hoops before it's possible to get a mortgage. The example I would give of regulation that was disproportionate was the issue around identity requirements for opening a bank account, which I think made it very difficult for some people to open a bank account. It was, in a sense, thoughtless.

Q634 John Mann: We are hitting at the heart of the issue because it does seem to me it's a bit like Groundhog Day, that the last three years haven't existed, because the consumer is paying a huge price at the moment: they're losing police off their street; they're losing a range of public services at the moment. But the banking world doesn't seem to quite get that. I mean, for you to be saying that the cost of regulation should be as cheap as possible—let me suggest an alternative phrase to assist you. Shouldn't the regulation that we have be as effective as possible, in order to ensure that the people of Britain don't have to pay the large amounts that they have to pay because of the banking crisis that we've just been through?
Mr Phillips: I absolutely wouldn't disagree with that point of view, and perhaps the word "cheap" was ill-chosen. Perhaps I should say "cost-effective", which is a better form of words. But there is an issue here about making sure that the consumer doesn't have to pay more than is necessary to get the protections that they deserve.

Mr Cornish: If I may, from a practitioner's perspective I completely agree. Clearly, it has been hugely damaging that we've had the extent of failure—on the part of firms, on the part of industries and on the part of regulators—and we have never called for a reduction in the cost of regulation. But I think the point you made that any level of regulation has to be very effective is the key issue. One of the things that we've pressed the FSA most consistently on, is to define what they're seeking to achieve with the regulation and to measure its success against those criteria.
Mr Phillips: To follow up on that specific—

Q635 John Mann: Just to pick up on Mr Cornish's comment, you seem to have been a bit critical of the FSA. Perhaps I'm understating your view on their effectiveness. You're also critical of new arrangements. When Mr Rolet from the Stock Exchange came here he made a much under-reported or non-reported statement. He said that he thought that the new arrangements in relation to the UKLA could lead to a second financial crisis and, when pushed on that, he confirmed that. That wasn't a slip of the tongue. He sees the new arrangements as being potentially—I'll use my term—I interpret it as being potentially catastrophic. Now, you seem to be critical as well. Where do you stand on this?
Mr Cornish: We certainly don't see them as potentially catastrophic. Indeed, we strongly support the development of the FPC, in particular, because I think clearly that entity is about identifying systemic risk wherever the source of that might lie. If that works effectively I think that has the potential to prevent the kind of crisis that we've just been through. While we have, as you say, criticised the FSA, in most instances—and certainly over the last couple of years—that has not been a criticism as in, "You're spending too much money; you shouldn't be doing this". It has been much more, "Is this effective? Are you going to be able to deliver the level of improved supervision of firms?" In the short term, what I would say is one of the issues we're most worried about is that, just to go through this transitionary process, the FSA will have to cut back on supervision at a time when clearly we are still in a period of relative crisis and tension within the financial services industry.

Q636 John Mann: I am obviously keen to ensure that my constituents are not lent money for mortgages ill-advisedly, things that they can't afford in reality to pay back, or are not getting additional loans, as in some of the cases that I took to the FSA, and then beyond for investigation to the Ombudsman, to ensure that there is not mis-selling. That is an important issue, but the much bigger issue is whether there is a proper openly transparent market. In other words, if we move away from retail do people know what they're buying and selling with complex financial products, or not, and is there a system in place that allows that market transparency? That's how I interpreted what Mr Rolet would like to see; that, in essence, we still have the potential for a system whereby products are put together that the people buying and selling them don't necessarily fully understand and, therefore, the kinds of problems we've had could re-emerge. Not necessarily at quite the scale we've had but still to the detriment of the consumer, i.e. the British taxpayer, with people making irrational, risky decisions in search of quick profits. How confident are you, Mr Cornish, with the new arrangements—not least, what the Government has just announced—that what we are going into in Britain is robust enough?
Mr Cornish: I will also ask my colleague to answer that, because he's closer to those markets than I am. But in respect of most of the arrangements the structures have been proposed. The potential problems with those structures, or the issues those structures have to overcome, have been articulated. What we haven't seen yet is how those potential issues will be addressed in practice. So I think it's almost impossible to say that we are comfortable, as yet, with how the structures will work and avoid those kinds of issues.
Mr Liddell: Yes. I don't think anybody would sensibly suggest that any structure that might be put in place would guarantee there wouldn't be another problem, because clearly there will be other problems. It's just a question of minimising. But I would submit that my organisation is active in markets globally and we have relationships with, I think, now 23 regulators around the world. My observation, from having had a lot of interaction with them, is that the wholesale markets are, in my view, likely to be much better served by being regulated by the Central Bank, in terms of large systemic risk.
Chair: One quick question then I must move on.

Q637 John Mann: I will let you pick up the Europe question then that I won't be able to fit in. We have had comments from Peter Clarke of the Man Group this week, on the restructuring that the Government has announced and to quote him, "It was a decision made by politicians"—talking about the FSA—"whether that makes it a political decision I don't know". We are in a strange position where the politicians, the Government, Mr Hoban who has made his announcements—he is not in agreement with the Stock Exchange and several other key players. Is this, in reality, politicians making political decisions, in your view?
Mr Liddell: In my view, I don't think it is. I think the practical reality is that in this sphere there will be differing opinions and individuals—like Mr Rolet, who I do know—may well have views that are not necessarily shared by others. So, to the extent you might hear contradictory opinions, I don't think that should be too much of a surprise.
Mr Matthews: The mantra of the Smaller Businesses Practitioner Panel has always been that the cost and burden of regulation is probably disproportionate and we want proportionality. Certainly we haven't seen any evidence or cost-benefit analysis that suggests that this could not have been achieved within the existing structures—with the FSA and additional aspects added to the FSA. The FPC, probably, is something we would have agreed to from a systemic risk point of view. But, other than that, £50 million being paid as a minimum cost for this transition; we certainly haven't seen any evidence.

Q638 Mr Mudie: Mr Cornish, in your evidence you said something about, "We're almost getting to the situation where they'll tell us who we can give a mortgage to". Are we not getting to that situation now with the FSA's recent declaration on mortgages?
Mr Cornish: Yes, but I think in a way that illustrates the point. When the regulators intervene, whether it is conduct regulation or whether it's prudential regulation, it isn't just firms that are affected. The UK mortgage market and the UK housing market goes to the heart of the macro-economy; arguably it goes to the heart of society and much wider than just economic issues. So I absolutely think that is a very good illustration of why people who are just looking at things through the prism of financial stability need to be subject to wider scrutiny. The point that we've made in relation to the mortgage market review—again from the perspective of absolutely not seeking to defend what's happened in the past, absolutely wanting a safe mortgage market where people can afford the loans they're given—is that those decisions should be taken in the context of a full analysis of all their implications. It might not then change the decision but least it should be a very conscious decision with all the implications explored.
Mr Phillips: One of the things that we see is that the creation of the CPMA and the PRA as separate bodies allows that debate to be held, in a way in which other people can engage with it, assuming that the FPC is sufficiently transparent as an organisation. Because there is a real balance between macro-economic tools that can be used to deal with asset bubbles developing in, for example, the housing market, and the conduct tools, which could have a similar effect but equally could over-depress the market if the two interact. So I think that that debate, which would have been happening inside the FSA—one would have hoped—will now be happening in a much more transparent space. So I see that as a real benefit from the new structure.

Q639 Mr Mudie: You say that debate could be happening within the FSA. Mr Cornish, I'm sort of appalled, from a constituent's point of view, with youngsters trying to get their first home, and the declaration from the FSA seems to me to make it impossible for a tremendous number of youngsters to be able to meet the requirements to allow you to give a mortgage. I'm surprised at the muted response to that because it has repercussions to ordinary people trying to get a mortgage and it has knock-on effects with the construction industry that desperately needs not a bubble but just a market to come back to normal. Why is it so muted?
Mr Cornish: Clearly the trade associations, particularly the CML, have been very public in their view. The Practitioner Panel prefers not to operate in the public arena because we think that doesn't help the FSA engage with us, but we have made our points very firmly to the FSA.
Mr Mudie: Are you finished now? Are you finished in terms of—
Mr Cornish: No, we haven't finished.
Mr Mudie: Because it doesn't seem to have had much effect on the FSA.
Mr Cornish: I'm not sure that is right. We believe the FSA has listened to us, and we believe that they are thinking again about the extent of the cost benefit analysis they need to do.
Mr Matthews: I think, from the panels, we felt strongly enough to join up and make some of those points to the FSA.

Q640 Mr Mudie: When will you get in a position where you'll write to all MPs spelling out what is going to happen to their constituency if the FSA get their way? Are you going to do that, Mr Cornish?
Mr Cornish: From a panel point of view that is very unlikely. Our nuclear option is basically writing to the board of the FSA and then getting them, if they continue to disagree with us, to write back to us. That is really as far as the current framework allows us to take our representations.
Mr Phillips: We issued our response to the consultation on Tuesday. We issued a press release, simultaneously, asking the FSA to do more work on the likely consequences of what they are proposing to do, because it is not yet clear that some of the things that they have talked about could not have a depressing effect on the market. We believe the FSA will listen to that and is going to do more work, which was what we think was needed.

Q641 Mr Mudie: I'm coming on to your views on the new regulatory structure, because when the British Bankers Association came before us they were the first to clock up what other witnesses have clocked up: the democratic deficit. You refer to writing to all MPs to point out to them the danger of the FSA's proposed new mortgage regulations as a nuclear option. Now, why do you exclude MPs from such an important item, and don't you think, pulling it to the bigger picture, that with the Bank of England so powerful, there is a real democratic deficit? You refer to it as their reaction to you; they might pay more attention to you or we will scrutinise them. What about the Treasury? Once every six months, I think, they will be told what they're doing.
Mr Cornish: I agree and I don't think that is frequent enough, given the scale of issues, and I think our submission has said precisely that we need to strengthen the mechanisms for accountability. The point I was making about nuclear options is that the way the panels are constructed we don't have too many routes that we can pursue. Ultimately the FSA can say they don't agree with us, tell us why and that's the end of the matter. We would welcome the opportunity to come and sit on a regular basis in front of this panel and give you a view of our perspective on the regulator. So I think there are all sorts of different ways in which that democratic deficit, that accountability deficit, can be strengthened.
Mr Phillips: I think also I would say, being chair of the Consumer Panel, that I have welcomed the ability to come before this Committee and raise issues about which we have real concern. I can think of two cases in the past. One was the way in which the FSA was dealing with the governance of with-profits funds, which we were very unhappy about and we felt there needed to be a much bigger debate, and you were able

to cross-examine the Chief Executive and the Chairman of the FSA about that. Another one would be raising the issue of the structure of the FSA's board and whether it was sufficiently diverse to provide the necessary effective governance to the FSA. So, again, in appearing before this Committee we had an opportunity to raise those points and you could question us.

Q642 Mr Mudie: I have one last question. What strikes me with the CPMA is that markets are going to predominate—in the press today four markets—and the consumer side is left out. Do you think that function lives easily in a market dominated division? Is there not a case for separating it in some way?
Mr Phillips: I think there are two things. First of all, the FSA has struggled with the consumer protection objective that it has. There is no doubt about that. That is a very good reason for separating that out. When it comes to the governance structures, in my view, there are two different functions that have to be played. One is trying to ensure that the people who are involved in regulation, who tend to get captured by the industry, are questioned by people who have a broader perspective, the other is to think about the detailed impact of the rules and that is much better done by a group of people, like ourselves, who can get involved in the detail than it is by non-executive directors who do not have the time or the resources to give to the job. The problem we face as a panel is there will be situations where we are, in effect, captured by the regulator. We have made the point. We've lost the argument. We've raised it in public and nothing much has happened.
The example I would give to you would be the issue about notifying customers about changes in their ISA rates. If the panel had tried to make that change I would have estimated it would have taken us about two years to go through the necessary process of negotiating it through. Because Consumer Focus made a super-complaint and the OFT had to respond within 90 days, essentially that will be sorted out within a year. So there is a real issue about the ability of people outside such an organisation to exert necessary pressure when it's required, and I am somewhat concerned that, with the abolition of Consumer Focus, there will not be a body who can bring a complaint of that nature, other than perhaps Which?.

Q643 Mr Love: Can I just follow the previous comments in relation to the mortgage market review, because as parliamentarians we've been told on one side by the FSA that—I'm talking about regulation now in the mortgage market—these are necessary changes to ensure that the activities that were undertaken during the bubble don't reoccur. But on the other side we've been told by the industry, in particular the Council for Mortgage Lenders, that this would be cataclysmic, in terms of the provision of mortgages to the housing market. Now, as parliamentarians, we have to make a decision as to how we go forward. What is the role of the Consumer Panel in helping us to do that and how do you seek to ensure that we are made aware of your views?
Mr Phillips: We have conducted a fairly searching cross-examination of the FSA staff, in relation to the research that they have done to establish whether the proposals they're making are likely to have unexpected side effects and consequences. As a result of those discussions, we came to the view that they hadn't done sufficient work, which is what we've told them. They are now going to do more work. So the influence that the panel has is one of scrutiny, internal scrutiny, in the development of regulation. I think that is where we can be most effective. If we reach the situation where we are unhappy we can go public. That's part of a MoU that we have with the FSA. We have to tell them we're going to do that but we can then explain in public why we feel that way. Essentially that's what we've done and they are going to do more work.

Q644 Mr Love: Can I just say to you—and in fact to all members of the panel—I understand your reluctance in this matter but I can assure you that there is no reluctance on the part of the FSA to write to Members of Parliament, and there's certainly no reluctance on the part of the CML to bury us in facts and figures about their concerns. So it would be helpful if there was some independent view that was communicated to members of the panel.
Mr Phillips: I will take that suggestion back. For the last six months we have had a public affairs person, which is part of the strengthening of our own secretariat, and one of his roles will be to engage with parliament. So you will hear more from us in the future.

Q645 Mr Love: Can I go back to some of the issues that Mr Mann covered and quantify them? The Government has suggested that the cost to the regulators of the changes that we're talking about will be £50 million over three years. Do you agree? Perhaps I should start with Mr Cornish.
Mr Cornish: Well, we don't know is the answer to that. We've been keeping very close to the transition process. We've been getting a monthly presentation from the project management team. They are clearly just now pulling together the budgets. There is a great deal of uncertainty around those. It depends whether separate infrastructures are set up around the Bank of England and the FSA. It depends on things like property and where people are physically located. It is certainly a plausible number. One would hope it wouldn't be too much more than that. We would be pressing for it to be less, particularly if the spend is not on regulation but on administration and back office things.

Q646 Mr Love: Let me extend that question into an area that you should have more knowledge of, and that's the cost to the industry of the changes. Have you tried to make any estimate of what you think the likely costs are?
Mr Cornish: Again, until we've seen the practical implications it's very hard to tell. As a firm that's supervised, clearly, by the FSA, going forwards we will be supervised by both the PRA and the CPMA. If that's done in a coherent way, so there's one point

of contact but the supervision team is working behind the scenes, then the direct costs need not grow too significantly. If the PRA and CPMA operate in a very fragmented way and we have double the number of review visits, double the number of information requests, and then the meetings that we'd have to go to to tie the two up, then the locations would be very significant.

Q647 Mr Love: I'm going to come to you in a minute, Mr Phillips, because it will end up with the consumer anyway. They will pay.
Mr Phillips: I know.
Mr Love: So I'll get your estimate in a minute. But I will perhaps turn to Mr Matthews and say: there is a lot of talk that this is going to adversely impact on smaller firms. What is your view about that particular issue?
Mr Matthews: Correct. This is our concern, that some of the smaller deposit takers, insurance companies and credit unions, will be affected by dual regulation. They will have to provide—and we're waiting for the detail on how they'll undertake such supervisory visits. Some of the smaller entities don't separate out their prudential and their conduct side, so in fact those people have to deal and provide separate data, and so on, and when those details come out I think that's when we'll be able to start to estimate. But we are concerned that this will have a major impact on smaller firms.

Q648 Mr Love: Mr Phillips, it is hard to see how, with twin regulation rather than single regulation, costs won't go up. Have you any idea what you think the consumer is going to be hit with in the longer term?
Mr Phillips: I am very concerned that an enormous effort will be made to ensure that costs do not go up, and that the price that will be paid is there will be less supervision not more. In particular, I'm concerned that the less supervision will be in the area of business conduct, which is an area the FSA has only just become involved with, which the industry is not terribly happy about because it involves looking at what they are actually doing as opposed to what they say they are doing. What they are actually doing when you do mystery shopping is a lot less good than they think it is. So we are concerned that the effect will be to reduce the level of scrutiny rather than to increase it, or keep it the same even.

Q649 Mr Love: All of you, in response to Mr Mann's comments, talked about cost-benefit analysis and urging the Government to employ this much more widely than before. Do you think that will deliver the appropriate regulation at an appropriate cost? Mr Cornish?
Mr Cornish: It ought to and, in my view, it needs to. Whenever we talk about cost-benefit analysis I think there's an assumption that what we mean is cost and we don't. The key thing in a cost-benefit analysis, or the key thing in any initiative, is that you focus on what you want to achieve and the effectiveness of that, because if you clearly articulated what you want to achieve it seems to me you're much more likely to design effective regulation. So we think that the whole discipline of cost-benefit analysis and effectiveness review should be much more prominent in the modus operandi of the regulator, whether it's the CPMA or the PRA, and we welcome things like a greater role for the NAO in making sure that that happens.
Mr Phillips: My view about that is that the estimation of the benefits is still too narrow in many cases. When you look at the mortgage market review, one of the key issues is the wider impact on society that it may have, and simply looking at the costs to the industry and notionally what that means in terms of delivering certain kinds of services is just not good enough.

Q650 Mr Love: Finally—I will ask Mr Phillips and Mr Cornish, and I apologise to the other two because we're running up against time constraints—all of this has to be achieved by 2012. Is that possible and, if it is possible, will proper regulation be a casualty of doing it within that time scale? I think you were hinting, Mr Phillips, that proper regulation may be a casualty of this.
Mr Cornish: I think the FPC can clearly be established within that timeframe. The more significant issue is the de-merger of the FSA into the two new bodies and I think it would be a big ask to achieve it by 2012. The FSA have been quite clear that it does involve having to de-prioritise some things and inevitably, given that most of the FSA resource is focused on supervision, it means a quite material scaling back in supervision. So that means by definition we are running a greater risk during a period where I would argue—and we can see what's happening in Ireland at the moment—there are still significant risks within the finance sector.
Mr Phillips: Absolutely.

Q651 Chair: It would be useful to know what the real cost is to consumers of regulation. We've never been able to find out. We keep on asking people and they never come back to us with an answer. They will come back to us with an answer for some incremental cost but never the real full cost. We can't do a cost-benefit analysis until we have that. Perhaps the panellists could reflect on that.
Mr Phillips: We have pressed on this because we did, some four or five years ago, ask the FSA to do work on what the benefits of regulation were, where they had Oxera look into it.
Chair: They wrote a very interesting paper, which I have seen. It was published by John Tiner.
Mr Phillips: That's right. Which never went any further and it would be interesting to revisit that, I think. One of the problems is that—
Chair: I think, rather than just interesting, what we have to do now—since regulation is in flux, isn't it—is get to grips with it and you have to play a crucial role, all of you, in making sure that we are using broadly agreed numbers.
Mr Phillips: I think that it would be useful to do that. One of the difficulties that Oxera had was to try and separate out what a well-run business would do to protect itself from what the additional requirements were from the regulators. So that—

Chair: I have taken a look at it. Let's not go into the detail now.
Mr Phillips: Okay.
Chair: Let's just try and get to a piece of work on the basis of which we can take better decisions.

Q652 Stewart Hosie: One of the consequences of the banking crisis was the almost complete withdrawal of overseas financial institutions, the merger of financial institutions in the UK, and the massive shrinkage of financial products, particularly in the mortgage sector. Should any of the new bodies in the regulatory framework—the FPC, the PRA, the CPMA—have direct responsibility for promoting competition and seeing a growth of new entrants into the banking and financial services market? That is to any of the panel members.
Mr Phillips: We put in our last submission to this Committee that we thought that competition was very important. You're going to be talking to me later but I would say that we still think that the most important issue for the CPMA is that they should be concerned about consumer protection—and I will expand on why we think that—but that a secondary objective has to be competition. Competition, in a number of sectors of this market, is not operating effectively and, therefore, it is a role for regulators to facilitate effective competition.

Q653 Stewart Hosie: That is interesting because that was the language that the FSA had to work within, facilitating competition. You think that broad remit should still lie in line with the CPMA?
Mr Phillips: I do, but and within banking there is a utility component, which is transactional banking. Everybody nowadays needs access to a financial transaction service. That has the characteristics, in my view, of being a utility and we have in the UK an effective monopoly. So because of the small number of banks that provide an effective service of that type, there is potentially a need for regulatory engagement to ensure there is value for money.
Stewart Hosie: That's interesting and that is something that I will come back to in the next session, specifically on that.
Mr Phillips: Okay.

Q654 Stewart Hosie: But in terms of promoting competition, you said it should be secondary to effective regulation. In relation to the promoting competition bit of it, how do you do that, what is the most effective route? Is it regulation? Is it consumer education? What's the most effective route? Or is it the encouragement of new entrants? How would it work?
Mr Phillips: I'll give an example of one of the areas where the Consumer Panel had an impact—it's very difficult sometimes to see the impact that our panels have on FSA policy. Because we're engaged at an early stage, by the time the policy emerges we've already had quite an impact. But there was one particular issue, which was in the period during which the FSA was focusing very much on principles-based regulation and was trying to take out rules. One of the rules that they tried to take out was a rule called RU64, which requires someone who is advising on pensions to make the customer aware of stakeholder pensions, the cost of a stakeholder pension, and explain why they don't necessarily think it's appropriate for them.
If you look at behavioural economics, one of the issues that behavioural economists come up with is the idea of framing something; explaining to somebody how they should make a judgement. So when you come in to find out from an adviser about a pension you don't know very much about it. The effect of RU64 is to give a benchmark product, designed by the Government to be cost-effective, as an example to the consumer and ask the salesperson to explain why you shouldn't have it. So the removal of that rule was very much pressed for by the industry because it made it much easier to sell high-priced pensions. We fought very hard to stop that happening. So that would be an example, I would say, where you can effect change.

Q655 Stewart Hosie: So are you suggesting then that, in encouraging more competition, there is at least a risk that regulation or supervision might be slightly reduced in order to allow that competition to take place and is that a real danger?
Mr Phillips: I would hope that that is not a real danger. I think that it's the way the supervisors work, rather than the fact that they're doing it at all. I mean one of the issues about conduct risk supervision—the idea of getting right down to what the staff are doing with a customer and supervising that, to check that they are acting as they are supposed to act—is to make sure that some of the biases that creep into the system, because of incentives to sell a product or because of partial information, don't get through. It is important that that is supervised.
Mr Cornish: I think we would disagree on this issue with the Consumer Panel and, to that last point, I don't think untrammelled competition between Northern Rock and Halifax in the mortgage market turned out to have been a good thing for anyone, let alone consumers. I do think that to give the regulator responsibility for such fundamental issues as competition is a bridge too far. It's an important issue, but it is one that adds another layer of complexity and scale and, speaking from an organisation that has a 2% market share, I think to reduce concentration in the banking sector means doing some very fundamental things with existing players; you know, breaking banks in half, all those sorts of things. Those, to me, have a feeling of decisions that have a political dimension as much as they do as a regulatory and a competition dimension.
Mr Phillips: I would say that we have an oligarchic banking market that controls the cost to the citizen. There is no effective competition in large sectors of the financial services industry. It is interesting just how much fund managers get paid. In my view, there is no reason why a fund manager shouldn't be paid about the same as any other middle manager working in industry and they're paid about five times as much. So I think there are some real issues here about whether competition is working.

Q656 Stewart Hosie: I suspect this is a debate that you've had before. Guy, can I ask you, in relation to the smaller businesses side and competition, where is your panel on this?
Mr Matthews: We want to promote competition and, therefore, it comes back to effective and cost in regulation. Many of the regulatory rules and policy-making view it from a large perspective, a large firm perspective, and some of the impacts it has on smaller businesses can be life and death.

Q657 Stewart Hosie: So you're arguing that you have proportionality.
Mr Matthews: Yes.
Stewart Hosie: I appreciate that. You wouldn't suggest, though, that the regulatory burden should be lifted in any way to encourage competition? I take it you wouldn't go as far as that?
Mr Matthews: No, I wouldn't. I still think it should be effective but proportionate, which allows competition. It allows smaller businesses to work. As I say, their framework and their alignment to consumers are probably closer. They're less inclined for volume business. They want long-term relationships with clients.
Stewart Hosie: Thank you.

Q658 Chair: Effectiveness and proportionality, isn't this all motherhood and apple pie? You're not going to come and tell us, "We want ineffective regulation or disproportionate regulation". What we need to know is: what could be changed that can give the consumer a better deal in that cost-benefit analysis, in that cost-benefit trade-off? Do you have a proposal?
Mr Matthews: I think, in terms of challenge to the regulatory bodies, it is to justify why they are doing some of the regulation; whether there is a real benefit, both to the consumer and the industry, to doing some of that; not making rules just for the sake of making rules.
Chair: If you have more specific proposals do come back in writing. I know that Jesse Norman wanted to come in with a very brief question and it will have to be, I'm afraid, a very brief answer.

Q659 Jesse Norman: Thank you very much indeed, Mr Chairman. It's just a sentence, if I may, from each of you. Do you think that under the emerging system the Governor of the Bank of England has too much power?
Mr Phillips: My view is yes, by the way.
Mr Matthews: I think yes, it needs challenge.
Mr Cornish: I think the structure is right but with that stronger accountability, yes.
Mr Liddell: No, I don't.
Jesse Norman: Because of the break, could I ask you to develop that for a second? Just give us something—
Mr Liddell: First of all, it is a personal opinion based on my own experience, but I just think that having more power in the hands of the Central Bank is more likely to reduce the risk of any large scale systemic problem in the wholesale sector.
Jesse Norman: Thank you very much.
Chair: That was a very interesting set of replies. If any of the affirmative respondents want to set out in a little more detail in writing why, we're in the market to receive it. Thank you very much, all of you, for coming.

Examination of Witnesses

Witnesses: **Mr Peter Vicary-Smith**, Chief Executive, Which?, **Mr Dominic Lindley**, Principal Policy Adviser, Which?, **Mr Philip Cullum**, Deputy Chief Executive, Consumer Focus, and **Ms Sarah Brooks**, Head of Financial Services, Consumer Focus, gave evidence.

Q660 Chair: Thank you very much for coming before us. We're hoping to finish at 12.00pm, not because we're not interested in your evidence, but there are other things many of us have to get on to today. Please feel free to submit further written evidence if there are points raised that you don't feel you've had an opportunity to answer fully. May I begin with a question to Which? You say, "There are serious flaws in the FSA's approach to conduct of business regulation". Can you tell us—
Mr Vicary-Smith: Sorry, I missed the question.

Q661 Chair: I am just reading what you said in your evidence. I quote, "There are serious flaws in the FSA's approach to conduct of business regulation". What are they?
Mr Lindley: I think it was that the FSA didn't do enough to tackle the root causes of consumer detriment, like complex products, like remuneration systems, which meant that someone could be paid six times as much for selling a loan with payment protection insurance as for selling a loan on its own, and the lack of competition in the market. When the FSA did identify detriment it spent a lot of time looking into it, conducting thematic work, instead of taking strong action, and eventually when it did get through to imposing fines on companies, those fines were such a low percentage of the amount of money the companies had made from mis-selling those products that it's not surprising it didn't have that kind of disciplining effect on the market, and also it refuses to reveal information about what it is doing.
The Committee might be aware of the freedom of information request that we submitted to the FSA, over a number of months, when the FSA was doing some work into the treatment of customers and mortgage arrears and it found that five firms were not treating customers fairly and referred those to enforcement. So we tried to get the names of those firms out of the FSA, because we thought that judges hearing repossession cases involving those firms should have a right to know what the firms had been doing, but the FSA refused our request. They said they couldn't disclose the names of those firms, partly because of the restrictions put on them by the Financial Services and Markets Act, but also partly

because they said if they disclosed the names of those firms it might lead to some reputational impact on the firms; it might make consumers more willing to complain, which could lead to unjustified complaints. So it's a definite change of approach that needs to be accomplished alongside the changes in structure.

Chair: That is an interesting and full answer. You're suggesting that the investigations are inadequate, that the fines are inadequate, that too much attention is being paid to reputational risk, and that there isn't adequate competition in the market?

Mr Lindley: Yes.

Chair: Have I summarised the situation?

Mr Lindley: Yes.

Q662 Chair: Do you know, roughly, how much consumers pay for the existing level of regulation?

Mr Lindley: I think the FSA's total fees were several hundred million pounds a year, which of course are paid by consumers ultimately. I think what's also important—

Q663 Chair: And the cost to firms?

Mr Lindley: Yes, and the cost to firms.

Chair: Do you know what that is, roughly?

Mr Lindley: Not in total. I also think it's important to distinguish between the cost of regulation and the cost of what you would expect good firms to do anyway. If you take mortgage regulation, then the FSA may have rules on affordability, but a good well-run firm would already be checking that consumers' income and expenditure was sufficient to be able to repay that mortgage. So the actual additional cost of regulation—

Q664 Chair: Yes, that's a business cost to protect shareholder value. What I'm looking at here is what the compliance burden is on that firm generated, for example, by its own compliance department. Have you ever tried to look at any of these issues or discuss it with the firms, your counterparties?

Mr Lindley: We have tried to discuss with firms what internal compliance they do, because sometimes if the internal compliance is over-burdensome, or inadequate, then there is something we can do about that. I think it's important to weigh those costs against the substantial costs we've seen to consumers, and firms themselves, when mis-selling is allowed to continue for such a long period of time for products, such as pensions, endowments and now payment protection insurance. We were raising concerns about payment protection insurance back in 2002. The FSA took responsibility for it in 2005. If the industry had done a much better job in not selling as many products poorly, then it wouldn't now be facing a redress bill of up to £3 billion and that doesn't even include the detriment suffered by consumers from buying those poor products.

Q665 Chair: That is a market failure that presumably can be assisted by more competition. How do you think we should get that?

Mr Lindley: In terms of more competition, we'd like the FSA to be given a specific duty to promote competition, because one of the problems—

Chair: A specific objective?

Mr Lindley: Yes. One of the problems that we've found is the FSA always viewed its competition objective as not putting in place extra barriers rather than seeking to proactively remove any barriers, which might exist already. Now that's weak for consumers because then, to get things fixed, the Office of Fair Trading has to conduct a very long and intense investigation, and that takes time. If you take something like the transferring of individual savings accounts, of ISAs, there was a complaint made and now improvements have been accomplished, but it would have been much better if the FSA—a year and a half ago, when it was introducing rules—had said to firms, "Look, you need to make sure that people can transfer ISAs within 10 days. Instead, the FSA made a rule saying people should have a prompt and efficient service, and then when asked, "What does that mean?" just codified existing industry guidance, which allowed them to take up to a month.

Q666 Chair: I understand. On reputational risk, just to be clear, I don't think there are any takers here for shielding firms who have behaved badly from public scrutiny, but have you given any thought to the concerns that are expressed, by the industry to the FSA, about the risk of misplaced allegations, which lead to reputational risk and therefore damage to the firms, and do you have a specific proposal for shifting the balance in that area that you think the FSA might be prepared to agree to?

Mr Vicary-Smith: I think, in a sense, we need to separate two elements of the information they receive. At the moment the FSA effectively says, "Anything we get in the conduct of our investigations is privileged information and, therefore, we're prevented from disclosing". Our view is: keep that between the FSA and the firms up to the point of enforcement, but once somebody has been placed into enforcement we then believe that the consumers have the right to know what problems exist. The issue at the moment is the FSA takes that issue right the way through to the point of a fine being levied, and that is the only point Which? has made. So it's the enforcement point.

Chair: You want the information out in the public domain at the point of enforcement rather than at the point of the fine?

Mr Vicary-Smith: Indeed.

Q667 Stewart Hosie: May I ask, when we get the restructuring of financial regulation, which will come, it's clear that the financial problems will rise, in particular the compliance cost. How do you think they'll pass those costs on to the consumer? Will it be higher premiums or will it be higher costs involved? Will it be one-off fees? Will they take some of those costs themselves or do you think everything will be passed straight on to the consumers?

Mr Vicary-Smith: I would suspect—given the evidence—it will pass on absolutely as much as it possibly can, to the consumer. It will not do that in a clear and allocated way. It will do that by a bit here and a bit there, by widening margins where it can. But we're clear that in all industries, not just in financial services, the costs of regulation are always borne by

the consumer. In this industry we would agree that the regulation failed in the crisis and therefore needs to be handled differently going forward. That is inevitably going to mean extra cost, and therefore the likelihood is that costs will be passed on to consumers. But there are also other reforms in the industry, notably enhancement of competition that, if it was effective, would result in the cost of products going down. So it isn't automatic that consumers need to be paying more for financial services in the future, than they have in the past.

Mr Cullum: Can I just jump in on that? I think there is plenty of experience in other sectors of firms and sectors effectively earning autonomy, or earning less regulation, by demonstrably behaving in a more responsible way and having simpler, more straightforward products. One of the issues in this sector is what appears to be a deliberate attempt by the financial services companies to make products difficult for consumers to understand and the selling process hard, so that consumers are misled. The more that is removed the less regulation will be required, because it will be much more straightforward and at a more basic level. But that does require quite a substantial culture change on the part of the industry. I absolutely agree with Peter. Ideally, the industry should be paying the costs of its own past and current irresponsibility, but we recognise that what will happen is they will try and sneak it on to consumers in various ways until there is effective competition.

Q668 Stewart Hosie: The competition point is interesting, but I'll park that just now. But in terms of regulation let's turn that question around. Do you think there is a possibility or potential that we could actually use regulation to reduce the cost to consumers, or would that place such an additional cost burden on the businesses that a number of them would go bust?

Mr Cullum: From a consumer perspective there are really two bases for regulation: one is about consumer protection, stopping bad people doing bad things; and the second one is about making markets work. Regulation that makes markets work should, in the end, lead to less regulation. I think one of the issues in this sector is, fundamentally, how does regulation achieve culture change? Because the last thing we want to do is, forever and a day, to be in a position where every aspect of what the industry does needs to be regulated in a command and control way. What we need is for companies to internalise the point of regulation, so that they start making the right decisions and see it as part and parcel of what they do to behave responsibly. There is no other sector—and we work across lots of different sectors on regulation—there is no other sector where you can conceive that the regulator would have a programme called "Treating Customers Fairly". That would be seen as self-evident in every other sector, and yet somehow it seems to be rather groundbreaking and novel in this sector.

Q669 Stewart Hosie: Just to push this use of regulation a little further. Would you suggest regulation might be used to cap an interest charge on a credit card, or to cap a commission fee on a pension fund, for example? Have you ever seen regulation used that way to protect the consumers?

Mr Cullum: It is certainly right that the regulator should be looking at the margins at the moment, which you touched on in the previous session. I think the jury is out in terms of caps on interest rates, and there is quite a lot of evidence to suggest that it may drive some consumers into the hands of the illegal or less good sector.

We've done quite a lot of work recently on payday lending, where a lot of people have called for this sector to be banned. What our research showed was that the consumers who use it really like it. It's the way that they use it that's damaging. So what we tried to do was to make a series of proposals that would retain the industry—because if it doesn't exist our fear is: not that they'll all start going to banks but they'll start going to the rather dodgier end of the market—to try and make that market work properly. So we would be concerned about some of the unintended consequences of caps.

Mr Vicary-Smith: I also think some forms of product regulation effectively needn't be as intrusive as some people see. We've talked with this Committee and with Ministers many times, for example, about the method for calculating interest on credit cards, and the fact that an APR isn't an APR, and why can't there be one way of calculating interest so that people can genuinely compare their credit cards? That doesn't seem to us to be a mind-numbingly intrusive element of regulation but the argument the industry always raises is, "But it's anti-competitive". I cease to see a consumer who thinks that there should be competition on how interest rates are calculated, and that's an example.

Q670 Stewart Hosie: That sort of approach, which simply delivers transparency, you do not expect to add any additional cost burden to commercial funds at all?

Mr Vicary-Smith: No, exactly.

Q671 Mr Mudie: The FSA was never seen to be comfortable with consumer protection. They were always behind the curve. The impression given by the new structure is that they've sorted everything out and discovered that they have consumer protection left over, so where the hell do we put it? So they have thrown it in with markets. Do you think it's injurious to the interests of consumers to be in that division where the synergies between the two seem slightly out of kilter?

Mr Vicary-Smith: I think if it's to be an effective combination then we need to change the primary objective of the CPMA that's in there. So we've argued in our submission, for example, that maintaining confidence in financial markets should not be an objective—it's caused so much trouble being in the FSA's objectives—but fair, transparent and competitive markets should be an objective of the CPMA. If you put that in there, then you turn the CPMA into something that is genuinely trying to bolster competition in the sector that we always say has far more rivalry than real competition, and then it can work effectively with that.

Q672 Mr Mudie: But does that not limit consumer protection to market activity whereas, along with financial services, there is a range—banking, for example—where we are interested in what you're going to say in the next session, about insurance, and so on. The fact it's in there, does that not circumscribe its activities?
Mr Vicary-Smith: In a sense for me, it only circumscribes it if the regulator chooses to interpret that brief in a very narrow way.

Q673 Mr Mudie: Could you not avoid that by making it independent?
Mr Vicary-Smith: I think the issue for me then is: how do you get the competition dimension working effectively in the markets area. So I think one of the biggest problems—
Mr Mudie: But the markets are arguing they don't want that competition, apart from the consumer protection, that pressure.
Mr Vicary-Smith: I'm sure the markets don't want competition. But in order for the markets to be working effectively we have to dramatically increase the level of competition. Real competition exists within this sector. That isn't the panacea but it is a huge step that needs to be conducted, and we're pleased the Vickers inquiry has been widened to incorporate that.
Chair: Then tell us how to do it because that's exactly what we want to report on.
Mr Vicary-Smith: Okay.
Mr Cullum: I think the key issue is that a lot of people from the industry side, and people that you've seen, interpret the consumer interest in quite a narrow way. So they see it very much about stopping companies doing bad things to consumers. Our interest—both Consumer Focus and Which?—is a much broader and more forward looking one, I think, which is about that in part, but is also about creating markets, which work properly, which meet the needs of all consumers, which are seen to be fair, and so on. I absolutely agree in terms of the statutory duties. I'm less convinced about having competition as a primary duty, just because my experience in other markets with regulators is they can obsess about competition for its own sake, and the point in this market is everything should be driven through the consumer prism in the end. Of course often that is about competition but competition isn't an end in itself, it's the consumer perspective.
But there are three worrying words in the Government's proposals: "champion", which we might come on to; "stability", which we might come on to, and "confidence", and Peter is right to pick out confidence. We could end up in the completely absurd position with a regulator agonising about whether they should act against a part of the sector or a product, because telling people how bad it is might reduce confidence. Well, that would be a crazy position to be in.

Q674 Mr Love: It was put to us—last week I think it was—by the Finance and Leasing Association, that APRs weren't particularly good at reflecting the cost to consumers of payday lending or home credit. How do you respond to that?
Mr Vicary-Smith: There is never a perfect measure when consumers are trying to compare things, saying that the APR was meant to be a good way that consumers compare the cost of a credit card; at the moment, it's not a very good way because of the way the interest rate is calculated. So I think, while there are undoubtedly other mechanisms that are useful, and consumers shouldn't just take one measure of anything, having APRs that could genuinely be compared would be a huge advance to enable people to work out which credit card is good value and which credit card is bad value.

Q675 Mr Love: Aren't you making an assumption that consumers will naturally look across the market where many of the people who will be interested in payday loans, or home credit, will either feel that it's inappropriate for them or have already been excluded from being able to take up a credit card as an alternative, and therefore you have to focus on what's available and appropriate for them in their circumstances, and in those circumstances APRs don't provide a helpful hand.
Mr Cullum: Can I just jump in for a second? Our predecessor body did the super-complaint, which reached the Competition Commission, on home credit. You're right that APRs are misleading on it. However, I don't think we should rule out the idea of competition, even in markets like home credit, for example by trying to get a fair way of comparison or allowing home credit customers to build a portable credit history for customers. It's quite important. We shouldn't assume that just because consumers are at the lower end of the spectrum that competition is impossible in some of those sectors. But you're absolutely right that it's easy to produce astronomical APR figures for some of those things, which clearly wouldn't mean anything to people. I'm not sure if it's still the case, but if you ever went to visit the FSA, and you came out of the tube at Canary Wharf, there used to be a figure of what percentage of people didn't understand percentages, and clearly there are issues about the information.

Q676 Mr Love: Let me take that a little further. From memory—and correct me if I'm wrong—the OFT did an inquiry into home credit and that came out saying that one of the solutions was greater competition, and they made some recommendations about not flooding the market, with one company controlling the whole of a city, or whatever. How effective have the recommendations they've made been in increasing competition? I get the impression it hasn't done very much but you tell me how you feel about it.
Mr Cullum: As far as I know, and I haven't seen the most recent figures, I'm not sure it's changed concentration. From memory, there were about 500 providers, but about four companies hugely dominating the market; so, in some respects, not unlike retail banking more generally. I don't think that's changed. I don't know, is the answer.

I guess one of the issues for the new single competition and markets authority could be when they revisit areas that they've investigated, because it wasn't just the OFT that looked at it, these were Competition Commission recommendations as well. Regulators are quite quick to try and assess other people's effectiveness—the regulated companies—but they're not so good at accounting for their own effectiveness.

Ms Brooks: Going back to the issue of payday loans and short-term loans, obviously APR doesn't make much sense if you're borrowing for 15 days or 30 days. It's helpful for people to understand exactly what they're going to pay back, and one of the things that our research into payday loans showed is that that was welcome. I know if I borrow £100 I'll pay back £130. That could be an APR of 1,000% or 2,000%. However, if they didn't borrow that money and went over their overdraft limit, they might be equally hit by £60 from the banks. So it's not always the case that these high interest rates are worse than some of the alternatives.

Q677 John Mann: I'll just ask my three questions together to allow the two organisations to give one answer each. You have communities across this country that are about to be brought to their knees because of the excesses of bankers and the risk-taking, and we still have no transparency. Consumer Focus is about to be abolished and—reading your submission—meekly walking towards the guillotine. We have the OFT merging with the Competition Commission. We have the industry, not least the BBA, opposing the concept of having consumer champion alongside regulator. So my first question is: in all of this, who is going to speak up for the consumer?

My second question is about the Financial Ombudsman Service, to see whether you'd agree with me that there is no weaker Ombudsman in existence in this country at the current time, and that, therefore, worsens the consumer situation. Thirdly, specifically to Which?, the consumers association, in all your submissions you seem to have skirted over the issue of investment banking and the lack of competition in investment banking, and we shouldn't forget that it was investment banking, not retail banking, that was at the heart of the excessive risk-taking and the start of the collapse that we're all suffering from now. So I wonder what is the perspective of each of the organisations on my three questions.

Chair: As you see, that was a brisk question and what we'd like is an even brisker reply.

Mr Cullum: Yes. Shall I answer the first one? I don't think we are meekly walking towards the guillotine. We're conscious that the Public Bodies Bill first needs to be passed, that there's a consultation next year and that an affirmative resolution comes after that. So if we're walking towards it, it's quite a long slow walk. I think we're clear that it's wrong for public bodies to devote public money to fighting for their own preservation, and our interest at heart is: what will be the functions of any new arrangements going forward? Of course Consumer Focus has a special place in our hearts. We think we've done a good job and we can point demonstrably to our success, not least of all our super-complaint on cash ISAs in this sector.

But, as I say, we shouldn't be arguing for our own self-interest. Our concern for this sector is the extent to which Government just doesn't seem to be interested in having any strong consumer advocacy. It is right that the panel exists, and both we and Which? think that panels are important in regulation but they perform a very different role from a consumer advocate. I used to work at Which?. Which? do a great job on aspects of financial services, Citizens Advice do some good work on financial inclusion, but I don't see anybody doing the kind of work that we've done on payday loans, the kind of work that we did on our cash ISAs super-complaints, and what we're doing at the moment on trail commission on pensions.

Angela Knight said in her evidence to you there needs to be a consumer champion. All she said was it shouldn't be in the regulator, which I would agree with. Where is it going to come from? Talking to BIS officials, I think essentially they would say that it's a matter for the Treasury, and the Treasury have made it very clear to them that their, supposedly, cross-economy take on consumer advocacy shouldn't tread on the Treasury's patch and the Treasury doesn't seem to be interested in it. So who is going to deliver Angela Knight's consumer champion? You could be a useful advocate on this issue, I think.

Chair: Yes, well that wasn't an even brisker answer, but it was very interesting. Maybe Peter Vicary-Smith can advocate.

Mr Vicary-Smith: On the same question, on question one, if you like, I think there are a number of functions being transferred to other bodies. I think you're right: the worrying dimension is particularly what is going to fall down the cracks and whether other bodies are aware of what is coming their way and they're going to be resourced appropriately. To my mind it is important that the various panels continue to exist. I know there has been some talk about: do we need panels or can they just transfer into some of these other bodies? No, the panels are very useful. They perform a very important regulator-facing function that is very hard for an external organisation to do, be it financial services or the communications panel, whatever it may be.

Of course, I would argue that Which? performs a large role and a large dimension of advocacy in a range of areas. I think it also behoves us in this changing landscape to look at what more we can do. Now, we have the good fortune not to be funded by Government, and we have already been, over the last few years, dramatically increasing our investment in this area, and we're now spending our time working out whether we can be investing more to cover some of these gaps, so that in the changing landscape consumers aren't left high and dry.

The other dimension, of course—which is the often forgotten bit of consumer protection, generally—is the role of Trading Standards. For many consumers it is Trading Standards where the rubber hits the road and where the first interface is. We welcome the reinforcement of Trading Standards' roles. We want to make sure that the funding that enables them to do

their jobs properly doesn't disappear in the cuts going on in local authorities.

There are a number of concerns we all have, but I think there are still organisations that are able to advocate on behalf of consumers and fight for consumers. We need to make sure that, where functions are transferred, resources are also transferred to help people do the job they're being asked to do.

Q678 Mark Garnier: Can I turn to the work of the FPC. One recurrent theme that seems to be coming up from your written evidence, and also from the evidence of Martin Lewis recently, was that if the FPC were going to act in trying to deal with bubbles, then it is going to have an effect on consumers' welfare. Surely the whole point about the FPC is that if you are going to try and take the heat out of a residential property bubble by controlling mortgages and loan-to-value ratios, and this kind of stuff, the whole point is it is going to affect the consumer. How do you square that circle?

Mr Lindley: From our point of view, it probably would have been good if there had been some restrictions on loan-to-values on mortgages in the boom years of 2004 to 2007, because then we wouldn't have seen as much growth in house prices and probably not have seen as much fall. As you say, I think the problem of leaving it to the industry is that while house prices were going strongly the industry was lending at very high loan-to-values, then as soon as they peaked it withdrew all those products. That's the opposite way in which a rational banker should be operating.

What we were saying is that when there is a change in the maximum loan to value that is going to have an impact on consumers, if you're halfway through buying a house and you've had the mortgage agreed but you haven't drawn down on it yet. So what we were trying to say to the Treasury is that in their consultation on these macro-prudential tools, they do need to look at the impact on consumers.

The other one is about variable capital requirements. Now, buried deep within your terms and conditions on your mortgage is probably an allowance allowing the mortgage company to vary the interest rate, depending on decisions made by regulators. So if the FPC introduces variable capital requirements and increases them, then could you see your interest rate go up? How that kind of term might be operated will be extremely opaque to consumers, whereas if you're on a tracker mortgage at the moment it's very clear to you that if the Bank of England interest rate goes up, then your interest rates goes up, and if it goes down, then it goes down

Q679 Mark Garnier: One of the interesting points, going back to this asset bubble that we've had, is that the MPC was originally charged with looking at inflation as measured by the RPI, and then when the RPI became a little bit too overheated it was decided to move it to the CPI, which of course doesn't include the cost of houses and mortgages. Surely, to take the heat out of the bubble, it would have been a lot simpler to have carried on using the RPI, which, I believe, does take into account mortgages and therefore interest rates would have gone up anyway.

Mr Lindley: It does take into account one measure of house prices. It's not a perfect measure. The other thing is that even if interest rates had gone up, the amount that it would have had to have gone up to have taken the heat out of the housing bubble might have been so much that it would have had a very detrimental impact on other sectors of the economy. That's where some of these other macro-prudential tools come into their own because you can target sectors of the economy that you do feel are getting out of control; commercial property was probably another one and residential property, certainly.

The fact that we have gone from a feast to a famine in the availability of mortgages damages consumers. It also damages house builders and other people trying to plan for the future. They would much rather there was consistent availability rather than that we went from feast to famine.

Mark Garnier: A lot of people argue that we're still in a housing bubble. We can see favours in dropping house prices to get it back to a long-term measure of normalcy.

Mr Lindley: Then, I think, we need to concentrate on those consumers who might be stuck with their existing mortgage provider. If you understand the variable rate, then for most consumers you have very little contractual protection. There is nothing to stop Northern Rock at the moment, or some of the other banks, increasing their standard variable rate. There are only a few consumers with banks like Lloyds TSB and Nationwide where you have that contractual protection. So we have to make sure banks can't take advantage of these captive customers by increasing their margins because they have nowhere else to go and they can't switch products.

Q680 Mark Garnier: Do you see there is likely to be a conflict of interest between the FPC and the MPC and the CPMA, and also the Consumer Financial Education Body? Do you think that's going to be a problem?

Mr Lindley: There might well be a conflict of interest if the FPC is imposing extra capital requirements on consumer lending at the same time the MPC is decreasing interest rates, and how you explain that. What we have said about the relationship between the PRA and the CPMA is that we don't believe the PRA should be allowed to overrule the CPMA. So say the CPMA finds a bank that has been mistreating customers so badly that if it was forced to pay proper compensation it might collapse, then the PRA shouldn't be allowed to overrule the CPMA. Because we've had "too big to fail", we don't want to get into a situation where banks, which are too big, don't have to treat their customers fairly because they know the full impact of them doing so will never be imposed on them.

Mr Cullum: I mentioned three words that worried us: "champion", "stability", and "confidence". On stability, of course, we all want a fundamentally stable system here, and the last thing we want to do is to have real systemic problems. However, competitive markets always have a bit of instability. If you look at

who were the big companies 50 years ago, versus who are the big companies now, a lot of it is a very different list. So the economy changes. The market should change. As colleagues from Which? say, we shouldn't be in a position where there are not just barriers to entry but there are barriers to exit as well.

Q681 Mark Garnier: There are two things that worry me about the FPC. The first is a socioeconomic impact, and I would be very interested to hear if anybody has done any work on how many people are likely to be affected. I know that is probably an impossible question to answer, because nobody quite knows what the FPC is going to be doing and how it's going to be doing it just at the moment. The first question is whether somebody could do some work on that just to give an idea of what the potential problems might be from it, from what you have already discussed. The other question, which is a much more fundamental question, is: do you think this is the right way of trying to deal with this issue? Is the FPC, in concept, a good idea or a bad idea, or is it just going to be able to do too much? In answering that it would be useful if you could talk about transparency as well.
Chair: Again an excellent very brief question, and even briefer answers please.
Mr Cullum: The categories are the right categories, in terms of macro-prudential and inter-prudential, issues on individual institutions, and then the consumer issues. Has it been divided up perfectly? I'm sure there are different ways of doing it and there are definitely some issues, in terms of how different bodies work together. Everything we see in other sectors shows that where there is more than one regulator the costs go up and it's more complicated because they spend a lot of time talking to each other. The one plus is the point that Adam Phillips made, which is that at least it's an open conversation rather than one that's behind closed doors. I think the big issue about the FPC—and I think it's right that somebody has to be in charge, and it shouldn't be the PRA or the CPMA; it's fine to have them as the strategic body—is: what is their accountability? I think saying that they're a sub-committee of the Court of the Bank of England and that the chair will have a couple of meetings a year with the Chancellor. This doesn't come up to scratch. What the FPC should be doing is setting out in advance what their strategy is going to be, engage people on that, including consumer organisations, and once they've made decisions explain what was the basis for the decisions, so that there is some accountability and some engagement on what they're actually doing.
Mr Lindley: I think the FPC in theory is a good idea. We just want to make sure that the impacts on consumers from it are properly addressed, and that there is not just a kind of technical, economic discussion about how this affects economic growth, but that real consideration is given to how it affects consumers.
Mr Vicary-Smith: I would also say, while we're on accountability, I am much more worried, if you like, about the accountability of UKFI than some of the new bodies. I think that is a problem that we have at the moment—a body with enormous power, which almost operates in the shadows, that never will come to meetings with anybody, except those who have the power to compel it, and whose decisions are clouded in mystery. I think it is, frankly, outrageous that such an important public body is held to such little account.

Q682 Chair: Sarah Brooks, you didn't have a chance to chip in. Do you have anything you want to add on the basis of what you've heard, briefly, or would you like to come back to us in writing?
Ms Brooks: I have nothing to add to what Philip said on that point, thank you.

Q683 Chair: I would like Mr Lindley to come back in writing on one point. You argued vigorously for tight led value rules, which amounts to rationing in the mortgage market, and the two key issues—it may be a good idea, it may not, it is back to the 1970s, in a sense—are why regulators might have superior knowledge about the cycle, and what response you would have to those who are denied access to the mortgage market, because of the introduction of the rationing. I recognise that I'm asking questions without giving you an opportunity to reply.
Mr Lindley: I would rather the market worked to discipline companies with risky business models like Northern Rock, but I think the lesson that the wholesale funders of Northern Rock have learnt is that they didn't discipline the risky business model of Northern Rock and they were bailed out as well. I think someone who is independent, like the FPC, could have some impact. Of course maybe it's better for consumers if house prices don't rise as quickly. I think one of myths the industry has been trying to propagate is that its massive increase in lending, from 1997 to 2007, led to a massive increase in home ownership. It didn't, and the number of households with a mortgage between 1997 and 2007 actually fell, the absolute number.
Chair: You're raising a number of very interesting issues, which I'm not going to engage in now. Thank you all very much for coming to give evidence today. We've learnt a great deal.

Tuesday 23 November 2010

Members present:

Mr Andrew Tyrie (Chair)

Mark Garnier
Stewart Hosie
Andrea Leadsom
Mr Andrew Love
John Mann
Mr George Mudie
Jesse Norman
David Rutley
John Thurso
Mr Chuka Umunna

Examination of Witnesses

Witnesses: **Lord Turner of Ecchinswell**, Chairman, Financial Services Authority, and **Mr Hector Sants**, Chief Executive, Financial Services Authority, gave evidence.

Q684 Chair: Good morning to both of you.
Lord Turner: Good morning.
Mr Sants: Good morning.
Chair: Thank you very much for coming along at this time of considerable change in financial regulation. Can I begin by asking you, Lord Turner, whether you think that it is right that so much power should be transferred to the Bank of England?
Lord Turner: I think that the—
Chair: That was a very long pause before a response. Were you deciding to be yes or no at that point?
Lord Turner: Chairman, the pause was not, if you are into the business of interpreting my pauses, about what I want to say in general to that but exactly how I would say it. Overall my answer is, no, I don't think there is a problem. I do think it makes sense certainly for there to exist a macro-prudential capability, which is within the Financial Policy Committee. In my own review last year I argued that that was a crucial missing bit of the existing tripartite structure. So I have been a very strong supporter of that. Although I don't personally think it was necessary to break up the FSA and move the PRA into the Bank, I think it is certainly a feasible solution. Indeed, I have been on the record of saying that if I was starting with a greenfield site, that is what I would have done and it is now going to happen. Insofar as I did not agree with the plans, it was solely that I thought we didn't need to have the change to get the benefit.
Chair: So we are getting to first best via second best, which you would have stuck with because we had got used to it? An unusual chain of arguments there but we'll go with it.
Lord Turner: I personally had the point of view that the first best is a separation between prudential regulation and consumer protection, with prudential combined with the central bank. I do think that is the first best. My belief was that it wasn't necessarily worth the restructuring costs of getting there, but the Government having decided that we are going to face the restructuring complexity of getting there, the key is to get to what at the end I think will be a better system.
But to return to your problem of is there too much power in the Bank of England, I don't think so because I think, in the two crucial areas of the Monetary Policy Committee with the interest rate decision, and the Financial Policy Committee with the macro-prudential levers, there will be a significant external representation on those and there will be high visibility of the analysis and decisions that are made. I think that's the check and balance to what might otherwise be too much executive power.

Q685 Chair: And all those people who are bleating about the over-mighty Governor have it wrong?
Lord Turner: I think there will be a challenge for the Governor, simply in the management of his time, or in some future case her time, or whoever is the Governor, because when you now look at the sheer workload of the Monetary Policy Committee, the Financial Policy Committee, the chairmanship of the PRA and the vice-chairmanship—as it's likely to be—of the European Systemic Risk Board, this is simply a huge diary management challenge that the Bank will have to think about, how to effectively use the Governor's time and effectively delegate other decisions. But in terms of the institution of the Bank, I think these are a reasonable set of powers to have been brought together.

Q686 Chair: Setting aside the management of the Governor's diary, how do you feel about the problem of democratic accountability with this institution having so much power?
Lord Turner: Well, I think there is a reasonable accountability. The way, as we know, it has been set up on the monetary policy side is through the fact that it is the Government and Parliament that set the inflation target and the Monetary Policy Committee and the Bank deliver within that. So I think that is a clear separation.
I think on the financial policy side it is more complicated because it is much more difficult in relation to the issues of macro-stability and macro-prudential to set down a policy guideline equivalent to a 2% inflation target. Therefore, one of the crucial things will be how, within the details of the forthcoming Act, one clearly defines what are the powers, what is the remit and what is the objective of the Financial Policy Committee.

Q687 Chair: What about accountability to Parliament? How do you think that should be done?
Lord Turner: I think that the accountability will come through the reports to you, the publicity of the probably semi-annual financial stability reviews, which will set out the analysis and the clear

justification for the actions that have been taken. But I do think there is an important aim here, which is tricky to get right, of giving to an authority like the FPC the ability to take decisions that Governments might not make at times in the electoral cycle. What we are trying to do is have a mechanism where a trusted independent authority can slow down a credit boom even if the elected Government at that time, with a majority in Parliament, rather likes the good feelings, positive feelings, among society being generated by that credit boom. I do think we need to create mechanisms that enable a trusted authority to do that. I think, therefore, the challenge will be for the Bank of England to earn that trust over time. But I think there is a role in society for us to have institutions that have power, that are trusted to exercise power, rather than us necessarily defining precisely under what constraints they operate.

Q688 Chair: I would like to ask Hector Sants one question before handing over to Chuka Umunna. I think everyone is agreed that the FSA made an effort to own up to the mistakes that it had made in the run-up to this crisis. We are giving the bank a great deal more power now. Do you think the Bank of England has owned up to all its mistakes?
Mr Sants: I think that—
Chair: Another very long pause.
Mr Sants: Well, I think that the central Bank's involvement in the crisis was of a rather different nature to the micro-prudential regulator. It is perhaps easier for a micro-prudential regulator to identify specific actions in relation to individual firms that it might have taken, and if it had taken events might then have followed a different course. So, in that sense I think it was right and proper that the FSA should be more forensic in its examination of what it had and had not done and it was right and proper that it then made, as you say, significant changes to the way that it went about supervising firms. I do expect those changes, may I say, to be carried over into the PRA and the CPMA. It's very important that we don't fail to learn from the past.
Chair: I was asking about the Bank.
Mr Sants: I think in relation to the central Bank it has demonstrated, by its actions that it's now very much supporting the creation of the FPC and the clear consensus that a central bank needs to be involved and should be in the lead of overseeing financial stability—

Q689 Chair: Those are Government decisions about structure. I am asking you whether the Bank, as an institution, owned up to mistakes it made during the financial crisis.
Mr Sants: From my perspective, if you take in the round everything that it has said, including its most recent pronouncements on the new structure, yes. Was that a more elaborate and lengthy process than the very straightforward approach that the FSA took? Yes.
Chair: So, lots of little snippets of remarks. If we join them all together and sew them up, we can get to the point that amounts to a comprehensive analysis and admission of mistakes.
Mr Sants: I think that would be the way I see it, while the FSA had a cleaner, more straightforward approach.
Chair: To 'fessing up?
Mr Sants: Yes.

Q690 Mr Umunna: Thank you, Chair. I would like to follow up on one of the Chair's questions to you, Lord Turner, but I just want to first of all revisit a very interesting interview that you did in *Prospect* last year. I was quite struck by a number of the responses that you gave when the reform to the tripartite regime was put to you. You said that the institutional architecture is the least important issue. You went on to say, "There's a spectrum of activities from the monetary policies of central banks through macro-prudential analysis, micro-prudential supervision and customer protection issues and whenever you divide it up you will create interface problems and you will have to manage them." Is that still your view?
Lord Turner: Yes, it is. That is why my overall tendency with many organisational challenges is to be a small "c" conservative and to believe that whenever you go for organisational structure change you will create new problems even as you solve old ones. I think if you look around the world on the organisation structures that different countries use to deal with this spectrum of activities, there are pros and cons of different ones, and indeed there is no real correlation through this crisis.

Q691 Mr Umunna: So we are still going to have problems with the new structure?
Lord Turner: Now, having said that, within this spectrum—and it relates to the answer I gave to the Chair—if I were to work out where I would do the divide, I do think the new divide will be a somewhat better divide than we had before. In particular it will help to close this gap in relation to the crucial area of looking in an integrated fashion at financial stability and macro-prudential. But we have to recognise that like any organisational change of this form, it will deal with one set of interfaces, it will make that work better, and it will create some new problems. We will undoubtedly have, between prudential regulation and customer protection regulation, some complex issues which span that divide. Let me give you an example. The issue of with-profits policies in the insurance area and whether with-profits funds, the balance with which they belong to shareholders or policyholders and the treatment of those, is simultaneously an issue which has certain prudential aspects and an issue which has certain fair treatment of consumers and policyholders aspects.
In future, we will have to—once we have two separate organisations—create some mechanisms that enable us to discuss and co-ordinate that issue. We will also, by splitting up the prudential authority and the consumer protection authority, have two separate teams of supervisors visiting the same bank or insurance company. That will, to a degree, create some duplication; there will simply be more meetings. My own judgment is that the benefits of making sure that there is an integrated approach to these

fundamental issues of financial stability and macro-prudential balance are more important than these problems, but I do think we have to recognise that as we make one interface better we are bound to create new problems of interface. That is simply a fact of life.

Q692 Mr Umunna: I suppose what I was getting at is that one of the problems was, of course, that the crisis demonstrated that the three bodies—the Bank of England, the Treasury and the FSA—in some senses were not always talking as closely as we would have liked them to. In the interview you pointed to this as being a problem and said that you believe that the closeness of the links required could be achieved by intelligent working relationships across the existing institutional divide. I got the strong impression from the comments you have already made in answer to the Chair that in some senses you give the impression that you think this regulatory overhaul is a bit of a waste of time. You said it is not necessary to make the change to get the benefit of the reforms and I am just left wondering, given that I think the transition costs of this reform are going to be in the order of something like £50 million, whether it is really worth it, given the comments you have already made about being able to refine and improve the existing arrangements.
Lord Turner: Let me be crystal clear, because I think I have been crystal clear and consistent on my point of view. I believe that, in theory, if one was starting anew to design a system, I am more in favour of the new planned system than the previous one. I am a supporter of a twin peaks approach, in theory, and I think it will, when we get there, have certain advantages over the present situation. I also, however, believed—and I argued this point, but I lost this argument, you sometimes lose arguments in life—that we could get the vast majority of the benefits of the new system by doing two things. One is by separating the internal organisation of the FSA between a consumer protection side and a prudential side, and the other is by creating a financial policy committee that bridged the Bank of England to the FSA. Indeed, had there been a different result of the general election, it was my intention to argue—and, indeed, I was already arguing—that if the FSA was going to stay as it was, we should make that division and we should make that bridge.
Mr Umunna: So you think it is £50 million well spent?
Lord Turner: So that is what I argued for, but Governments have to make decisions and we will now go through this process and, as I think the Chairman correctly put it, my own belief is that once we go through the transitional pain of this transition the new system will be a better system than we have at the moment. I think that is a clear position that I have set out.
Mr Sants: Could I maybe make a more general point here, which is no organisational structure is going to be perfect. There is no way organisational change alone is the solution to learning everything that needs to be learned from what has happened in the last few years. There is a need to co-ordinate across the entire spectrum of regulation; conduct risk can become prudential. So, in theory, you either have to have one monolithic organisation, which avoids the problem of institutional gaps but raises the question of focus, which was an issue that was rightly raised about the FSA in the past, or you make divisions. Wherever you place the divisions, you will have a co-ordination problem. Organisational structure is not the substantive point here.

Q693 Mr Umunna: My last question is to Lord Turner. You are the leading authority in these matters but you are absent from the field once we've completed the transition to the new arrangements. Are you surprised that there has not been a place found for you in the new regulatory structure once it is put in place? Some might think it is a bit like having a striker on the subs bench. Do you feel you should be back on the field once all these new arrangements have been put in place?
Lord Turner: It is going to take us about two years from now to put these arrangements in place and I am very happy concentrating at the moment on delivering that. When that is done, I am going to be very happy to do something else.

Q694 Chair: You have no idea what you think that might be?
Lord Turner: I have really no idea.
Chair: It took a moment or two to get to that answer as well.
Lord Turner: Mr Chairman, are we going to continue analysing pause length throughout this?
Chair: Depends how long the pauses are. George had a quick rejoinder to an earlier question.

Q695 Mr Mudie: How you answer questions here, does that affect what you're going to do in the future, do you think?
Lord Turner: Does what?
Mr Mudie: How you answer questions here, does that affect—
Lord Turner: I have to say I do not spend time thinking about this. I am very happy concentrating on the job we have in hand.

Q696 Mr Mudie: Hector, when you and the Chairman had that very polite, coded exchange about the FSA openly admitting their mistakes but the Bank of England dropping them in little hints here and there and you had to join the dots to see, you left us all in the dark. What was the biggest mistake the Bank of England made in the last three years? At least we would have something to start our search.
Lord Turner: I will let Hector answer.
Mr Mudie: I am giving him time to think so it is not a pause.
Mr Sants: That is appreciated. Of course, the word "mistake" is always emotive, isn't it? I think maybe a better way of thinking about these things is what would we like to learn from in the future. I think that two points come to mind as I look back over the period. First of all, to pick up the earlier exchange, it was rightly pointed out that the level of communication, and the level of interest, from the

central Bank in financial stability issues was recognised by all to have been very low, to say the least, in the pre-2007 period. As the crisis began to build—recognising, of course, it went through a number of phases, maybe of a more domestic nature pre-Lehman Brothers and of a more global nature post-Lehman Brothers—I think it would be fair to say, and that everybody would recognise, that the central Bank was slow to recognise the need to really engage with the financial stability question. So that, of course, takes us back to why it is right, and I fully support and have been on record as supporting, as Adair has as well, the creation of the FPC and the fact the central Bank must lead on financial stability matters, i.e. must be in charge of the oversight of the system. It is absolutely not right that the micro-prudential regulator should have such a responsibility. The FSA never was, never should have been, in charge of the stability of the system. The central Bank should be and, in my view, should have shown more interest in that issue even under the previous remit. So that, I think, is one point I would make.

I think the other point I would make is relating to the fact that in a crisis the traditional, conventional wisdom of the interaction between the provision of liquidity support and solvent institutions becomes a very difficult judgment to make. There are times when in the round that very much becomes a forward-looking judgment that needs to be made early to avoid the situation compounding itself. As events demonstrated, significant liquidity support did end up being put into the system through the SLS and other measures and that could have been done earlier. So, I think the importance of that judgment around liquidity support and the importance of a central bank taking a clear responsibility for financial stability were the two issues. The current proposal clearly shows that those lessons have been learnt. Then there is this very interesting question around a series of tactical decisions, but I think they're now lost in the mists of time and not really relevant.

Chair: Lord Turner wanted to add something. If you could be very brief.

Lord Turner: I just wanted to say that I think the most crucial mistakes were not, I think, a set of tactical issues but an entire philosophy that goes back over the last couple of decades, and which was shared by finance ministries and central banks across the world, which was a belief that monetary stability defined by the inflation rate alone was a sufficient condition for a stable economy.

Chair: We have had your evidence on that before.

Lord Turner: There was a belief that you didn't have to focus on financial stability as an activity in itself. That was the dominant intellectual belief of central banking and of the economics profession throughout the world. I think any tactical mistakes have to be understood in terms of that, I think, quite fundamental philosophical mistake.

Mr Sants: And the final point you'd make, of course, is about the Basel regime. The Bank of England sat around the Basel regime table along with the FSA, so insofar as the rules undoubtedly have been proved to be flawed, that was a joint responsibility and I guess if you looked at the media at the time that probably wasn't as clear.

Chair: I've not met anybody who is prepared to stand up for Basel, but there we are. Jesse Norman.

Q697 Jesse Norman: Thank you very much, indeed, Mr Chairman. Before I ask my question, I must say what you have said in coded Mandarinese, Mr Sants, is extraordinary. The Bank of England could have shown more interest in stability before 2008—

Mr Sants: 2007.

Jesse Norman: 2007. This is a central bank whose principal job is to watch these billowing monetary aggregates and bank lending, and keep an eye on the stability of the system. I think it is extraordinary that that should have been allowed to occur, and I am grateful to you for clarifying that issue.

The question I want to ask now goes back to the issue of the power of the Governor of the Bank of England itself. If you look at the Governor's current situation, he sits on every major committee, and a series of new powers and committees have been added to the remit of the bank. He is surrounded by a team, all of whom have been created or brought in through his own office and patronage, broadly speaking. The court of the Bank of England is not an enormously effective institution, it appears, in holding him to account. What forms of accountability are going to be exercised on him over and above periodic disclosure?

Lord Turner: I think there are different forms of accountability you have. In relation to things to do with the internal operational cost-effectiveness of the Bank, I think the court process is fairly effective, but it really has nothing to do with challenging the actual decisions that are made. To that extent the court is in a very different position from the board of the FSA, which does get involved in substantive decisions about actual policy. That is not the role of the court at the Bank. I think in relation to the policy decisions, it does derive from the fact that crucial decisions are made by committees of which the Governor is the chair but where his say-so does not always sway. The fact is that on the Monetary Policy Committee, which has been defined as the single most important thing that the bank has done—that will change with the Financial Policy Committee—the Governor does not always get his way. There have been times when he is outvoted on that committee. The votes are clear; the votes are public; the arguments are public; and the analysis is public. The inflation report provides a clear understanding of the intellectual basis on which the MPC has made its decisions.

So, in relation to monetary policy, I don't think we do have a problem of accountability. I think the challenge, as I said, is going to be on the financial policy side where one could be pulling different levers with somewhat different objectives—countercyclical capital in order to slow down a credit boom. It is less easy to reduce it to a clear set of votes and it is less easy to define the objective as, "Parliament has said the objective shall be 2%". But I still think it is possible in that area to set up a process that will be seen as one where while the Governor is clearly leading that process intellectually and analytically, there are checks and balances through the external

members of that committee and the visibility. I think the challenge is simply to make that visibility and openness and sense of potential challenge work on the financial policy side in exactly the same way that it has, I think, effectively worked on the MPC side. I don't think on the MPC side people have said that we have an unaccountable, over-powerful Governor. In fact, it's a much more open system than if you look at the Federal Reserve in the US, where there has in the past been a feeling that people will not oppose the point of view of the chairman, whereas we do have a process where people are willing to oppose the point of view of the Governor.

Q698 Jesse Norman: On the monetary side, it is very striking that inflation has been above the target now for a long period of time, for many well known reasons, and the Governor has been writing letters to the Chancellor like confetti. Given the power of the Bank and the increasing power of the Bank, do you think this failure to hit the inflation target reflects its powerlessness or its insubordination to the will of Government, since Government has set a 2% target?
Lord Turner: I think on the inflation target we have the process working. The reason why the inflation target was set not as an absolute, but as an absolute with a range around it and a trigger point of a letter, was precisely to recognise the fact that there can be certain circumstances where a reasonable judgment is that inflation, either up or down, has gone beyond the bounds for exceptional reasons, but is expected to come back in future. There are, as you know, a set of reasonable explanations, particularly in terms of the impact of the depreciation but also the impact, for instance, of VAT changes and so on, which can help explain what has occurred. It is really for the Treasury and you to question the Bank about that, but I don't think the fact that there has been this overshoot in any way suggests that the process is wrong. I think the process is working and requires the discipline of the Governor having to write a letter setting out why he and the committee believe that this overshoot is temporary. There are some reasonable prima facie reasons for believing that that is a good argument.

Q699 Jesse Norman: That's very helpful. Thank you. Just changing the subject to the position of Ireland where we are met together with it in great crisis. Do you think that the exposure of the banks to the Irish situation, and therefore in some sense our bailout, is the result of a failure of regulation and, if so, how would that be corrected by the new system?
Lord Turner: I think it's very important to understand the nature of the exposure of the UK banking system to Ireland, and it is useful for me to take this opportunity to clarify the situation because there has been—
Chair: If you can manage to do it briefly.
Lord Turner: I will do it as quickly as possible.
Chair:I know it is a very big subject that has been opened up.
Lord Turner: There has been some commentary that we are, as it were, significantly exposed to the Irish state or the Irish banks. That is broadly speaking not the case. The holdings of Irish Government bonds by the UK banks are not at all worrying in their scale; we are well aware of the figures, we look at it, we think about any consequences that will follow. That is not a true issue. Nor, indeed, is the direct exposure of the UK banks to the Irish banks out of line with what you would expect or at a worrying level. The reason why the UK banking system has some significant exposure to the Irish economy is that there are two of our major banks, RBS and HBOS, which have significant businesses in Ireland. Most obviously in the case of RBS, it owns Ulster Bank, which has been there for decades. It was owned by NatWest, which was then bought by RBS a long time back. So what you have there is an exposure, which seemed to be a perfectly sensible thing to do: why wouldn't a bank own another bank in a closely linked, nearby economy? It's not the product of a sudden splurge or an irresponsible entry.
Ulster Bank is a large bank, both in north and south in Ireland. Inevitably, therefore, it is exposed not to the Irish state or to the Irish banks but to the general conditions of the Irish economy. What we do, therefore, when we run our stress tests on RBS or on Lloyds to determine their capital adequacy, the tests cover assumptions about how bad it could be in the Irish economy, exactly as we do in the UK economy. So, the processes that we are using to make sure that those exposures are understood by us, and are adequately allowed for in our capital adequacy, are exactly the same when we are looking at a residential mortgage extended in Dublin as a residential mortgage extended in London. But the crucial point I want to make is that the fundamental exposures of the British banking system are to the Irish economy, not to the Irish state or to the Irish banks.

Q700 Jesse Norman: Except you haven't quite answered the question, which is about why the failure occurred. I take it we don't want to be writing checks for £7 billion or whatever our total exposure is going to be—more than that even. Some failure has occurred. It was modelled in the stress test; what has happened?
Lord Turner: There was a failure, as Hector has already mentioned, of our entire capital adequacy regime. We have been running banking systems across the world with far too light capital requirements, with insufficient shock absorbers in the system to deal with the bumps on the road. In addition we had, both in the UK and in Ireland, in some cases some very poor extension of lending to, for instance in particular, commercial real estate. We have that problem in the UK as well as in Ireland. A regulator can only to a degree keep control of that. The key controls on that should be either the ongoing capital rules or the macro-prudential rules. Indeed, the Irish situation illustrates above all the desperate need for macro-prudential rules. What ought to have been happening back in 2005, 2006 and 2007 is a mechanism that would have enabled the Central Bank of Ireland to impose countercyclical capital requirements on the Irish banks. That is what was really needed.
Chair: We will come on to that in a moment.

Mr Sants: You have to remember the Irish banks are regulated by the Irish regulator and therefore we're talking about European standards.
Chair: Hector, I'm bringing in John and we can come back to this subject in a moment.

Q701 John Thurso: Let me ask you, Lord Turner, the question. You said in a speech, I think in March, that we need some new combination of macro-prudential tools. What tools, what will be most effective and what can we put in that doesn't need international agreement?
Lord Turner: This, of course, is going to be the crucial issue for the interim FPC when it is established. In preparation for that, there are people in the relevant bit of the Bank already producing papers that will be before the interim FPC when it first meets. Clearly the debate about what those tools should be is important. I think we know some of the tools. One of the tools is a countercyclical capital requirement, the ability—in addition to the consistent continuous capital requirements in Basel III—to impose additional capital requirements on the banks when credit conditions are expanding rapidly. That is clearly set out in the Basel III regime where it talks about an extra layer of capital of up to 2.5% of risk-weighted assets, though—almost certainly—with freedom for national authorities to go beyond that. That, in itself, will be a powerful tool. It is not a tool that one would imagine switching on every six months or so. I think it is a tool that would highly likely not to be applied at all for five or six years and then would be brought in when there is a major credit boom emerging—as a very important tool.

Q702 John Thurso: Can I just ask you on that one: five years, seven years goes by, suddenly the assets bubble appears, the tool is brought in, there is a squeeze and suddenly nobody can get mortgages. Have we thought through whether this is a realistic proposition?
Lord Turner: The answer is that I think it is. It is obviously the case that the impact of this is to constrain the supply of credit that would otherwise exist. But I think we all recognise now that if in 2005, 2006 or 2007, before the crisis, we had had a mechanism to slow down the supply, both of residential mortgages and commercial real estate lending, we might not have the increases in public debt and recession that we face at the moment. Would that mean that if we had done that in 2005, 2006 or 2007 somebody would have had less mortgage availability than they otherwise would have, that they would have had to borrow with only an 80% loan to value ratio not a 90% loan to value ration? Well, obviously. But we have realised that the process of credit expansions, booms and busts, is one of the most destructive things in the economy, and we cannot create macro levers that slow that down without that meaning that at the margin somebody in those specific circumstances is prevented from getting credit that they otherwise want. That is the consequence of that.

Q703 John Thurso: Do you think it is important that we make it clear what the consequence is? We are talking now about this wonderful thing of macro-prudential tools. The average guy in the street hasn't a clue what we're on about, but when the mortgage doubles or they can't get the mortgage, then they will and that will translate back to Parliament. So we need to be robust about this.
Lord Turner: That is absolutely right and other countries are familiar with this. At the moment there is, for instance, a very significant property price boom going on in Hong Kong. Hong Kong is unable to move an interest rate lever because, of course, it has a currency board system where it is fully pegged to the dollar and therefore its monetary policy is essentially that of the US. It is, therefore, trying to slow down that property price boom by, for instance, and I was going to get to this, variations of maximum loan to value ratios. Many other countries like Hong Kong, like India, like Singapore are used to the idea that these levers are pulled. Of course, when they are pulled, somebody who would rather have liked to borrow a whole load of money to buy a house that they thought would have gone up in value is unable to do that. We do need to be honest with people. This is, in the famous phrase, mechanisms to take away the punchbowl before the party gets out of hand and that is not always a popular thing to do.

Q704 John Thurso: Coming down off the very high macro level, as Hector said earlier, organisational change of itself doesn't really achieve a great deal, it is what you do with it. The macro-prudential tools are an important part of the toolkit. The other side of the equation is behaviour, and one of the behavioural sides of the banking crisis was broadly around the whole question of remuneration. Can we have regulation of banking without addressing remuneration and the bonus culture?
Lord Turner: Well, we are addressing it and I think we are addressing it in a way that is appropriate for a regulator. I don't think you can expect a regulator to be the authority that expresses, as it were, society's preferences for how much people are paid. If society has a point of view about inequality, the relevant tools and the degree of progressivity of the income tax system, all things like that, what you can ask a regulator to do is focus on whether the structure of how people are being paid is creating incentives for excessive risk taking. Before this crisis, it was the case that people were being paid cash bonuses at the end of a year for what looked in that year to be fantastically profitable trading activity, well before we knew whether this was what looked profitable but had simply left a trail of toxic waste for people to look after in the next couple of years. That is why our focus has not been on the level of pay, but on things that require a certain proportion of it to be deferred and that require that getting that deferred element is then subject to looking at the performance over the two or three years to make sure that it still looks as if that was a profitable, sensible activity. That is what we have done.
We played a major role in the development of the international Financial Stability Board code, which was agreed at the Pittsburgh Summit in September 2009, and we have been as forceful as any authority

in the world at implementing that. I don't think this will be transformational, but I think it will play a useful role. If I can just illustrate why I think it will be a useful role: I have sat on the remuneration committee of a major bank, and it is true to say that before the crisis when we were deciding the structure of remuneration, we did not, I think, adequately think about, "Does that have some consequences for the riskiness or otherwise of behaviour?". We focused almost entirely on, "What do we have to pay to get this person in order that the competition doesn't get them?" I think we have provided in this regulation a set of rules and guidelines that will change the behaviour of good remuneration committees so that they will be focusing on and integrating risk considerations into remuneration considerations. I think that will be a step forward.

Q705 John Thurso: You neatly sidestepped what society thinks. I think society has a very clear idea that people getting £12 million or £15 million a year for no capital invested of their own is bonkers, but the evidence we've had is that if we try and change it in this country all the bankers will go elsewhere. Are we just stuck with paying ludicrous amounts of money in a way that completely devalues the concept of capitalism, or can we do anything on our own?

Lord Turner: As you know, I think those are important issues for us to think about and they are issues that concern me but they are not ones that I think a regulator can directly address. I think we can indirectly address it through, for instance, adequate capital requirements. It is my belief that some of the trading activity that occurred was blown up to a level that was not required by the economy and did not serve an economically useful purpose, partly because we allowed it to because we set far too low capital requirements for trading activity. We have already very significantly increased the capital requirements for trading activity and we are now engaged, through the Basel Committee, in a fundamental review of capital requirements for trading activity, which could produce further major changes next year. From a regulatory point of view, that is the relevant tool that we have available. Will it be transformational? Not necessarily. I think there is something about the financial system that means that at the end of it there will still be high pay for things which many people in society will not believe are useful to them, but that is not something that we have the power to entirely fix.

Q706 Andrea Leadsom: Thank you, Chairman. Just going back slightly, back in 2007 I was working for a major UK funds management company whose senior fund managers—award-winning fund managers, I should say—for two years had not been buying bank equities, specifically and very openly saying that there was a credit bubble going on; money was too cheap; the Bank of England needed to raise interest rates; don't touch bank debt; and particularly don't touch building societies. And yet the FSA completely failed to see Northern Rock coming, or at least completely failed to do anything about it. What about the new structure is going to make that any different? There were all the signs out there for at least a couple of years. Why will the new system enable us to avoid that kind of problem in the future?

Mr Sants: I think we need to come back to the points that Adair has already covered to some degree. We do need to distinguish between the role and the effectiveness of firm-specific supervision, and the role and effectiveness of overall oversight and intervention in the system as a whole. As everybody, I think, is in general agreement—the Committee, ourselves and others—there was no process in the then tripartite system to invest in any one body responsibility for looking at the overall system and the degree of risk in the overall system. The FSA, as we have said repeatedly, did not believe it was—and was not—charged with financial stability responsibility and was not looking at the overall risk in the system, and nor was the Bank. I have already observed that is the central bank's role going forward and fully support the creation of the FPC in consequence.

Within that, however, even if you do have a system that then develops too high a degree of risk, which then potentially puts individual institutions at risk through the systemic issue, there is the question of the degree to which those institutions might be able to isolate themselves from that systemic risk in terms of their own particular circumstances; business model and capital liquidity management. I think we've also been through in this Committee more than once namely that the firm-specific rules of capital and liquidity were the responsibility of the Basel Committee and then subsequently interpreted in Europe through the European regime. The Bank of England and the FSA were jointly involved in this process as part of the international collective. Those rules have been proved to be fundamentally wrong. There was an intellectual failure of the international regulatory community in respect of that global set of rules that the UK and the FSA applied. On top of that, the FSA had a supervisory approach, which was to intervene only when things had gone wrong, so it was not doing any great business model analysis, which compounded the problem. But the individual supervisory actions are the least important in that chain of events.

Q707 Andrea Leadsom: So, going forward, under the PRA, surely when it all boils down it's about personal accountability, isn't it? So, in the event of a failure of a firm in the future, or the suspected failure of a firm or a set of firms, who will be accountable? Will it be you or will it be the Governor? Obviously you will be chief executive of the PRA. So whose role will it be to take responsibility for that failure?

Mr Sants: If it is a systemic failure of the overall system and it is deemed in hindsight—presumably we'll assume those people in those roles in the future have been doing their best to make sure these failures do not occur—that they could have made an intervention using one or many of the tools we've just been touching on through the FPC, then obviously the FPC and the central Bank would be held to account. Of course, we have just observed in the debate on accountability that the FPC is a committee—it is not one person—but it would be the FPC and the central Bank accountable for systemic failure.

Andrea Leadsom: So you're saying that there isn't—

Mr Sants: If it was a firm-specific event, then you would look to the PRA and the chief executive of the PRA. But could I just make one point here in passing, which is a really important point in terms of the philosophy of the PRA? The philosophy of the PRA, its intention and the way it should be judged should be different to the way that in general the FSA has been judged. It should not be judged on stopping firms failing for idiosyncratic, firm-specific reasons: it should be judged on whether those failures then carry costs to the system. If you look back on actually what went wrong, arguably there were three main failures in the tripartite system. The first was the lack of a bank resolution system and the second was a poor financial compensation scheme. The third was probably the absence of a financial stability oversight mechanism. If Northern Rock had been resolvable over a weekend in a way that did not create cost to taxpayers, did not create detriment to society and did not cause a problem for users of the banking system, then I would say going forward the PRA would consider that a reasonable solution.

We are not trying to take idiosyncratic failure out of the system. If you do that, you do not get innovation and you do not get economic growth and a vibrant economy. So, the PRA should be judged by whether it can avoid failure which comes with a cost to the system, not whether it can avoid failure. Orderly failure should not be seen as poor performance by the PRA.

Q708 Andrea Leadsom: But, Mr Sants, my question is about accountability and you're telling me that this remains spread amongst FPC and the bank and the PRA. I am asking about individual—

Mr Sants: No, micro-prudential is with the PRA.

Andrea Leadsom: Is it your problem in future if an individual bank goes bust? Because, let's face it, if a large bank goes bust there are automatically systemic risks. They don't go bust in isolation; we've just discovered that. So, who will be accountable? Is it you or is it the Governor?

Mr Sants: For individual banks failing it would be the PRA and I, as the chief executive, would take responsibility for that, no doubt accountable to the board with the Governor as the chair. But it is normal practice, which I subscribe to, for chief executives to take responsibility for their organisations. I'm just making the point, however, that failure of a bank is not necessarily to be deemed a failure by the PRA; you need to look at the circumstances of that failure and the consequences. I am trying to wean people off an expectation that you operate a no failure regime and explain that, going forward, if you can have failure without cost to the system that would not be a failure from the PRA's point of view.

Q709 Andrea Leadsom: What worries you about the next failure? Where is that going to come from? Is that going to come from off-balance sheet risk, is it going to come from shadow banking? What do you worry about most?

Mr Sants: Clearly, history tells us that crises tend not to repeat themselves in the precise nature of the crisis and the precise drivers, so the next one is likely to be different in nature from the last one. Hopefully it will also be some way off and hopefully also less detrimental in impact, but undoubtedly at some point there will be another crisis. Where is that likely to come from? I'll tell you that what worries me in the generality is that effectively where we saw the build-up in risk over the last 20 or so years, and particularly in the key period pre-2007, was within the banks and also within the shadow banking system, but basically within the managers of risk. And because those institutions, both off balance sheet and on balance sheet, were inadequately capitalised and the liquidity regime was poor, when the shock occurred they weren't able to absorb it. That's what we're now addressing through the regulatory actions Adair has referred to earlier. But one of the consequences of that could well be to push risk out of that aspect of the system, not just into the shadow system but out of the system altogether. So, you can then push risk effectively into the consumer—into the user of product and out of the manufacturer of product.

So, for example, if you have something like an ETF, you can put leverage in an ETF and then consumers themselves buy the product with the leverage. So I think the risk is the leverage moves out of the visibility of the regulator from the point of view of regulating the manufacturers of product into the consumers of product. So this is kind of a long-term issue. I don't think it is happening to a significant degree at the moment, but logically I think that is a potential area of future risk that we need to very careful about, which is why I think we need to make sure that we are reforming the trading environment and the market environment—the central counterparty environment—at the same time as reforming the capital and liquidity regime of the banks and the shadow banks. So, it will be something to do with risk occurring away from the core banking system.

Q710 Andrea Leadsom: So just very quickly, if it were your example of exchange-traded funds, would you see it as the PRA's role to continue to monitor that and to take responsibility?

Mr Sants: No. Well, not primarily because the PRA is not the market's regulator. That would be sitting with the CPMA and potentially with the clearing and settlement component of the Bank of England. The PRA is a firm-specific regulator for prudential risk in the insurance and banking system. That is the way that the Government are proposing to set it up.

Q711 Andrea Leadsom: So there is going to be an issue there then of you needing to pass information to the CPMA if there's something that's bothering you about the activities of a particular firm?

Mr Sants: Of course, or back to the point earlier, whenever you have an organisational divide, information must be exchanged. As we said before, the advantage of a single regulator is that firm-specific risk is looked at by a single team of supervisors who are at least meant to be looking at everything in the round. If you split it up, you get the focus and there is no likelihood of them being distracted by another

mandate or competing mandates, but they have to co-operate. Risk will move around across the system, and if the various different parts of the system do not co-ordinate, that risk will be lost to visibility.

Q712 Mr Mudie: I think it's refreshing and good that we look at a new structure, learning from the mistakes of the past. Just on that, did the FSA have a view on whether Barclays should have been able to purchase Lehman Brothers?
Mr Sants: Yes, we did. Yes, most definitely, and we had the same view—I had the same view and the FSA had the same view—as the senior management of Barclays, namely that it should not purchase Lehman Brothers if there was any possibility of it putting Barclays at risk, and at no point did Barclays ever suggest to us a deal that was of that sort of nature.

Q713 Mr Mudie: No, but that's not the question. The report has come through that Bob Diamond had negotiated a bad Lehman Brothers that was left in the Americans' hands and Barclays were going to buy the good part of Lehman Brothers, and that was what was turned down. Is that a mistaken report?
Mr Sants: Yes.

Q714 Mr Mudie: So it was always a purchase of bad assets?
Mr Sants: As John Varley has reported a number of times—and my recollection of events is completely in line with that of John Varley's, and since we were talking and we were the decision makers here that would seem to be where you should look to establish the facts—at no point did Barclays make a clear proposition to us in relation to the acquisition of Lehman Brothers that we then turned down. There was no structure, as I understand it, which John Varley and the board found acceptable and therefore they didn't put one to us. If they had put one to us we would have evaluated it on the criterion I have just described, but we did not have a definitive proposal put to us.

Q715 Mr Mudie: On the question of shadow banking that Andrea was dealing with, how much of the shadow banking world—it's estimated at $20 trillion, twice the mainstream banking money—do we regulate?
Mr Sants: I think Adair is wanting to—
Lord Turner: This is an issue that we are looking at carefully within the Financial Stability Board and within the Committee for Supervisory and Regulatory Co-operation, which I chair. It's one of our most important workstreams for the next six months. I think the crucial thing, and the first thing we are going to be doing, is really defining what we think we mean by this word "shadow banking", because it's not straightforward.

Q716 Mr Mudie: No, no, before you take up time going in a different direction, I am asking at the moment and in the past few years how much of the shadow banking market have we or are we regulating as we sit? It is all right telling us what—
Lord Turner: No, okay, but to answer that I need to first of all quickly define what we would mean by shadow banking. The shadow banking system was, in its core, primarily a US phenomenon, although with connections into the UK. The absolute core of it is a process whereby a chain connects money market mutual funds, a series of vehicles like SIVs, conduits and prime broker dealers, and indeed hedge funds and banks themselves. To begin with, a lot of that was not regulated; the capital levels of SIVs and conduits were not regulated. The money market mutual funds, which are not a significant phenomenon in the UK but were a very big phenomenon in the US, were not regulated. What they were doing was taking a maturity transformation risk. Banks take a maturity transformation risk: they have shorter term liabilities than their assets. Through this chain, that maturity transformation was occurring. There was a group of American investors in money market mutual funds who believed that they had money they could get back immediately, and at the end of a chain there was a British retail residential mortgage-backed security with a 20-year loan. If that had occurred within a bank balance sheet, we would have closely regulated how much of that maturity transformation was occurring: because it occurred for different steps along the road, we didn't broadly regulate it.

Q717 Mr Mudie: I think you lost me about five minutes ago, but that's not hard. Put in percentage terms, I've not heard you say of the $20 trillion—
Lord Turner: Yes, but I don't recognise the $20 trillion. The trouble is since I don't know where the figure comes from—
Mr Mudie: That's a New York Fed research paper of July this year, available on the net.
Lord Turner: Which I have read from cover to cover.
Mr Mudie: Well, it is in there.
Lord Turner: Yes, but that is one particular definition. There are other definitions that—

Q718 Mr Mudie: No, no, look, we are speaking about regulation and we're trying to work it out. There is $10 trillion stuff that we regulate and there is a $20 trillion shadow system. You have just explained to me what we don't regulate; I've not heard that we regulate any of that $20 trillion. What percentage, as you've described it, of the shadow banking exercise do we regulate?
Lord Turner: I'm afraid I don't think that is a meaningful question and therefore it is not possible to give a meaningful answer.
Mr Mudie: Okay, well don't answer it then.
Lord Turner: I'm sorry, but the shadow banking system has become much smaller than it was, we didn't regulate any of it, whatever it was—
Mr Mudie: Well, it's $15 trillion now. That's again the same research so it's still considerable.
Mr Sants: I think we could say this, couldn't we, Adair, if this helps.
Mr Mudie: It is still considerable.
Mr Sants: Without the breakdown of the $20 trillion, I agree with Adair, we wouldn't want to be over precise but—

Mr Mudie: Well, what figure would you put on it? Seeing you won't take the Fed's figure, what figure would you put on? Hector, what figure do you put on it?
Mr Sants: I would say the following, what is within the UK's regulatory net we do, and have always had oversight of. We regulate hedge funds. We do not have money market funds of the size and the significance that you see in the US and the remaining small amounts of off-balance sheet conduits and SIVs owned by the UK banks, where we are the lead regulator, are visible to us. So there is very little shadow banking by entities in the UK that doesn't fall broadly into our oversight regime for prudential and financial stability purposes. The vast majority of that number will apply to activities outside of the UK and probably in the US, and until the US have completed the changes to their regulatory architecture, which includes increased oversight of hedge funds, it probably remains relatively unregulated in comparison with the UK. Is that a fair thing to say about it?
Lord Turner: Can I very quickly—

Q719 Mr Mudie: I have very little time so I just want to ask Hector, because you are going to take this up in the future. So, you're saying to the Treasury Select Committee that it's not a major problem in Britain and it's well under control from your organisation's point of view, so we don't have to worry?
Mr Sants: In terms of the visibility of that which we have regulatory responsibility for, the answer is yes. That does not mean, of course, that we might not be systemically affected by events in other parts of the world where we do not have regulatory responsibility.

Q720 Mr Mudie: That is where I come to you, Lord Turner, because you are involved with the G20. How confident can we be—people are losing patience with all the arguments about regulation and so on—that they have the determination to move on to that?
Lord Turner: I think reasonably confident, but it requires effort and it requires work. I can very quickly give you some figures. There is a money market mutual fund industry in the US; think of it as $3 trillion or $4 trillion. It wasn't previously regulated; it now has some regulation. There is a hedge fund industry worldwide; think $2 trillion or $3 trillion. There are debates about whether that needs to be regulated but we certainly need to oversee it. SIVs and conduits were $1 trillion or so, but are now much smaller. I think we have greater control over it, but we need to watch it very carefully, because what we learnt in the past is that these things transmute, they mutate in ways that we don't understand. We failed to see that the broker dealers—such as Goldman Sachs and Lehman Brothers—which were not systemically important in 1980, were hugely systemically important by 2008. This system has shrunk quite a lot already. Bits of it are being regulated that weren't previously regulated, in particular the US money market funds, but I think we have more work to do to make sure that we really understand it. That's why it's a key priority for us to look at now.

Q721 Chair: Before I hand over to Stewart Hosie, we have been talking here about the various ways in which this punchbowl might get full again. At the moment the punchbowl is very empty, and it is important to find out if both of you are thinking about ways in which some normalisation of credit can resume, using macro-prudential tools, using various weapons that may be available to you. In addition to the ones we already have in play, do you think that there are some other things that we should be considering and are you considering any? In particular, do you think we can have normalisation of banking conditions without a recovery in the securitisation market?
Lord Turner: The issue of the supply of credit to the economy is one that we, with the Bank and the Treasury, have debated at considerable length. We have done a very careful exercise with all of our banks to understand what their plans are for the next three years—three years in which they have to repay the Bank of England special liquidity scheme, meet our new liquidity requirements and to term out their funding—and what the consequences of that could be for their lending volumes, and whether those lending volumes are sufficient to serve the needs of the real economy. That has been an integrated exercise that we have been at work on and it has a very detailed set of figures attached to it.
What the analysis suggests is that until now the supply of credit to the economy—while problematic, perhaps, in particular areas like SMEs—is not significantly different from what you expect at this stage in a recovery from a recession. If you look at the pattern of 1993–1994, early stages of a recovery from a recession are often not particularly credit intensive. It is also clear, however, that it is at least possible that the combination of us applying new liquidity requirements and the Bank requiring the repayment of SLS by early 2012 might constrain the future pace of credit growth which might be required to support the economy. The crucial lever we have available in that, which we have debated with our tripartite colleagues, is to think carefully about the pace of the application of our new liquidity standards. We have twice this year communicated that we are not switching on those liquidity standards immediately until there is an assured pace of recovery. So, to that extent we are taking into account those credit conditions.
Chair: That is an important and well rehearsed argument.
Lord Turner: That is the single biggest lever we have.

Q722 Chair: My specific question was whether we can have a recovery without a recovery in securitisation?
Lord Turner: On the securitisation, I think we can have it without securitisation. It would be easier with securitisation; on the other hand I think we have to be realistic. Quite a lot—and this does relate to the previous issue about shadow banking—of what was previously securitisation was based upon unsafe forms of maturity transformation and is not coming back.

Q723 Chair: What proportion? What was good and what was bad? What have we lost that we'd rather not have lost?
Lord Turner: I'm afraid the vast majority of the UK securitisation pattern was based upon a particular set of investors that were not sustainable. Very quickly, if I can draw the distinction: if it had been the case that UK residential mortgages, which are essentially 20-year assets, were ending up being securitised and ending up in the hands of the natural buyers of long-term assets—pension funds, insurance companies—then you would have a sustainable non-bank form of mortgage credit intermediation. That was hardly what was occurring at all. Almost all of UK RMBS was, through a series of chains, ending up in the hands often of US investors who at the end of that chain thought that they had a short-term asset. That was something that I think no amount of transparency and better regulation is going to make come back, because it was risky.
Chair: You have given me a clear answer, and if you have further substance you want to add to it in writing we would be interested to see it.
Lord Turner: I would be very happy to do it.

Q724 Stewart Hosie: I have a number of questions about structure and staffing of the new bodies, but can I just go back to something you said about the future? You said, Hector, that it wasn't about stopping banks and financial institutions failing, it was about stopping failure without cost. I take it you mean failure without systemic risk, as opposed to cost?
Mr Sants: And also cost to the taxpayer.

Q725 Stewart Hosie: Fine. So that means you would not have put £37 billion into Bradford & Bingley because their failure wasn't systemic? You'd have let them fail?
Mr Sants: Exactly right. If you had a regime, which the US to a degree had, that enabled a bank to fail with the cost of that failure being borne only by those who had subscribed the capital, and therefore did so knowing that there was a potential cost if it failed, that should be acceptable to Society. If you can have a failure where the cost only falls on those who provided the capital and there is no adverse impact to the rest of the system for systemic purposes and no adverse impact to the consumers and users of those bank accounts—their bank accounts are transferred over to another bank, for example, I would say going forward that the PRA would not see that as a failure of the PRA. It is reasonable to have a system where failure of that nature occurs because without the opportunity for that sort of failure you do not get risk and innovation.

Q726 Stewart Hosie: Fine, and the same would apply to Northern Rock and Dunfermline?
Mr Sants: Quite so. In the US hundreds of banks fail all the time and normally this is not considered to be a regulatory failure. The consumers are not inconvenienced and historically the costs have not fallen any further than the providers of capital.
Stewart Hosie: I just wanted to get that clarified.
Mr Sants: I think it would be very helpful if people understand that, in terms of judging the PRA going forward, that is the right way to judge it.

Q727 Stewart Hosie: Thank you, it is helpful to get that on the record. Can I ask some questions about how we move forward now? The Government in their consultation said that whenever the CPMA disagrees with the PRA, the PRA's decision would be final—reflecting the important role of prudential judgement in the delivery of regulation. Do you agree with that?
Mr Sants: Broadly speaking, yes. I think there is a risk that that sort of language creates some notion or idea that somehow or another the CPMA is a secondary authority. That would be wrong and if that impression gains ground that would be very unfortunate, and we should try to avoid that. But the point of substance is that conduct risk can evolve into prudential risk. For example, as we've discussed in this Committee in the past, mis-selling can obviously lead to prudential risk through the build-up of poor quality assets on the balance sheet, and it can also be a very important lead indicator of poor cultures, which can lead to prudential mismanagement. So there is a clear interaction between conduct regulation and prudential regulation.
There is also interaction at the systemic level where you can envisage certain circumstances where a closure of a bank might have systemic implications, for the reasons we have just discussed. In those circumstances, and those circumstances alone, it is right that the CPMA should have to consult before taking an action with the PRA and, if the action it was taking was deemed by the PRA to have systemic implications, it is reasonable that the PRA should have an override. We all know that the cost of this crisis has been multiples of any single mis-selling event and therefore, in terms of the impact on society as whole, systemic failure is the most costly.

Q728 Stewart Hosie: I'll come back to this perception of the CPMA as a secondary body in a moment, but what you've just said would lead us to conclude presumably that consumer protection would always be compromised in order to protect the integrity of the financial system, if there was a conflict between the micro-prudential and the systemic and the consumer?
Mr Sants: It depends how you view consumer protection. I think it would be reasonable. Obviously it is a matter for Parliament, but I would say it would be reasonable for Parliament to make the judgement that systemic failure is a failure that affects consumers. If, at the end of the day, what we want is a market that works for consumers in the round, that should include avoiding systemic failure. But you're right: the judgement has to be that systemic failure is bad news for consumers. I happen to think systemic failure is very bad news for consumers, and therefore that is something that the regulatory system should try to protect consumers against.

Q729 Stewart Hosie:I agree entirely, systemic failure is catastrophic for everybody, including consumers, but there is a perception in the real

world—not on this Committee—that this is once again Government and regulators looking after the banks with the consumer deemed or seen to be a poor second to the big picture of this.
Mr Sants: Yes, I think that's an educational challenge for Parliament and the regulators over the coming months to get over the point that we have just exchanged views on. I think that we're broadly in agreement: this is not about a structure where consumers are second choice or coming off second best. It's about creating a structure where consumers are at the forefront and that is designed to give the best possible result for consumers.
We had a discussion earlier on about the benefits of change and everybody was relating it back to the question, "Does this mean the crisis wouldn't have occurred again?" I personally think that the biggest opportunity is not just about trying to avoid a repeat of the crisis: it's about taking the opportunity of change to improve the deal for consumers. So it's really important that the CPMA comes forward with an improved set of powers, relative to what the FSA has had, and that there is a real opportunity here to improve the lot of consumers.

Q730 Stewart Hosie: That's helpful, but you're going to have to have high quality staff in the CPMA. Given that there is this perception at least that it may be a secondary body, and the CPMA, as you said in a previous answer, would have to consult with the PRA, how will you bring the right staff into the CPMA to do what is a very important role in its own right, while it seems to be playing second fiddle to the PRA?
Mr Sants: This is a really important point, I think, and Adair wants to add something in a moment, but I think that is a clear challenge. As I've just said, in normal market conditions there is a tremendous opportunity here for the CPMA to make a real difference to society and that, I hope, would appeal to individuals and provide a compelling reason for them to want to work in the organisation.
Certainly, within the FSA, broadly speaking, we have yet—we still have 18 months to go—to settle on the final numbers, but it's going to be something in the order of two-thirds of the FSA staff will be in the CPMA. The PRA will be a much smaller entity than the CPMA, and the general reaction of staff within the FSA is one of excitement about an opportunity to deliver a better result for consumers than we have had in the past. So I think there are lots of people out there who are very interested in improving conditions for consumers.

Q731 Stewart Hosie: I'm glad staff are excited, but in your written evidence you were speaking about how the problems might be mitigated through people strategies and good initiatives such as secondments between the PRA and CPMA. Does this not really say people are going to serve a bit of time in the CPMA and hope they're very quickly going to get the move to the organisation they really want to go to?
Mr Sants: I don't think so, no.
Lord Turner: I don't think that is going to be the case. We are well aware that the FSA board and executive has to achieve two things over the next year and a half to two years, one of which is to divide off the PRA which will become part of the Bank. The other is to create what is the bigger successor body, which is the CPMA, and we are now going through a process of selecting a chief executive-designate for that, who we will have in place some time in the spring. It is quite an exciting opportunity to create a new body that gives consumer protection its own distinct focus. I don't think it is going to be seen as a second-best organisation at all, but certainly that is something that we are aware we need to dispel any belief about. I think it's more a belief that we hear expressed in meetings like this or from the press: it's not something that I think we feel within the organisation ourselves—the secondment thing.

Q732 Stewart Hosie: You said, "We envisage there being some difficulty in attracting and retaining specialist prudential advice in the CPMA which will continue to have some prudential responsibilities."
Lord Turner: This is a very specific point about prudential advice.
Stewart Hosie: Indeed. I make the point that those are your words.
Lord Turner: Okay, but they are related to a very particular set of skills, yes.
Stewart Hosie: We are probing this. That's important.
Lord Turner: I understand, yes.
Mr Sants: There is a particular point which that submission highlighted that the CPMA is not just a conduct regulator. It is also proposed that it will be a prudential regulator for those firms that the PRA is not the prudential regulator for—the non-banks and insurers.
Within that context, there is potentially somewhat of an issue that that expertise could feel subordinated to the core activity of the CPMA, which is conduct regulation, and therefore we will want to make sure that there is plenty of expertise exchanged between the prudential regulator—the PRA—and those people doing prudential regulation in the CPMA. But that was not a comment about the whole of the CPMA.

Q733 Stewart Hosie: Let me just ask a final question then. We do know the prudential and consumer are not unrelated: they are linked, of course they are. What will you do in practice to ensure there is proper co-ordination between the two bodies, not rivalry, and that we don't create another crack or an underlap, as we've had in previous architectures?
Mr Sants: This is undoubtedly a major challenge and it is the principal risk in the new system, which everybody has rightly identified. I think we have to work hard at this. There are a couple of obvious measures to be taken. First, wherever possible we should continue to retain common standards of regulation and a clear interaction between the CPMA and the PRA in articulating those standards. So, for example, in the authorisations process, where we have a requirement for probity, we should not be having one judgment of probity being different to the other from the two organisations. So there needs to be convergence where standards are common.
Secondly, which I think is the principal action that needs to be taken, we need to ensure that in terms of

oversight of individual firms that we put in place some structural co-ordination mechanisms through formal MOUs and do not rely on informal processes and rely on the fact that at least initially the staff will have all worked in one organisation in the first place, which will obviously help. We need to institutionalise the requirement to co-operate and, as the Government's document indicated, we would envisage—to use regulatory speak—colleges for the larger firms that are supervised by the CPMA and the PRA. I think we need some structured obligations for interaction and communication. We need to make sure as well, of course, that firms don't feel we're building an inefficient process, thus we'll need to have common interfaces for collecting data, a common data set and so on. So we'll need a set of structural processes as well as hard-working communication at the senior management level.

Q734 Mark Garnier: My questions are to Hector Sants, and before I start can I set you the challenge of brief and pithy answers, if I may, because I think we're running a bit short of time. Following on from this and also from Andrea Leadsom's questions a bit earlier, if we follow your reasoning about what keeps you awake at night—that risk is going to be pushed to the consumer rather than to the manager of risk—what do you think that is going to make the next crisis look like?
Mr Sants: Well, of course, if I knew precisely the answer to that, we would be taking anticipatory action now. I think that, as I say, at the end of the day a financial crisis ultimately has to be linked to the build-up of risk somewhere in the system. That is the intrinsic nature of a financial crisis. It will be the build-up of risk somewhere, either that is not fully visible to the regulatory system, or that is visible but they have misjudged the level of risk or do not have the appetite to make an intervention, which is the—

Q735 Mark Garnier: So, following that, that is absolutely where the risk goes to the consumer, because that could be hidden risk because you can't see into that. So, the crisis is going to come to the consumer, which is a lot of personal crises as opposed to huge crises that can be dealt with by the state; personal crises aren't quite so easy to deal with. Does that mean that the CPMA, rather than the PRA, are going to be attempting to mitigate this risk and how are they going to do it?
Mr Sants: I think, at the end of the day, if consumers have built up financial risk they will do so through the owning of financial products; a mortgage, an investment product and so forth; and The CPMA must therefore equip itself to fully have the required information and data and to understand the risk that the consumer is owning. So, that takes us back to the earlier discussion about having a transparent markets process, a good clearing process, a good data process. Secondly, it must have a mechanism of intervention, which is where I think the earlier intervention on the product side—

Q736 Mark Garnier: Risk is not just about owning one product: it could be owning a number of contradictory products. You can have a mortgage, which in itself is fairly straightforward, but then you can have an overdraft and a credit card. Each one of those individually is not a problem, but you put all of them together and you've got a colossal problem for a family or a household. How are you going to deal with that? That's how I see risk being pushed down to the consumer and I don't see how you are going to deal with this.
Mr Sants: That's a mixture of two. The CPMA intervention would be on a product-specific basis and a product-design basis, but the aggregate risks—sorry, we're back round in the circle again to our FPC discussion—that would be for the FPC to intervene, using the various mechanisms that we've already described. So I'm just making the point it's a twin process.

Q737 Mark Garnier: I'm trying to move on. Has the CPMA got the tools to deal with your element of it and what tools do you think they are going to—
Mr Sants: The CPMA, if it only inherits the FSA's tools, does not have sufficient tools.
Mark Garnier: So you'd need more finance?
Mr Sants: We need powers of product intervention. At the moment the FSA's powers, in the round, are essentially to make a rule, which then would ban a product, but you have to go through a whole process in order to make the rule. If Parliament wants a genuinely interventionist, powerful CPMA, which is seen as powerful, then it needs the power to make executive-driven, direct interventions to ban products.

Q738 Mark Garnier: In response to one of Stewart's questions, you said that your staff are excited by the opportunity for better results for consumers. Let's turn to RDR, because there has been a lot of controversy about RDR among the IFA community. You set out to try and, "Improve the clarity with which firms describe their services to consumers; address the potential for adviser remuneration to distort consumer outcomes; and improve advisers' professional standards." Have you achieved that?
Mr Sants: Well, since the RDR is not yet in force of course we can't answer that question. We believe that the measures we have laid out for implementation through the RDR process will broadly do that. I think it is fair to say, however, over the lifetime of the RDR, which traces its life back to Adair's predecessor who made a speech about some of the failings in the consumer market, it has become more focused and more realistic in its intent. We've laid out very clearly our intention to have a transparent and fairer charging system, a better qualification framework for advisers and greater clarity around the type of advice that is being offered.
So, the RDR is set to deliver three specific elements that would contribute to, overall, a better regime for investors. I think the measures we've laid out, when they are in place and implemented, will deliver those three specific outcomes. I do not think you should characterise the RDR as the panacea to the investment market and the solution that is going to lead to a new savings culture and a fundamental change in the marketplace.

Q739 Mark Garnier: I think a lot of people would agree with that. What do you think was then behind themoneymarket.co.uk's article on 16 July saying that the FSA at a board meeting had discussed scrapping RDR?

Mr Sants: I'm not aware of that article. We have not discussed scrapping RDR so I think it's media speculation.

Mark Garnier: So all these reports about you potentially scrapping RDR?

Lord Turner: I can assure you that there has been no discussion at any board meeting of scrapping the RDR.

Mark Garnier: Fantastic.

Lord Turner: And in fact I wasn't aware of the article, so I didn't even know the statement had been made.

Q740 Mark Garnier: I will get it forwarded to you. The other really important point about this is that the cost-benefit analysis was originally talking about £400 million cost; it has now gone to £1.7 billion. Now, let's leave aside the massive cost overruns that this has introduced—

Mr Sants: If I may, it's not a cost overrun, just to be quite clear for the record. An FSA cost-benefit analysis invites the industry to tell us how much they think it will cost to implement a measure. The judgment of how much that is is made by us on the basis of the industry feedback. The initial consultation of the industry came up with the first number you mentioned: in subsequent consultations, the industry revised their estimates of cost. So those are cost estimates made by the industry to the FSA. Any suggestion that is the FSA's direct cost, which has not been managed, is obviously a complete misunderstanding of the story.

Q741 Mark Garnier: I absolutely stand corrected. I stand corrected and I'm glad you put that on record. Nonetheless, what you are effectively doing is taking £1.7 billion out of the savings pool, because this is going to be borne directly by savers. Here we are in a country where I think we have the lowest savings ratio of the G20, we have the highest personal debt in the G20—an average of £28,000 per person—and the FSA, which is a regulator but is also there to help the savings market, has effectively sucked £1.7 billion out of that savings market. Is that a good thing for the FSA to have done?

Mr Sants: I think, as you say, it's a judgment and we have to make that judgment in the round. What we are looking at—and I think it will be the same data as you're looking at—is that we know that over the years there have been some very significant consumer mis-selling events, pensions, mortgages and so on. These, in total, have added up to many billions; £13 billion is one particular estimate. We have also, which I think is maybe more pertinent to the direct issue of RDR, done some sampling of the degree of mis-selling that we can estimate in respect of smaller, more regular events and we've come up with an estimate of around £250 million per year. We have some other data that suggests that's an under-estimate; it's probably more like £0.5 billion or so. The RDR is estimated to cost, in terms of ongoing cost, around £200 million a year; your £1.4 billion to £1.7 billion range includes a set of one-off costs of some £700 million. So we're looking at an estimate of the annual benefit it would bring, in normal circumstances, of a multiple above what we think the annual costs to the industry are.

Mark Garnier: Assuming it works.

Mr Sants: Assuming it works but, of course, we have to make that judgment and we've done it on the basis, I think, of some thorough analysis and the knowledge that there are some very big events out there that completely dwarf the annual running costs. So, I think that's a fair judgment for us to make this time around and the numbers we've laid out there do support it.

Lord Turner: I think it is a very good challenge. It clearly is concerning when there is a large cost from the FSA itself, or from the compliance costs that we impose upon an industry, that must come from consumers at the end of the day, but the starting point is a system where pretty much everybody is agreed that we don't have a very good retail financial distribution system to start with.

When I did the work that I did on the Pension Commission it was quite clear that the sales of personal pensions, to take one product, were involving a completely harmful degree of churn where people were just churning through different products from different providers because the commission bias, under which IFAs were operating, was providing them with incentives to do so. We did analysis that showed that very significant proportions of people's total pension pot, by the time they got to retirement, had disappeared in the reduction in yield from all the different costs that were created by this system. I think it was why, when Callum McCarthy gave his speech that announced this, he said we have a system which pretty much everybody was agreed didn't work particularly well for the consumers or for the producers, because there was so much cost going in the administrative and selling costs.

We are trying to get to a more sensible system and I think at the core of that, the absolute core, is that the removal of producer commissions must be a sensible thing to do because the fact that people or intermediaries are paid by producer commissions is an extraordinary incentive for churn in activities, which is wasted money. So we're trying to end up with a system that has less wasted money, but the fact is we start with a system where a depressingly large amount of people's savings is disappearing in the intermediary and administrative costs.

Hector, you also wanted to make a point and a quick reply.

Mr Sants: The biggest bit of the ongoing cost burden results from the change in the commission structure. Almost all our submissions from consumer groups are very, very supportive of banning the practice of being paid by the manufacturer of your product which must put bias into the selling process. So the main cost change is in relation to the main detriment, where I would say there is very strong support from consumers for change.

Q742 Mark Garnier: I completely accept there are a number of good things about RDR and it would be wrong to completely say it's all rubbish, because

generally a lot of it is good. However, amongst the IFA community there is a reasonable proportion, about 30% or so, who are outraged by what's happening and find it very difficult and there's a significant proportion of that 30% that are now considering completely coming out of that industry altogether. Do you feel that that is an acceptable cost to implement RDR?
Mr Sants: Well we obviously have looked closely at this issue. We have some data that suggested more like a 10 to 20% reduction in capacity could flow from the RDR measures. We've obviously deemed that to be acceptable or we wouldn't be going ahead. But in my experience in the lobbying process you tend to get fairly extreme statements made, which don't necessarily always come about in practice.
Lord Turner: But we shouldn't exclude the possibility that some exit of capacity from the industry, which is therefore also an exit of administrative costs, may be in the interest of consumers. That's a cost that is being absorbed, isn't it?
Mark Garnier: I put on the record I disagree with that.

Q743 Mr Love: Mr Sants, we've discussed this morning all the complexities of the structural reform that we're talking about and now that the consultation is finished, that may be tweaked in some way. We're just about to go on to talk about mismatch in Europe and the challenges that face you regarding that. You have a major programme of activity: we've talked about RDR; there's a mortgage market review. And against that backdrop, you're having some staff retention problems. Are you going to be able to complete this structural reform by 2012, facing all of those challenges?
Mr Sants: Yes, but it is very difficult, for the reasons you've outlined.

Q744 Mr Love: Can I ask you then because, Lord Turner, you said in an article that there are some risks to business as usual from bringing in this structural reform: where do you see the real challenges that you face to bring it in by 2012?
Lord Turner: The challenges, which were extensively discussed by the board two weeks ago on the basis of very detailed presentations from the executive, are essentially these. A process of organisational change will absorb the time of many of our major managers. For instance, they will have to sit down with people and discuss with them where they are going in the new organisation and where they want to go. They will have to design training programmes and some people may challenge where they are going to go. Those processes, those actual personnel processes of selection and decision and challenge, simply take time—anybody will tell you that—and that is taking key resources away from business as usual activity. That's a fact.
The crucial thing then is to plan that out very clearly, and we were discussing two weeks ago very clear plans to make sure that we have thought through whether there are things that can be temporarily de-emphasised, either on the policy side or on some of the issues to do with frequency of supervision for some of the lower risk authorised firms, which will free up that resource that is required. It varies according to the different bits of the organisation. There are some bits of the organisation where essentially they will, what we call, lift and shift. Pretty much the whole of our prudential policy division we know is going, in its entirety, to that side.
Mr Love: Excuse me for interrupting.
Lord Turner: But there are others where there is a major split, that's what we have to manage.

Q745 Mr Love: Excuse me for interrupting you, but we are limited in time.
Lord Turner: Yes, sure.
Mr Love: I wanted to focus specifically, since you're talking about staff retention, on the financial stability division, which has two major problems. First of all, the head has announced that he's leaving and, secondly, this is the part that will merge with the Bank of England, and therefore there's a possibility of redundancies; let's say there's uncertainty about the future. How are you coping with that and is that a major strain on you?
Lord Turner: It's not a major strain at the moment. We are sad to lose the head, David Strachan, but there are very good people beneath him. We are continuing to do our work in that area. We are continuing to head towards, for instance, our prudential risk outlook in the spring. The work that they are doing is of very high quality. We will, with that group of people, have to be completely honest about the fact that there may be some overlap with the Bank of England and we will have to manage that through.
But I can assure you at the moment that is not an area where I would be worried about interruption to business as usual. I would be more worried about interruption to business as usual in our core supervisory teams where what we have to do is split them in two and decide who is going which way. That's where we are more concerned and really focusing to make sure that things don't slip through the cracks.

Q746 Mr Love: Mr Sants, can I ask you the first question by a roundabout route. Say you complete it by 2012, will there be so many stresses and strains within the organisation that you won't function to an optimal level in terms of regulation?
Mr Sants: Clearly between now and 2012, as Adair has just laid out in some detail so I won't go back over that again, we have a finite number of people and they are going to have to do an additional task in that period. The additional task in that period is this reorganisation. Reorganisations are very time consuming. We have to prioritise delivering that reorganisation in order to hit the 2012 deadline, which I believe we can do, but if we prioritise carrying out the reorganisation that involves partly, for the reasons you have just said about staff uncertainty, managers spending a lot of time internally—putting staff at the forefront of their minds—then there will be less time to carry out other functions.
The main activity of the FSA is frontline supervision. Relatively speaking, if we look at our activity breakdown, we are a micro-prudential regulator. We

spend the bulk of our time on day-to-day supervision, not on designing new policies. We are in fact trying to do as little as possible by the way of new initiatives, other than those mandated to us by Europe. So we will do somewhat less supervision in that period, but we will make that judgement on a risk basis and seek to make sure we mitigate the adverse effects. But it obviously necessarily follows that if we are doing something extra we do a bit less elsewhere.

Q747 Mr Love: That's very helpful. I want to switch now back to an answer you gave to John Thurso in relation to the mortgage market review and it's this hoary old question about appropriate regulation. Do you think, in terms of where you've gone so far, you've hit the right button in terms of appropriate, because the accusation has been made that it's too onerous?

Lord Turner: We are very aware of the need, as we bring the mortgage market review to conclusion over the next several months, to really step back and to think very carefully about this balance, and this is one of our highest priorities over the next few months, to get this right. It is a matter of balance. If we protect some people against taking on board unsustainable mortgage commitments, at the margin somewhere else we'll constrain somebody's right to take on board a mortgage commitment that might have been affordable: that's almost necessarily the case. We are looking at it very carefully and we will be conducting a complete economic analysis of all the proposals before launching the specific proposal next year.

But I would make two points. Can I quickly make two points? First, easy credit supply is not necessarily good for first-time buyers. One of the features that occurred in the mortgage market up to 2008 is a gradual fall in the percentage of credit going to first-time buyers as more and more of it went to remortgages and mortgage equity withdrawal, where the easy supply of credit, by driving up the price of houses, was actually making it more difficult for first-time buyers to get into the market. So the somewhat easy assumption that easy credit is good for first-time buyers is not necessarily the case. That's point one.

Secondly, there was a clear tail of very harmful lending that occurred before the crisis, extending it to people who could not afford it and that is why, for instance, from people like Shelter and Citizens Advice there is strong support emerging to say don't compromise on the FSA proposals, which is balancing the argument from the other side of the industry of saying we've got it wrong. We are very well aware of the need to strike a balance. We'll be thinking very carefully about it and we will communicate very carefully the balance we've struck and the macroeconomic analysis.

I called last year for a very open public debate about this. It's one of the most important decisions we've got to make and we're not going to rush it.

Q748 Mr Love: You mentioned about the tail, which you estimate, as I understand it, to be about 5% but the mortgage companies are suggesting much higher, some of them dramatically higher figures. The accusation that they are making is that you're not putting any responsibility on the consumer, and that all the responsibility, not only to carry out affordability tests but also to make an assessment of the consumers' ability to pay, they consider that very onerous and they're likely, they claim—and I'm not one to put words in anyone's mouth—that that will mean a withdrawal from the marketplace. How do you respond to those concerns?

Lord Turner: We don't think there will be a major restriction of mortgage credit. You have to always distinguish here. It may be that at the margin some people will only be able to borrow on an 85% LTV, not a 90% LTV, but that's different from somebody not being able to get a mortgage at all, and that gets mixed up in these figures claiming that 50% will be affected. So we are looking at it very carefully.

On the basic concept of assessing affordability, most of the major lenders believe that that is something they should do because it's something they should be interested in. They shouldn't be interested in writing a loan contract where the person can't afford to pay it back, because that's just going to produce arrears and repossessions down the line. So I don't think the concept of affordability assessment is being challenged. It's simply how we get the correct calibration of how significant the constraints should be, how tight they should be.

In particular, on crucial issues like when you offer somebody a mortgage at 3.5%, how much should you stress the interest rate to deal with the fact that it might go up in the future? That's something where we haven't been definitive yet and accordingly, as you flex that, that's the sort of thing that either produces a big effect or a small effect. We are going to think very carefully about that in the final stages of this consideration.

Chair: You can come back to all this. A quick further question from Andy.

Q749 Mr Love: I wanted to get this question in, and it goes back to something that John Thurso said, the interaction between these consumer protection measures and macro-prudential tools. Have you given any thought to how they would interact with each other? If you go more on the consumer protection, does that inevitably mean that we won't need to use the macro-prudential tools as much?

Lord Turner: We are not seeing what we are doing within the FSA's mortgage market review as focused on the macro-prudential side, and that is why it is focused on the tail of bad lending rather than the general supply of lending. So we're not intending, in the mortgage market review, to do things that would, as it were, have slowed down the across-the-board growth of credit in 2004 to 2007. That is a separate set of tools that have to be discussed by the Financial Policy Committee. Obviously there has to be a joining up, which is why the future chief executive of the CPMA is rightly one of the members of the Financial Policy Committee. But we do see these as complementary, and we do not see the tools that we are intending to put in place on the mortgage market review as addressing the wider issue of the through-the-cycle variation in the overall supply of credit. That

would be more countercyclical capital requirements, or perhaps LTV or LTI constraints.

Q750 John Mann: Thank you, Chairman. I will not be seeking to catch your eye again in this hearing.
I do have three questions and possibly a supplementary, particularly on the last question. First, I wanted to pick up your answer, Lord Turner, to Mr Mudie on what I thought was a very important issue, where you stated—I think I have this down accurately—that the FSA didn't realise the systemic risk from investment banking. Talking in confidence to FSA insiders, as I have been doing, I put to you that that's not accurate, that in fact the situation inside the FSA and the discussions that you had were not that you did not appreciate the systemic risk from investment banking, but that you truly did not anticipate the extent of the systemic risk: perhaps more fundamentally, you didn't know what to do about the systemic risk with investment banking. I put it to you that investment banking is fiercely competitive in some areas, but there is no competition whatsoever in other areas. The big question being asked is "are banks too big to fail?" Isn't the more pertinent question "are investment banks too big to regulate?"
Lord Turner: I'm not sure I agree with what you're saying there, because I do think the fundamental problem was a failure across the world to understand what was going on in the area that spans investment banking, securitisation and the shadow banking system, but that of course includes the trading activities of major commercial banks. Let's be clear at this point, the trading activities of UBS, which is a commercial bank, were as relevant to this as a standalone investment bank like Lehman Brothers or Goldman Sachs. I think there was a failure to put together the bits of the jigsaw puzzle and to realise that once there were things going on in the money market mutual funds, the SIVs, the conduits, the trading books, the investment banks and the broker dealers themselves, the totality of the system had a set of risks that people didn't understand. Indeed, let's be clear, it's not just that they didn't understand it: there was a very overt philosophy, attached in particular to Alan Greenspan but set out in documents, that you didn't need to understand how it all fitted together because you could have confidence that the free market was bound to disperse risk so that it would be constrained. I can point to bits of IMF documents that say that.
So, I am not sure that it was the case that there were a whole load of people looking at it. Obviously you then have a matter of degree, but there was a failure to understand how this new system of credit supply all fitted together. Remember in the US, the pure play investment banks—the five banks that did exist—they really did escape prudential regulation, because they were regulated by the SEC, which is not by its nature a prudential regulator, it's a conduct regulator.

Q751 John Mann: I'm sure that we'll be keeping a very close eye on both whether there is competition, and whether there is any real regulation of investment banking.
Let me come to you, Mr Sants. When did you warn the Treasury about the seriousness of our exposure to the Irish economy?
Mr Sants: I am going to have to give you a written answer on precisely when the first meeting on Ireland was, but it was a long time ago. This is not something that has suddenly sprung on us, for the reasons that Adair outlined in terms of his analysis of what is underlying in the Irish crisis. I'm trying to think when our first Irish meeting—
Lord Turner: I would imagine probably the tail end of 2008.
Mr Sants: Yes, 2008 or something like that. It is a long time ago that goes right back into the depths of the crisis; I would guess 2008 some time.

Q752 John Mann: During the last three or four months, how much have you been warning the Treasury?
Mr Sants: I think warning the Treasury is probably not the right description of events. I think all elements of the tripartite system, the Treasury, the Bank of England and the FSA, have nearly continuous meetings and discussion on this subject for the last 12 or 15 months. There is always work going on in the FSA on Irish banks. That information is regularly communicated to the Treasury and we are doing it jointly with the Bank of England. So, because it is such a longstanding issue, it is something that is now embedded in our work as business as usual. It is reviewed regularly in all the deputies meetings, and principals meetings.

Q753 John Mann: So the Government has had good time to plan its decision making then in relation to the Irish banks. Are there any other economies where you are warning about our exposure, for example Portugal or Spain, at the moment?
Lord Turner: The situation on our exposure to Portugal and Spain I would say is as follows. In both of those we again had relatively little exposure to sovereign bonds. In general around Europe, the major exposures to sovereign bonds by banking systems are not in the UK. You can see that from the results of the CEBS stress test earlier this year, which revealed significant sovereign bond exposure of some of the continental banks but not the UK banks. We do have one bank that has a non-trivial involvement in mortgages in Spain, because it has a business in that area. Those will, of course, depend upon the quality of those mortgages. Some of them, although they're in Spain are, of course, to British citizens who have taken out mortgages to buy second properties. But the scale is not on the same scale as the Irish exposure. We do not have the same equivalent of RBS owing a large Irish bank.
John Mann: I appreciate that. Let me—
Mr Sants: Eurozone issues have been a regular part of our stress testing supervisory approach to the UK banks for well over 12 months now.

Q754 John Mann: Mr Sants, didn't you think it appropriate, considering that British taxpayers are having now to bail out Ireland and Irish banks, that

the Chairman of this Committee should be alerted to the seriousness of your concerns?
Mr Sants: First of all, I think to be quite clear, it is not a result of the failure of UK regulated entities among the UK banks that has led to the Irish banking crisis. That is a matter for the Irish regulator and—

Q755 John Mann: No, but we're involved in the bailout and there is a specific link between this Committee and yourselves. Considering the seriousness of the situation and the seriousness of the advice that you have been giving to the Treasury, did you not think that this Committee—at least the Chairman, whether in confidence or not—ought to be alerted to the situation where the British taxpayers are being asked to bail out Ireland and Irish banks?
Mr Sants: The decision to bail out Irish banks or the contribution to the Irish package is a decision for Government not for the FSA. As I understand it from the public announcements that have been made—the decision takes into account a number of other factors, including our export/import relationship with the Irish economy, and no doubt other factors of which I'm not aware—this is not a specific regulatory intervention.
Lord Turner: Can I just make one other point? The fact that RBS has a large exposure to Ireland has been obvious to anybody who picks up an RBS annual report and realises that it owns Ulster Bank. This is not something that, as it were, the FSA has to discover and reveal to people. It's an obvious matter of public record that follows from the ownership of Ulster Bank, which, as I say, before RBS bought NatWest, was owned by NatWest for decades.

Q756 John Mann: Yes, but it may be a surprise to the British taxpayer to have to fund it. But let me ask you a different question on a different issue, Lord Turner. You have been in post since September 2008. Isn't it the case that you have taken your eye off the ball when it comes to what is happening in Europe and European regulation, and as a result of that we have not been winning the battles when it comes to European regulation?
Lord Turner: No, I don't think that is the case. We have been focused very clearly on the European regulatory environment and many of the things that have occurred in Europe we have strongly supported. There have been debates, for instance, about the alternative investment fund management directive about things to do with passports and so on, but it includes within it the powers for the regulator to gather information to understand where prudential risks are emerging, which are precisely what we require to keep track of the shadow banking system. That has not been something imposed on us: that is something we've argued for. We are coming forward with European capital requirement directives, which are the expression into European law of precisely the things that we have been involved in agreeing in detail at the Basel Committee on a global basis. Now, of course, when things happen in European law, people may add bits of the agenda that we don't like, but the broad thrust has been things that we're arguing for.

Q757 John Mann: Why then is ESMA based in Paris and why do we have only one seat on ESMA?
Lord Turner: ESMA is based in Paris because CESA, which existed before, is based in Paris, and because CEBS, which will become the European Banking Authority, is based in London. A deal was done a long time ago that said there were three main committees, which are now three main authorities, and they are in Paris, London and Frankfurt.

Q758 John Mann: Yes, but some people might agree more with me that you have not had your eye properly on this issue. For example, Peter Clarke of the Man Group says, "The UK's bargaining position in Europe has been impaired". Mr Rolet, head of the Stock Exchange, goes much further: "The regulatory environment probably sows the seeds for the next crisis". That is pretty stark coming from the head of the Stock Exchange. Basically, Europe has trampled all over us while we have been restructuring in this country, hasn't it?
Lord Turner: No, I don't think that is true at all, and I don't think there is any evidence to suggest that, whatsoever.
Mr Sants: The European regulatory structure that is now being implemented from the beginning of next year was decided through a full European process, which is primarily one determined by governments rather than regulators, long before the proposal to restructure the UK environment was proposed. These decisions pre-date this entire debate we're having. These decisions were made in 2008 to 2009, not in 2010.

Q759 John Mann: So you disagree with Mark Hoban when he says that we've been losing the arguments in Europe?
Lord Turner: We do not think that we have been losing the arguments in Europe. You win some, you lose some; that is the nature of the European debate, and it always has been, and it will be the case whoever is the Government in power. We have been working with Europe to achieve some re-regulation of our financial system, and I'm a bit surprised to hear you totally supporting those who favour a completely light touch approach against the bad European imposition. I'm slightly interested—

Q760 John Mann: I'm asking the question because Government has made changes to our structures. A lot of time and effort has been spent on them. They don't come in until 2012, but Europe is up and running with its regulation in a month's time.
Lord Turner: Some of which are direct responses to problems that we have. Let's be clear that the problem of the Icelandic banks revealed to us that a single market in financial services can be a very dangerous thing, unless there is some mechanism at European level to check and challenge the quality of supervision in all the countries of the European economic area. We, and I think this Committee, argued that there had to be action at European level to deal with the problems that were revealed by that.

Q761 John Mann: You are putting up a robust defence of how that has been negotiated, which is very clear for the record. Has there been any step change in the last three months in terms of how effective we've been in winning arguments in Europe and, if so, what?
Lord Turner: I don't think there has been a step change, I think this is just a continual process in which we are extensively involved, the Treasury is extensively involved and, given the nature of European decision making, there are many things that result that we agree with and there are some that we disagree with. I think if you don't want that you should probably join UKIP.
Chair: We are going to be having Mr Barnier along very shortly and we will be able to take these issues forward there. Hector, I would like to draw this to a close now, unless John has one very quick question.

Q762 John Mann: Just one final question. What I am attempting to see is whether over the process, particularly since you've been in post, Lord Turner, whether in essence our approach to Europe on this matter of regulation has been consistent over your time in office, or if there has been huge variations during your time in office?
Lord Turner: I don't think there has been any variation. I think you can legitimately ask whether we have won all the arguments, but I've seen no sign of a shift in our approach during that time, because it has been a consistent process. That's what I would say.

Q763 David Rutley: I would like to turn to something at a much more micro level, which we have not discussed so far but I know many of us around this table have had some concerns from constituents around foreign exchange businesses, particularly Crown Currency Exchange. I know it's quite a complex regulatory environment—not complex, perhaps, but not well regulated—but the FSA hasn't been required to regulate all the activities, particularly on the foreign exchange activities of that company, and the administrators are reviewing the situation. That said, people are out of pocket, so it's not great. I just wondered what lessons you have learnt so far, prior to the administrators coming back? Are other companies being reviewed actively to determine whether their business models are fit for purpose? Are there any emerging thoughts about how you can improve the regulatory framework within the context of the twin peaks?
Lord Turner: What I suggest is Hector says something specifically on this case and then I'll just make one very brief point about a general principle we draw from this.
Mr Sants: It is an important case to focus on, not just because of the current consumer detriment but in terms of learning some lessons here for the legislative framework for the CPMA, which Adair can expand on in a moment. But, as you rightly point out, the FSA is not responsible for regulating foreign exchange transactions. Its only jurisdiction over Crown or similar business is in relation to the powers given it by the Payment Services Directive, in relation to money transmission—the forward activities where money is being paid to another party, not just by going in and exchanging your forex over the desk. The activity, therefore, the FSA have their engagement with is a very small portion of the Crown's business. We were not regulating Crown through the FSMA Act. We were running a registration service. We run a registration process under the Payment Services Directive. The only oversight we had was in respect to that registration, which requires a form to be submitted.
There is a significant misunderstanding here where consumers are under the impression that registration with the FSA under the Payment Services Directive in some way or other implies that the FSA is regulating and overseeing that type of activity in the same way as it does for FSMA firms: we do not. In my view that registration process does not imply any investor protection of any materiality whatsoever and, therefore, that was a misunderstanding. The power we should have had, and we've asked for, is the power to say to firms, "You cannot publicise the fact you are registered with us". The fact we run registration is an administrative service for the Government's compliance with the Payment Services Directive: it's not a regulatory activity.
So, no, we are not out there now looking at other firms because we are not regulating other firms in that space. We run a registration service. What needs to be changed is the confusion caused by that registration service. Then I think there are some wider perimeter issues.
Lord Turner: I think what this illustrates is that there is a distinction in the law and in our activities, between authorisation and registration, which I suspect is not clear to many consumers. What we essentially do on companies of this sort is register them in the same way that Companies House registers companies. The point is going forward, I do think one should consider going in one or other direction. Either we should not be the registrar of these things, or it should be done under a completely different brand name, or they should be authorised and regulated, but I do think we have a slightly uncomfortable—
Chair: We get the point. David, you have one more question.

Q764 David Rutley: Should they be authorised and regulated, based on what you see?
Lord Turner: I think there could be an argument for doing that. We'd have to think in detail about whether to do all of their activities. Certainly those that go beyond the straightforward instantaneous exchange of currency do not need to be regulated, because there isn't a risk in that, but for those where you end up with some sort of forward commitment from them to deliver your money, then arguably there should. But I think the crucial thing is that it's one of these things where we have to go one way or the other. We need clarity. We are in an uncomfortable position at the moment where we are being asked to do something called registration, which consumers probably think is more significant that it is.

Mr Sants: The longer term point is that it's very important that Parliament doesn't dilute the brand name of the CPMA. I think the CPMA, if it is to be set up as a consumer champion, needs to have the right set of powers, and it should only be overseeing those firms that that full set of powers apply to, otherwise you run the risk of dilution and confusion in the consumer's mind, which is what—quite understandably I might say—has occurred here, because we'd been asked by Government to take on these additional tasks, no doubt for the convenience of the process. We should avoid this convenient parking.

David Rutley: Thank you.

Chair: That is a very helpful exchange. We are running behind schedule and I think we all deserve a five-minute break and then we are going to resume—for, unfortunately, a briefer look than perhaps the subject demands—at competition and choice in banking. Thank you.

Thursday 25 November 2010

Members present:

Mr Andrew Tyrie (Chair)

John Cryer	John Mann
Michael Fallon	Mr George Mudie
Mark Garnier	Jesse Norman
Stewart Hosie	David Rutley
Andrea Leadsom	John Thurso
Mr Andrew Love	Mr Chuka Umunna

Examination of Witnesses

Witnesses: **Mervyn King**, Governor, Bank of England, **Paul Tucker**, Deputy Governor, Financial Stability, Bank of England, **Andrew Bailey**, Executive Director and Chief Cashier, Bank of England, and **Andy Haldane**, Executive Director, Financial Stability, Bank of England, gave evidence.

Q765 Chair: Governor, we had Hector Sants before us on Tuesday and he was asked whether he felt, as the FSA had done, that the Bank had been as explicit in owning up to errors that it had made in the preceding three years. He sort of got to an answer saying that the Bank had, but it took him some while. I wonder whether you wanted to comment.

Mervyn King: Well, not particularly. It seemed to me—

Chair: I'm going to oblige you to comment.

Mervyn King: You are? That's very kind of you. I did read the transcript of that and I must say that to describe your questions as leading would perhaps be an understatement. The words, I think, were yours rather than his. But the substance is this: from day one of this, way back in September 2007, we came to this Committee with quite a long list of lessons that we had drawn from this experience and things that needed to be put right. Initially that was about the need for a resolution regime for banks in the United Kingdom, from a change in the regulation of liquidity, changes in the regime for disclosure, later on capital requirements in dealing with banks, the whole regulatory framework, macro-prudential; a long list of things. Indeed, in response to your own Committee's report that came out in 2008, we have reformed the whole basis on which we provide liquidity insurance to the banking system. That is still evolving. We've introduced recently some new auctions that enable us to disentangle the incipient pressures on liquidity in financial institutions that we have relationships with. So I think we have a long track record of coming to this Committee and saying, "Yes, these things need to be changed".

Q766 Chair: The reason I ask is that you are going to be in an unprecedentedly powerful position. You already chair the MPC, there is the FPC coming along, there is the Prudential Regulation Authority and, of course, the ESRB, of which you'll be vice-chairman—Lord Turner told us that—as well as being Governor. That is quite a long list of roles. In fact he suggested you might need a new diary secretary. My question to you though is how somebody in such an unprecedently powerful position can best be made accountable to Parliament and to the House of Commons?

Mervyn King: One footnote before I answer that question, which is no decision has been made on who will be vice-chairman of the ESRB. That is for the General Council of the ECB and the European System of Central Banks to decide, probably in December, but that decision has not been made.

Chair: So Lord Turner was jumping the gun?

Mervyn King: He may well have been. The substance though is clearly an important one. But I'd like to distinguish between the individual and the institution. The institution of the Bank clearly will be more powerful with three bodies taking significant policy decisions: the Monetary Policy Committee—you've just met with the MPC—the Financial Policy Committee, to be set up fairly soon I would expect, and the board of the new Prudential Regulation Authority, which will come into effect once the new statutory framework applies at some point in the second half of 2012.

There are two kinds of accountability that matter on that, I think. One is on the policy decisions and judgments of those three respective bodies, where I think the principle is that those bodies should be accountable to Parliament and the public. They should not be accountable to the industry. They should be accountable to you. This Committee is the primary form of accountability and I think it is inevitable that there will need to be special hearings in front of this Committee for those various bodies.

The second form of accountability is accountability on resources, use of resources, management of the process. Do these committees have the right support? Are we providing the right framework of support for those three different bodies? In that, the Court of the Bank plays a very important role. It does so already in respect of the Monetary Policy Committee. It will do so in respect of the others. We have a smaller Court that is very actively involved. There is a highly professional Audit Committee, and the Chairman of Court spends much of his time inside the Bank of England. These people are deeply involved with ensuring that the Bank is managed and run efficiently and properly and we are transparent.

Q767 Chair: So we should be taking a closer look at the Court?

Mervyn King: I think you certainly should be taking a look at the Court and inviting members of the Court to report, not on the policy judgments, of MPC, FPC or PRA but on the use of resources in the Bank and whether or not the Bank is well managed. That is their responsibility, and you're entitled to hold them to account because they are appointed by the Chancellor to carry out that role, very clearly. As far as the individual is concerned—

Chair: I wasn't asking about the individual but by all means, do reply.

Mervyn King: What I hope you will see, and have seen both this morning and over the last 10 years, is that we have a pretty strong track record of ensuring that these decisions are taken not by the Governor, not by me, but by the committee as a whole. I have been in a minority three times as Governor on the Monetary Policy Committee. I think that is unprecedented for any central bank in an advanced country. We've demonstrated we can express different views and judgments because most people understand that these issues are ones that naturally result in different opinions.

Chair: And we have just seen that this morning.

Mervyn King: So I think we have a good track record on that.

Q768 Mark Garnier: I want to carry on on a similar sort of line questioning but more specifically to the FPC. There are going to be 11 members of the FPC, with only four external members. Do you think those external members are going to have enough clout to be able to hold everybody else to account?

Mervyn King: Their job is not to hold us to account, it's to contribute to a balanced judgment. I think they will. I think we've seen that on the MPC where it's four out of nine. I think with four out of 11, they won't all be internal bank executives. One of the seven, other than the four external members, will be the chief executive of the CPMA, the consumer protection body, and then you will have Hector Sants coming in as the chief executive of the PRA. So we have quite a range of different positions that people hold. I think they will have no difficulty in contributing fully. Of course that depends on having the right appointments, and no doubt you will want to look at those appointments when they're made.

Paul Tucker: The other thing that's worth saying here, if I may, is that this isn't a kind of internals versus only four or five externals. It's by having externals that changes the dynamic among the internals. The Monetary Policy Committee doesn't work on the basis of four externals and five internals. The big effect of having four externals is precisely to liberate the internals from a monolithic line management structure, and I think the FPC will be much the same. Having the externals there means that you just don't go along and say, "Well, it's absolutely clear what we ought to do and we all agree".

Q769 Mark Garnier: Which means, therefore, that the choice of the externals is incredibly important. One of the criticisms of this whole new regulatory regime, although perhaps it applies less to the FPC than it does to the CPMA and the PRA, and the problem that people are worried about is that it is, broadly speaking, banking focused. The whole of this change of regulatory regime is focusing on a banking problem. There are a lot of people who are worried about the fact that it's too banking focused and choosing these four other members to be external members is quite crucial. You're going to need potentially people who really understand the insurance market. You may even need someone like Martin Lewis from moneysupermarket.com who will understand the social effects at the poorer end. Have you given a huge amount of thought, as yet, to the type of people you will be seeking out?

Mervyn King: There have certainly been discussions. Of course, this is not the choice of the Bank. The names of the four external members is the choice of the Chancellor, and he will select those in due course. But what matters is not that people are representatives of particular types of business, industry, and certainly not representing an interest. It can't be that. Indeed, conflict of interest is a major criterion in choosing the right people. They must be free of any conflict of interest. What we need are people who understand the financial sector but can think through what the issues are.

Remember, the purpose of the Financial Policy Committee in the end is to protect the real economy from the consequences of unnecessary fragility in the financial sector. That's the ultimate purpose of it. The PRA is there to regulate the financial sector and to ensure the stability of the financial system as a whole. But the purpose of the FPC is to make sure that what goes on in the financial sector doesn't threaten the economy as a whole.

Q770 Mark Garnier: One thing though that might come out of that, given that you're talking about the financial sector and all the rest of it, is that it is therefore likely that we're going to find people from the City being those four external members. This could lead to accusations of cronyism or to a clubbable type of committee. How would you counter that?

Mervyn King: I don't think anyone thinks that the Bank of England is susceptible to cronyism or is excessively clubbable. I think we've always set out to do a job in public policy. One of the big changes at the Bank in the last 20, 30 years is that we are no longer seen as a body promoting the interests of the City. We are seen as a body carrying out a public policy role on behalf of the whole of the British economy. I don't know yet who the members will be but coming from the City is not of itself a qualification. Understanding financial markets and the damage that an excessive expansion and then contraction of the credit mechanism and the balance sheet of the financial sector can do to the real economy is what the FPC is all about. So we'll need to have people who can understand the consequences of that as well as having those who understand the financial sector.

Q771 Mark Garnier: So there could be academics coming in, economists?

Mervyn King: There could be a wide range of people. What matters is not the sort of label we attach to them but the individual qualities they bring. One of your functions, I think, on the Committee is to make sure that the calibre of person is, indeed, appropriate to the task to hand.

Q772 John Thurso: Governor, you are to be the chairman of the FPC and may or may not be the vice-chairman of the ESRB. But in either case you will have been involved heavily in both bodies. Do you think that decisions on macro-prudential policies at the European level, and indeed at other international levels, will impact on and possibly even undermine what the FPC do or can do?
Mervyn King: The macro-prudential role at European level could be extremely helpful. We will have, I hope, whatever happens in terms of positions, an influence on the debate and discussion and one way or another I'll be there, and the Bank will support this role and we will be able to discuss the macro-prudential questions in Europe. The ESRB will not have the power to instruct or determine what any national body can do. It may make recommendations of a rather generic kind, but I would hope that the analysis would leave them to make recommendations of a kind that would reinforce the ability of the FPC in its role, rather than contradict it.

Q773 John Thurso: Can I just flesh that out? And it may be that I'm misunderstanding what the ESRB can do, but supposing they took a decision that the capital requirements, adequacy requirements, within banks as part of a countercyclical move were necessary and a judgment was made by the FPC in the UK that it was not necessary. You're saying that the UK's will would predominate.
Mervyn King: Indeed.
John Thurso: In that situation, is there not a tension then or is that just going to be one of those things?
Mervyn King: There is a tension, but I rather doubt that the ESRB is going to say we have specific recommendations for each of the countries in the European Union as to what they should be doing this week to countercyclical capital requirements. I think it's going to be a much more generic issue about where the big risks lie. It may well be that they say this is the time when macro-prudential regulators around Europe should think about raising capital requirements and increasing those countercyclical buffers. They will have to be applied to individual circumstances, which is a national responsibility, but I would hope that the arguments would reinforce each other. I see no reason at all, based on past experience, as to why they wouldn't.
What I think is more relevant, and where I'm slightly more concerned, is that what I think we could slip into if we're not careful—and this is very much a matter for Parliament, it's not for us—is that if we have one European body saying that in the context of the Capital Requirements Directive, CRD4, the latest variant of it, there is a ceiling on how big these countercyclical buffers could be and then another European body, the ESRB, says, "Countries should be putting up their countercyclical buffers", what you don't want is a uniform ceiling on what can be done in each country, which prevents the national macro-prudential regulator from implementing the spirit of the ESRB recommendation.
I think it is going to be very important that at European level we ensure what the ESRB is capable of achieving, which is drawing to everyone's attention the risks and the need to take action about them, but that we don't, by accident, put in place some harmonisation requirements that prevent the national macro-prudential regulator from carrying out its task.

Q774 John Thurso: That's a very important point that you raise, and I'm sure it's one we will come back to. Can I ask one quick question to Paul Tucker, please? The FPC will be required to report every six months under statute. The Bank already does a report. Is this just going to be the same report or are there differences?
Paul Tucker: First of all, I think it's worth saying that there will be a report of each quarterly meeting and then, as you say, we envisage a six-monthly report. It will take the current *Financial Stability Report* as the base, but I think it will end up being somewhat different because it will be explaining the decisions, and the analysis lying behind the decisions, that the FPC are taking.
The really big change here, and I do think the FPC is the big institutional change, is moving the Bank of England away from commentary to taking decisions, making concrete recommendations, and the FSR will have to move away from being a document where it's trying to set out an analysis in the hope that somebody with some levers somewhere will pick them up and use them, which sounds rather pathetic, in hindsight, doesn't it?

Q775 John Thurso: The big difference is you'll be able to report on what you've done.
Paul Tucker: Exactly, what we've done and why we've decided it. Then you will be able to say, "Well, hold on, does the analysis support what you concluded or did it lead to another place?" I think, for what it's worth, you'll be helped in that the public commentary around the FSR will get transformed over time.

Q776 Andrea Leadsom: Andy Haldane and Paul Tucker, on Tuesday this week we heard Hector Sants telling us that he believed the next crisis would come from banks trying to push leverage away from their regulated entities and on to consumers. A specific example given was exchange traded funds where consumers may end up bearing the risk of leverage. Do you agree that that could be where the next crisis comes from?
Andy Haldane: Shall I start? I think certainly this goes back to a point that was raised, I think, earlier on by Mark. The last crisis was centred in the banking system and there is always some risk of fighting the last war. So, I think looking forward from now, there is some danger, as we tighten regulation of the banking system, that risk migrates elsewhere. You mentioned one possible avenue; there are others. Paul and others have spoken, for example, of the shadow banking system. There are vehicles or conduits off the

balance sheet that can harbour leverage or maturity mismatch and can cause many of the same problems we saw banks causing during the crisis. So I think that is a real risk. It was a risk in the run-up to the crisis that was realised, and the risk hasn't been lessened by the crisis.

How best to address that? I think a key aspect of the FPC's remit is to look beyond the boundary, to police the perimeter and to reach a judgment on how great the risks are beyond the perimeter with a view then to making recommendations to Government about whether that boundary needs to be shifted, where the regulatory perimeter might need to be extended to prevent risks migrating and growing.

That is a problem, that regulatory arbitrage has been with us forever. It will be with us forever. The best we can do, I think, is to try and track it in real time and, where action is needed, for us as the FPC to make recommendations.

Q777 Andrea Leadsom: Thank you. So, Paul Tucker, does that give you a concern that with the PRA regulating the banks themselves and the CPMA regulating orderly markets, where those two things meet is exactly where the next crisis might come? Is that something that would worry you?

Paul Tucker: I believe in twin peaks and so the splitting up of the FSA does not worry me. I have believed in twin peaks since the mid-1990s, before the 1997 election. That is widely known, although I'm not sure I've stated it so candidly to you before. But what does matter is that there's co-ordination. When you move everybody around, you shift the point at which co-ordination and co-operation is needed. The chief executive of the CPMA will be on the FPC. The whole point of the FPC, in a way, is to step back from the particular micro-regulatory mandates that are being given to the PRA, CPMA in the future and say, "Does all this fit together?"

One problem over the past 10 years—it may have happened if we'd been the regulator, who knows—is that the banks issued loads of subordinated debt that counted as capital within the banks and the insurance companies bought this debt as almost risk free as an interest rate hedge. So that didn't fit together very well. What has been missing, one of the big four lessons, is that you have to give somebody the mandate of stepping back and saying, "What is going on here?" Then if I may, coming back to your question about problems beyond banking, yes, that is something that I am concerned about. We think that domestically the FPC will help. We have encouraged the International Financial Stability Board to make this one of the themes of its work in 2011. A world in which we try and sort out the safety and soundness of the banking system or of the securities markets and then don't go on and say, "What are the behavioural effects of that?" would be naive.

I'd like to make one other particular point, because Hector mentioned ETFs. I do think that the inclusion of leverage in ETF structures is something worth watching. We talked about that, either in the last FSR or the one before that, and we think that in this country, and in America and elsewhere, it will warrant monitoring.

Q778 Andrea Leadsom: Just very quickly then, for clarity, are you saying that the FPC will form the role of ensuring that there is the oversight of the activities going on in the PRA and the CPMA? Clearly what we had under the previous tripartite arrangement was a situation in the Northern Rock case where different regulators weren't quite sure where the accountability lay. Are you saying that under the new twin peak regime the FPC will fulfil that role and will be able to ensure that there is that co-ordinated leverage?

Paul Tucker: Where it bears on stability. Where it bears on consumer protection and the adequacy of services provided to consumers, absolutely not at all. Where it bears on the soundness of individual institutions, if they can fail safely, that will be for the PRA and the PRA board, but where it has a bearing on stability, yes.

Q779 Andrea Leadsom: Just one very quick question for the Governor. The CPMA always suggested to me that it was a kind of consumer type of organisation. Do you think it should be called the MCPA in order to give proper weight to its markets' role as well as its consumer protection role?

Mervyn King: I don't think it's for me to say what it should be called, but what is very important is that you and others hold it to account for looking at both of those. They are distinct roles, and they are both very important. But what to me is the most important thing is that both are distinct from the style and type of regulation that is prudential regulation. Prudential regulation is not about enforcing the rules. It is not about checking whether people have complied with particular provisions. It's about judgment, it's about whether the balance sheets of the regulated institutions are creating too much risk for the system as a whole. The purpose of prudential regulation, unlike the regulation in either market enforcement or consumer protection, is not about checking whether the individual institution has or has not done something, will or will not fail, it's about the risks to the system as a whole. That's the sole purpose of prudential regulation. We will not be setting out to ensure that institutions never fail. Institutions will fail. The crucial point, as Paul said, is that they can fail without causing disruption to the rest of the system.

Chair: I'm glad you took that question very seriously. Names and even acronyms carry resonance and so if you come to a view in the fullness of time, we'd be interested to hear it. Jesse Norman.

Q780 Jesse Norman: Thank you very much indeed. The Government owns substantial positions in several of the major banks through the Bank of England. Do you mark those to market? Do you keep an eye on how much they're—

Mervyn King: No, that is the job of the UKFI and the Government. It's not for us.

Q781 Jesse Norman: Thank you. You talked about conflicts of interest; do you think that creates the potential for conflicts of interest, either from a Government policy standpoint or from the position of the Bank itself?

Mervyn King: I think from the perspective of the Government, we've seen that in every European country in this crisis the Governments, in order to take stakes in banks, had to ensure that they were not violating the rules of competition at the European level, and I think the European Commission has done a very good job at enabling governments to deal with the financial crisis, while still ensuring that there is a proper competitive framework. No Government, I'm sure, wants to maintain permanent stakes in these institutions. It was necessary in the crisis in which we found ourselves in October 2008. I think there was no alternative to it at that point. The question is what is the best way over a period of time in the interests of the taxpayer to get out of it. I think that's a matter for Government.

Q782 Jesse Norman: But in the very broad spectrum of decisions that the Bank is going to take with regard to the stability of the financial sector, can you be certain that, as it were, you'll be motivated purely by those factors rather than a desire to maximise the value of the stakes that the Government holds in the banks?
Mervyn King: I can give you an absolute assurance that the members of the PRA board and the Bank of England would be motivated solely by our concern for the stability of the system and the remit that the different committees will be given. We have always given enormous weight to the remit to the Monetary Policy Committee that we are given by Parliament, the remit that will come from you to the FPC and the remit that again will come from you to the PRA board.

Q783 Jesse Norman: I'm very grateful for your crisp answers. Lord Turner has previously been very clear in his own mind in a series of lectures that he regards the huge growth of the financial sector over the last 20 years in this country as essentially distorted in many respects, and its ability to take high capital sums as rents out of the economy as, in some respects, rather dangerous. From a financial stability perspective, do you think there is a risk that the financial sector is too large compared with other parts of the economy?
Mervyn King: If you look backwards, what we saw that was far too high was the leverage in the banking sector and the financial sector as a whole. That made it fragile. That was the brunt of the problem. It was the extraordinary degree to which the leverage of the sector rose.

Q784 Jesse Norman: So you don't take a position as to whether or not that occurs—the sector could be 98% of the GDP of this country and you wouldn't have a problem with it?
Mervyn King: The point I have made, and I think this is of fundamental importance, is I don't think it's for us, or indeed for any of us here today, to try and second guess the market as to which sectors should be big or small. But what is fundamental to that is that if you have a sector that has institutions that are too big to fail, too important to fail in my language, where Government feels it has to stand in to support them, then you get a distorted market incentive where those institutions can borrow money more cheaply than they would otherwise be able to do, and hence become bigger. That is a distortion and that bit needs to be removed. But if we can find an answer to that too important to fail problem then I think we should let the market decide what institutions can survive.

Q785 Jesse Norman: Thank you. A final very quick question: Lord Myners suggested in testimony to this Committee that as part of the compensation of bankers it should be paid in subordinated debt in commercial banks and potentially other organisations as well. Do you think there is some wisdom to that idea?
Mervyn King: I'm not going to comment just like that on the form in which compensation should be paid. I think a lot of these problems go back to the question of if institutions are given implicit subsidies from the taxpayer because the people who fund them believe that they're too important to fail, that's when it becomes possible for levels of compensation to become excessively high.
I don't think we would have to worry about levels of compensation were we to believe that there were not implicit subsidies that are available to those institutions that, during a crisis, have turned into explicit subsidies.

Q786 Jesse Norman: But you don't think that equity compensation might have given the leaders of the banks too much of a growth agenda, too much on building up the balance sheet?
Mervyn King: I think that the incentives that have been created by linking compensation to the rate of return on equity is clearly a distortion because it gives an incentive built in to raise leverage. Other things being equal, for a given return on assets you can increase the return on equity by raising leverage. I have never understood why people thought it was a sensible idea to base compensation in these institutions on the return on equity. Return on assets is a better method.
Jesse Norman: I think it's very important you said that. Thank you very much.

Q787 Chair: Extremely valuable. It's a subject to which I have no doubt we will return, unless you have something in particular you want to add briefly.
Paul Tucker: I was just going to say that I have aired that issue in two or three speeches, but on broadly the same lines as Paul Myners and the Governor has just now.

Q788 Mr Love: Mr Haldane, can I turn to the issue of supervision? There have been reports in the newspapers that the Bank is considering a less intrusive form of supervision for the PRA. I understand that they may be a little wide of the mark, but perhaps you can set the record straight as to whether there is going to be a change in the style of supervision.
Andy Haldane: It's for the Governor and Andrew maybe to speak more directly about the plans on the supervisory front, but speaking to the newspaper article to which you refer, the issue here for me, for us, is not one of intrusiveness, intensity or not. This is more a question of degree. So I think where the

risks are large it is appropriate that the regulation and supervision is appropriately intensive and intrusive. So, should we have been intrusive about a big bank taking over ABN Amro? Yes. Should we have been intrusive about the big portfolio of asset-backed securities that banks were holding on a mispriced basis? Yes. Should we have been more intensive about banks laying off their risk to a single insurer, such as AIG? Yes. I think those are all places where the risks are large enough where you want to take a very close look.

Equally, I think, where the risks are of a lesser scale, one of the ideas would be that we can afford in those situations to be somewhat less intensive and intrusive. So, a focus on the bigger risks and somewhat less on the smaller ones.

Q789 Mr Love: Mr Bailey, Hector Sants said people should be very frightened of the FSA. Should they be very frightened of the PRA?

Andrew Bailey: It goes back to what Andy has just said. We will be intensive and intrusive on the things that matter. You don't set out to frighten people but they should be very clear that that's where we will be focused, and the one thing I would add there, building on what Andy has said, is that the thing that helps here in the new arrangements is that there is what I call the driving overall objective of the stability of the financial system. I'm not saying that to frighten people, but they should be very clear that that's our focus and it will be an intensive focus. That's what they should be clear about.

Paul Tucker: Fear is the language of securities regulation. You write a rule, you check compliance with it. If the rule isn't the right rule it should still be complied with because capital markets have to work within rules; if the rule is breached it requires punishment. This is not the function of the PRA or of the FPC. The language of fear may or may not—it will be up to its management and board—fit with the CPMA. It is not the right way of thinking about the function of the PRA or the FPC. Distance, respect, professionalism, prioritisation, all of those words, but we don't need people to fear us. We do need people to expect that we will take action without fear on our part when it's needed to protect the stability of our financial system.

Q790 Mr Love: That sounds to me like there's a gap opening up between the style that the PRA and the CPMA will undertake.

Paul Tucker: No, I don't think so. I know Hector pretty well and the circumstances in which Hector made those remarks related, I think, to the other part of the FSA's business rather than to the safety and soundness of the core banking system.

Q791 Mr Love: In terms of leadership, Governor, you are leader over all of this. What leadership will you give to the differences that are likely to emerge between the two supervisory bodies?

Mervyn King: Between PRA and CPMA?

Mr Love: Yes, the PRA and the CPMA.

Mervyn King: I don't think that there are obvious differences in terms of their judgments, because they are dealing with very different aspects of the behaviour of financial institutions, and I see no obvious reason to suppose there would be differences in their conclusions. They'd be dealing with different problems. The style of regulation will be very different between the two, very different. As Paul has said, there's a good reason for that, which is that the issues are quite different and the appropriate style of regulation should differ.

My leadership will be based on a recognition that I have very strong people working under me. I will have three Deputy Governors: Charlie being on monetary policy, Paul Tucker on the macro-prudential and Hector Sants on the micro-prudential. They are supported in turn by three very strong people in Spencer Dale, you saw this morning, on monetary policy, Andy on macro and Andrew on micro.

Q792 Mr Love: Let me just stop you because I'm being ko'd by the Chairman. Is there more than just the difference between who it is you are regulating or supervising? Is there a philosophical difference between bankers' attitude towards this and regulators' attitude?

Mervyn King: I don't know, because this is not a function of bankers versus regulators. This is about the central bank being concerned about the stability of the system as a whole. What is different from the CPMA is that they are not concerned as such with the system as a whole. They are concerned with the conduct of individuals and individual institutions within it. We are concerned with the stability of the system as a whole. We obviously do it through supervising individual institutions, but the objective is very clear. It's the stability of the system as a whole.

Q793 Mr Mudie: I'd like to take you back to Andrea's question, because I think we seem to be getting the regulatory system right in terms of the banks, and there seems to be an international consensus about the direction. What I'm not convinced about is how seriously we're taking the shadow banking system. Andy, you use the word "perimeter" as though we can build a fence and we'd watch that they would not intrude and damage our system, whereas Paul, I thought, indicated an awareness that that might not be enough by referring to the "International Settlement Board", I think it was, because it is an international thing. I need convincing, we need convincing and the ordinary public needs convincing that we're not tidying up the system and that's enough, given that there is a secondary system, which is twice as big as the visible banking system, and it seems to be unregulated. How can we convince people the crisis will not happen again if there is this massive secondary system working, and it's largely unregulated? I couldn't get an answer from Lord Turner a couple of days ago about how much it was regulated. Can we have any reassurance or is anybody working on it at international level?

Paul Tucker: Shall I take this? They are working on it internationally and I think this will get greater momentum during 2011 for precisely the reasons you say. Two or three points, if I may. First of all, some things have been done to strengthen capital markets.

Stepping back, one of the roots of this crisis is the whole regulatory regime in this country and internationally did not keep up with the evolution of our capital markets. Some things are being done to strengthen this. eg the whole business of putting more of the over the counter derivative markets through central counterparties. This is an unambiguously good thing. It is a terrible tragedy that it's happening now rather than a decade ago. The reason that's relevant to your question is that some of the shadow banks will be part of that. It's not just for the regulated community. That's the case, both in the States and over here.

A second point is that some manifestations of shadow banking are effectively derivative of banking because their lifeblood is a liquidity line from the banking system. This is the most malign form of regulatory arbitrage in a way: where it's not consolidated, it depends on a liquidity line, but it's kind of offstage somewhere over here. The bank regulators can do something about that. The regulators, PRA, FPC, should not be allowing the banking system to feed and fuel a monster that is offstage.

The third point I would make is that there is a very big debate going on right now, particularly in the United States, about some forms of shadow banking. Other than the so-called Fannie and Freddie, the biggest form of shadow banking in the world is the money market mutual fund industry in the United States. This is about the same size as their banking industry, and it's not a domestic US thing. It has global implications. They fund the European banking system to a significant degree. The so-called President's Working Party, chaired by the US Treasury Secretary but bringing all their agencies together, has recently issued a report on options for fundamental reform of one kind or another of that industry. I think this is of first order importance to us, even though it's somebody else's domestic financial system.

The fourth point I'd make, if I may, is how one does horizon scanning in this area. Even if we get the right list of shadow banks or non-banks now, how on earth do we do that in the future? The Governor referred to three executive directors. I would add that I think the Markets Director of the Bank of England has a profoundly important role to play in the coming years and decades in knowing sufficient about what's going on, in partnership with the New York Fed, the two central banks in big financial centres acting as a radar service and bringing issues to the FPC and others, and having a bias to think something might be an issue, examine it and prod it rather than thinking that it's always a benign variant of capitalism.

Q794 Mr Mudie: That is reassuring to this extent, it's an indication of an awareness of the problem. The worry I have is the dates you mentioned. I don't think that they are realistic in terms of getting agreement, particularly given the American political situation, and I fear that it will run out of momentum and we'll be satisfied with a public edifice.

Paul Tucker: Yes, it's a risk. For what it's worth, my personal view on this, and I spend a lot of my time, as my colleagues know, at international meetings on this with Adair Turner, is so long as unemployment remains unacceptably high in this country, the rest of western Europe and in America, I don't see the momentum behind it weakening.

If you sit round the Financial Stability Board table, we still feel, quite rightly, under pressure from the G20 Finance Ministers and the G20 leaders, to make the system safer. That's why the agenda internationally for 2011 is a development in the direction that you describe. Are we bound to get it right? No, we're not. If I may say so, I think your focusing on this as a committee is quite an important part of the process going forward.

Andy Haldane: Can I just add, just re-echoing Paul's points, it's clear from the crisis that our fleetness of foot on things like monitoring risk and in regulating risk needs to change gear fairly fundamentally. So an example: the Basel agreements. Basel II was 10, 15 years in the making, and the cake was not palatable once we'd finished. Basel III in regulatory terms has moved through at warp speed, so we're close now to having an agreement, basically in the course of 12 to 18 months. I think that pace of change, that fleetness of foot in both what data we collect and how our regulation operates, needs to be carried forward importantly into the future otherwise we'll miss the next risk.

The second point, just very quickly, is however we shouldn't always, I think, jump to regulation being the solution. So, there are parts of the financial system that operated rather well outside of the regulatory net. Hedge funds, which were the bogeyman going into this crisis, have been a part of the financial system that has performed relatively well, partly because they were able to die and then spring up without causing very much collateral damage to the manner in which—

Mr Mudie: You're not cheering me up here, Andy, if hedge funds is the best you can do.

Andy Haldane: The general point, though, is before we leap always to regulate that which we see moving, we should ask ourselves the question: is what they're doing, can we link it back to a malfunctioning of the system, to the flows of credit, to the flows of payments? If we can't, it might be better left outside of the regulatory net.

Chair: The Governor, on numerous occasions, has told us that there are limits to what can be achieved by regulation, and also that there are costs to getting it wrong, and no doubt we will come back to that on a number of occasions. It would be very helpful for the Bank to think through how those points can be articulated in more detail in the debate of regulatory structure in the months ahead.

Q795 David Rutley: In your evidence to the Committee over the years, and particularly the last few sessions that I've been at, you've been very clear about the purpose of the Bank of England, what it does and doesn't do. You've demonstrated that again today. With the new structures that come into place with the new regulatory framework, what makes you feel comfortable that you'll continue to have that same clarity of purpose given that much wider remit?

Mervyn King: I think that's one of my primary tasks as Governor, to give that leadership to ensure that we

do. I think a key part of it, and what has been very helpful over the years, is that in monetary policy the fact that you in Parliament gave a clear remit to the Monetary Policy Committee in my view was fundamental to the Monetary Policy Committee operating as an effective body. We didn't have to sit round and work out what our objective was. We were given the objective. I think it's important that you give us a clear remit for both the Financial Policy Committee and the PRA. I think, broadly speaking, as I've described it, it is fairly clear and I think they reinforce and complement each other. We saw as a result of the crisis that monetary policy became more difficult because of a severe instability in the financial system. Equally, over the years one of the causes of instability in the financial system has been highly volatile monetary policy creating instability in the macroeconomy.

So I think if we can succeed in these three different areas they will all naturally reinforce and complement each other. To that point of view, they're all part of the same overriding vision of delivering one word to the British economy, and that's stability.

Q796 David Rutley: Do you think you've been given a clear enough remit for FPC and PRA?

Mervyn King: They're still discussing what the wording will be but, broadly speaking, I think we're going down the right lines, yes. But, of course, in the end, you in Parliament will debate and agree that wording.

Q797 David Rutley: In terms of your priorities then going forward, as you see the landscape, which isn't completely constructed yet, what are your top priorities and how would you communicate any change of priorities that you see as the landscape changes yet further?

Mervyn King: The first priority of the Bank is to make sure that we meet the inflation target and communicate effectively the reasons why we believe that inflation is presently above target, and that we think policy is on track to deliver monetary stability. The second is to explain the transition to the new arrangements, because we can't determine the actions or the views of the FPC or the PRA board until they're set up and created. Only they can do it.

It's clearly a big transitional job. I know people think of this as being a major extension of the Bank's responsibilities and in a formal way it is, and that's why there needs to be new accountability. But of course since October 2008, we have been deeply involved in the management of the liquidity and regulation of major banks in this country and worrying about stability of the system. So, in practice, I don't think what happens today is that different from what has been going on. Andrew could say more because he's been deeply involved in it.

Andrew Bailey: You don't want me to tell you the whole story since autumn 2008, but that's right. It comes back to the fact that we have now two big responsibilities as the central bank today, which is the age-old responsibility of being the lender of last resort and providing liquidity to the system. Now we have the formal responsibility of being the resolution authority, which of course then creates a regime in which you can handle bank failures. Both of those things reside in the Bank of England now, and they have to be properly tied up now to the objectives of the prudential supervisor. One of the big things we're doing in looking and designing how the PRA will go about its job is to do exactly that; tie those up so that we understand why we're regulating banks. We understand that we can deal with them if they do get into trouble and all that fits together. That's critically important. We can do that now in a sort of integrated approach.

Q798 David Rutley: In terms of the new structures and the relationship with the Treasury, obviously it's going to be very important that you have the proper level of accountability, and the Treasury is going to have a role on the FPC, one non-voting representative. Is that enough? Should the Treasury have a vote? Some people say it should. And should the Chancellor ever be in a position to be able to overrule the FPC?

Mervyn King: I think not. I think there is a very clear division of responsibilities and this is why I think to give the Treasury a vote puts the Chancellor in a more difficult position because he might then feel accountable for the decisions of the FPC, and he's not. He's accountable for setting the remit of the FPC, with the agreement of Parliament, and you hold the FPC to account. The fundamental area where the Chancellor has the overriding power of decision is on any action that involves the use of taxpayers' money. Any use of public money is a matter of decision for the Chancellor. One of the arrangements that I've discussed with him, that is a new proposal in the consultation document, is that there be a very clear formal requirement on me, as Governor, to give the Chancellor adequate information and time to reach decisions on anything that could be said to involve public money. He should be accountable fully for that and responsible for it.

When it comes to the decisions on the regulation of individual institutions or the decisions about the instruments that you will give to the FPC about, for example, countercyclical capital requirements, those are the responsibility of the FPC and shouldn't be second guessed by the Chancellor. They have to be decided by those bodies. If you don't like the idea of those bodies taking those decisions, then please don't set up the FPC or the PRA board. But if you choose to set them up, then let them do their job. But where public money is concerned there will be arrangements in place to ensure that the Chancellor always takes those decisions.

Q799 David Rutley: One final quick supplementary: are there any things in the relationship with the Treasury that you're uncomfortable with at the moment or think need to be further clarified?

Mervyn King: There's a lot of detail still to be sorted out on the drafting of the legislation for both the FPC and the PRA. A lot of detail is being discussed as we speak. So I think we'll have to see how those discussions go.

Q800 Stewart Hosie: Paul, you are Deputy Governor for Financial Stability and Hector Sants, as the chief executive of the PRA, will be Deputy Governor for Prudential Regulation. Will there be any overlap between you two and the roles?
Paul Tucker: I hope so. Formally, I will be on the PRA board. Hector, the person holding that job, will be on the FPC board. You may be surprised that I say I hope for overlap, but, as I've said before, I feel very strongly that one of the problems in the previous system was that there was underlap. Underlap is terribly comfortable for bureaucrats because nobody accuses each other of turf in a world of underlaps. It's just terribly bad for society. We need to tolerate a little bit of overlap, while being careful about efficient use of resources for the obvious reason, which is that—this is true of any financial system, but it's particularly true of our financial system with a relatively concentrated banking system—lots of the questions of the resilience of the system as a whole are going to come down to questions about the resilience of individual institutions.
Going back to Mr Mudie's question, you can't become so dazzled with that proposition that we don't look beyond the individual institutions, and so we're going to have to find ways of bringing PRA insights on individual firms into the FPC, while ensuring that the FPC remains focused on what only it can do, which I think will be mainly the job of the Governor and partly my job.

Q801 Stewart Hosie: I'm very pleased to hear your comments on avoiding underlap. I share Andrea's view about the huge gaps that existed in the tripartite. What then happens to the existing financial stability function at the Bank under the new structure? Does it merge with the Financial Stability Division of the FSA, does it become a secretariat of the PRA or the FPC, because there's clearly going to be a great deal of experience in the existing financial stability function at the Bank?
Paul Tucker: Little bits of all of that. In the first place, not only the financial stability directorate of the Bank of England—in fact the Bank of England's financial stability directorate does not map one-to-one into the Bank of England's financial stability mandate, but both that directorate, Andy's directorate, Paul Fisher's directorate, who is the Markets Director, Andrew's, and at times Spencer Dale's, the monetary side, will need to feed into the FPC and they will need to think of themselves as serving the FPC in the way that the monetary analysis and markets parts of the Bank think of themselves as servicing the MPC.
The second part of your question is are there people or functions within the FSA that would perhaps most naturally become part of the financial stability, small "f", small "s", part of the Bank of England rather than the PRA? In my view the answer is yes, because there are people in the FSA who understandably, given the tripartite structure, aren't working on the prudential supervision of individual firms but are trying to pull it all together to make the FSA's contribution to the tripartite on stability.

Q802 Stewart Hosie: That's again very helpful. I take it the work is underway to identify the individuals, their roles, where they would sit and the lines of communications, so that's done and dusted as best it can be.
Paul Tucker: That will be down the road a bit. The priorities right now are the much bigger shift of staff to what Andrew will be involved in the PRA.

Q803 Stewart Hosie: Can I ask a slightly more general question? Governor, you spoke about how a bank or financial institution might fail, and we have the new resolution regime in place. A lot of the talk about managing this is at the very high level with managing out systemic risk. I'm concerned that when I hear that sort of language, and we heard it from Lord Turner and Hector Sants as well, I'm not hearing an awful lot of talk about how we manage specific risks in specific institutions to try and manage out their failures in the first place. I'm not filled with confidence, and I suspect the general public most certainly won't be, if we have an elegant failure of a bank. I think we'd rather have all of you in all of the organisations mitigating the risks from happening in the first place. How does that work?
Mervyn King: I think this would be a profoundly mistaken view to pursue, to be honest. If you felt that our job was to ensure that the management could never take decisions that led to the failure of the institution, then what you're asking us to do is to be a shadow management of that institution. It is very important that management fears failure, that they can be thrown out of their jobs, not by us but by the shareholders, and that if necessary, an institution can be allowed to fail in a way that does not disrupt the financial system as a whole, such that retail depositors are protected, their accounts can be switched to another bank.
If we do not have that then you are basically saying that our job is to ensure that all the institutions that we regulate are, in some sense, too important to fail. I can't understand why, if that's the case, they're in the private sector at all.

Q804 Stewart Hosie: I'm not suggesting that at all. But I do wonder, and I suspect the general public will wonder or hope and expect that the regulators and the supervisors will manage or at least supervise sorts of things such as products and the levels of leveraging—I am not talking about specific decisions—much better than they were previously.
Mervyn King: Let's be careful what is at stake here. We will not be regulating individual products; that's for the CPMA. If banks are taking a lot of risk with leverage that we think is creating risk in the system as a whole, then we will put a stop to it. We would like to have the power to be able to limit leverage directly. We will certainly raise capital requirements on individual institutions if we think those risks are excessive.
But our focus will be on those big risks and not on trying to chase round each and every individual institution to make sure that everything they do is sensible. That was what failed around the world. The one thing we know was that we were not short of the

numbers of regulators; there were lots of them all over the world. They failed to spot the big risks. It's not numbers that helps here. It's having quality people who will sit back and prepare to challenge the chief executive, look in the whites of his eyes and say, "I don't believe you when you tell me your balance sheet is safe. An extra requirement on your capital, please, until you can convince us that you're not taking a set of risks". That's the kind of judgment that will be required, and it is very different from the style of regulation that we've seen, at least over the last decade or so.

Q805 Mr Umunna: I'd just like to ask you, Governor, about the regulation of the actual activities that our banks engage in. Earlier this year, at the World Economic Forum, Bob Diamond, who has reached some notoriety for various different reasons, argued very strongly in favour of maintaining universal banks. The impression I get from the comments that you have made, Governor, is that you clearly disagree with him on that. If I just quote to you some of your Mansion House speech in June last year, where you said it's not sensible to allow large banks to combine High Street retail banking with risky investment banking or funding strategies. I raised this issue with Lord Turner when he appeared before us on Tuesday. I was just wondering whether you could perhaps on the record clarify for us exactly what your position is on this. Do you take a position that is akin to, say, Glass-Steagall, which we had in the States, that required a complete separation of investment from retail banking, or do you take the position of, I think, the Dodd-Frank Act, which is that you should simply take proprietary trading out of it, or are you in the place that it appeared that Lord Turner sits in where he said the important thing was that you can have all these activities but you need to erect firewalls between certainly the retail part of what a bank does and the rest of its functions? Where are you on this and is my reading of you clearly disagreeing with Bob Diamond correct?
Mervyn King: I'm going to repeat what I said before, which is I think firewalls are important because at one level it's very hard to say to people, "Your deposits are certainly safe", which is what we do want to say to retail depositors, and allow the same balance sheet to take highly risky activities. It's not possible to tell people that highly risky activities can always support safe deposits. Somebody has to be there in order to square the circle, and at present it tends to be the taxpayer.
That's the principle; we need to think about the nature of the firewalls. How to do that? I don't think Glass-Steagall is terribly relevant now because that is something that was put in place in the 1930s to separate particular types of activity. The principle of thinking of firewalls is important, but I don't want to take a strong position on how, in practice, that should be done until the Independent Banking Commission has reported. They've been set up to look at these issues. I don't want to make life difficult for them by saying this is what they should say in their report. I want to wait. There are difficult issues here. The principle is not institutional separation, it's separate balance sheets. The firewalls have to be between different balance sheets for different types of activities. That's the principle. What that means in practice, I would like to wait and see what the Independent Banking Commission has to say and at that point I will be very happy to come back to you and discuss it with you.
I'd say one last thing, which is we can afford to take the time to do this. There are other areas where we need to work more urgently, but in terms of these longer run structural questions of where the banking system goes, we have time to sort this out. At present the banking sector is headed still in the direction of contracting the size of balance sheets. The time we need to worry is probably 10, 20, 30, 50 years down the road when the memories of this crisis have faded and people haven't put in place the lessons we should draw from it.

Q806 Mr Umunna: So in some senses, I suppose, those who have been characterising your position as being one against universal banks have been slightly over-egging the pudding?
Mervyn King: I have quite deliberately avoided saying that this is a detailed specification of what should happen. What I've tried to set out in my public comments is an analysis of what went wrong and what is wrong with our banking system. I've tried to be clear about that. What we should do about it, I would like to leave that for the moment to the Banking Commission.

Q807 Mr Umunna: Delaying comment, which is a perfectly sensible position, Governor. Just one other question. You gave a speech, I think in October, where you talked about the size of the top 10 banks and how they have reached 450% of GDP, and there has obviously been a concentration as well in the market. Do you think that concentration has resulted in reduced competition, and do you think that contributed to the financial crisis?
Mervyn King: I don't think reduced competition as such contributed to the financial crisis. Whether it led to less effective competition, particularly at the retail level, is something that again the Banking Commission is looking at. What I think is the most important thing about this is that Britain is very well placed to be a successful international banking and financial centre. There are many reasons based on history, a wide range of ancillary institutions, legal, insurance and other, that contribute to being a successful financial centre. But what this crisis has shown more than anything else is that a country that has a very large banking system relative to the size of its GDP cannot afford to allow the too important to fail problem to be one where every now and then, even if it's only every 50 years, the taxpayer ends up standing behind the banking system. That is what is happening in Ireland today. Their banking system was too large for their economy to cope with when it got into serious trouble. The same was true in Iceland.

The reason why Switzerland has introduced such large capital requirements for its big banks is for exactly the same reason. And I think one of the big lessons for the UK is we should be a major international financial and banking centre. We have every comparative advantage but it is vital for the health of the British taxpayer and the economy that we can ensure that it's structured in such a way that it isn't, in future, too important to fail.

Chair: That's a very interesting and important set of exchanges on which to end. I'm very grateful to you for coming along today and particularly for being prepared to stay for what is just a little under three hours, and answer our questions, which I am sure will be noted very carefully by people outside this room. Thank you, Governor. Thank you to all four of you.

Mervyn King: Thank you very much, Chairman.

Tuesday 30 November 2010

Members present:

Mr Andrew Tyrie (Chair)

Michael Fallon
Mark Garnier
Stewart Hosie
Andrea Leadsom
Mr Andrew Love
John Mann
Mr George Mudie
Jesse Norman
David Ruffley
John Thurso
Mr Chuka Umunna

Examination of Witnesses

Witnesses: **Mark Hoban MP**, Financial Secretary to the Treasury, and **Emil Levendoglu**, Team Leader, Financial Regulation Strategy, HM Treasury, gave evidence.

Q808 Chair: Mark Hoban, thank you very much for coming before us today. We've managed to keep roughly to time so far; so we'll try and keep that up. I'd like to begin by asking you about the interim FPC. Has it met?
Mark Hoban: We're in the process of establishing the interim FPC and hopefully that process will be accomplished by the end of this year.

Q809 Chair: The consultation document in July said that it would be created in the autumn. I don't know what you feel about things but it looks like winter out there to me.
Mark Hoban: We are working very closely with the Bank to establish the interim FPC, and get the right people on board, and we aim to do that by the end of this year. It's taken slightly longer than we'd hoped but—

Q810 Chair: Why?
Mark Hoban: Well, because we are going through quite a radical process here, Chairman, as part of this whole regulatory reform package and it does take some time to put these bodies in place.

Q811 Chair: When is it going to meet?
Mark Hoban: Once we have established its membership, it will meet shortly thereafter.
Chair: I'll just ask the same question again if you don't mind. When is it going to meet?
Mark Hoban: We don't have a timetable for it to meet. Once its membership has been established, then it will be in a position to meet and then to undertake some of the tasks that we are keen for it to look at, including, for example, assessing the macroprudential tools that will be available to the full FPC.

Q812 Chair: Hasn't this got shades of the tripartite, a body that never quite met?
Mark Hoban: I think once it's in place the interim FPC will meet. It's important that it does meet, and I would say that you are right to highlight the failings of the previous tripartite arrangement, where the principals clearly hadn't met before the financial crisis.

Q813 Chair: You are going down the same road again. You put a consultation document out in July saying you were going to meet in the autumn. Now you're not even giving me a promise that it's going to meet before Christmas.
Mark Hoban: Our aim is to complete the appointment by the end of this year, as is sufficient to meet and undertake its work and fulfil the remit that we want it to undertake, including, as I said, a review of the macroprudential tools.

Q814 Chair: When it does meet, will it publish minutes?
Mark Hoban: We want to make sure that the new regulatory architecture is more transparent than the previous architecture. We think it's important that the FPC does publish minutes and that it publishes notes of meetings, and obviously the six-monthly *Financial Stability Report* is a public document already. But we're committed to developing that further, so not only would it identify the risks that the committee have agreed on but it will also set out some of the responses to those risks.

Q815 Chair: Of course we understand that some aspects will need to be confidential on commercial regulatory grounds, perhaps, but can I take it from your answer that minutes will be published in a timely manner after meetings?
Mark Hoban: Yes. I think we've said that the record of meetings—
Chair: That's "Yes"?
Mark Hoban: It is "Yes".

Q816 Chair: Okay. How often do you think the FPC is going to meet?
Mark Hoban: We're committed to the FPC meeting on a regular basis. It will produce formal reports every six months, but obviously it will meet in between that time as it thinks is appropriate.
Chair: How often?
Mark Hoban: I can't remember the precise details of how often it is going to meet.
Emil Levendoglu: The assumption is that it would meet on a quarterly basis, but with the flexibility to meet more frequently if required.

Q817 Chair: We're making a bit of progress on that. I want to ask a second set of questions, which concerns the control of macroprudential tools. When

the next crisis hits—and we're all agreed there will be one, one day—who controls the tools?

Mark Hoban: We have established the Financial Policy Committee to take responsibility for assessing the threats to financial stability, and it will have at its disposal a range of macroprudential tools that it will be able to use as a response to those risks and it will be able to instruct the PRA or, if appropriate, the CPMA to use those tools.

Q818 Chair: Exercising those tools, who controls the FPC?

Mark Hoban: The FPC will be controlled in a number of ways. Obviously it will be established with a clear objective and remit. It will be transparent. It will be accountable to Parliament, through its reporting process, and I'd assume, Chairman, that the Treasury Select Committee would also seek to engage with the committee and review its regular reports. So there is a range of means by which it is controlled. It will be a broad-based committee. There will be six members of the FPC who are drawn from within the Bank, the Chief Executive of the CPMA and then four external appointees.

Q819 Chair: When macroprudential tools are employed public money is very often on the line. I'm asking you: who is in charge of this body that is taking decisions that may well lead to the use of public money in support of a macroprudential objective?

Mark Hoban: The range of tools is to be determined but we're very clear that, where public money is put at risk, the Chancellor is accountable for that. But if we look at—

Chair: Sorry, that the—

Mark Hoban: When public money is put at risk in this process the Chancellor of the Exchequer is in control. But the macroprudential tools people are talking about at the moment include such things as varying levels of capital and proposals on counter-cyclical capital. That is putting the bank money at risk, not public money at risk. A loan-to-value ratio is another tool people talk about. There may be liquidity measures that people use. So I'm not clear at the moment which tools you think will require the deployment of public money.

Q820 Chair: When meetings take place which may put at risk public money, will they be chaired by the Chancellor?

Mark Hoban: As I say, I do not believe that public money will be used to implement the tools that it is currently envisaged the FPC will deploy.

Q821 Mark Garnier: I completely get that the CPMA and the PRA are going to, in the broadest sense, replace the FSA, but this FPC is quite a change, and a lot of conversations have been going on in this Committee about the effect of the FPC on certain elements of society. One of the things that is going to happen is that the FPC may well be making decisions that are going to affect the economy in ways that perhaps are not necessarily intended. I will give you an example: if you tighten up the mortgage market in order to try and collapse a hovel, the people it is going to affect most are, for example, the mobile work force moving to another area or the people who are less well-off in our society. Although the FPC is going to be completely independent there will be political ramifications for the Treasury. How do you see this panning out in the future?

Mark Hoban: I think that there are always aspects where independent decision-making will have a political impact and we have seen that already with the MPC. The Monetary Policy Committee has been given independence to set interest rates to achieve an inflation target, so this is not a new situation. I think that we need to make sure that the remit or the objectives of the FPC are correctly framed, so they are making the right judgments about the trade-off between, say, financial stability and economic growth. In the same way, if we look at the objective of the MPC, that's a very symmetrical one. The Governor needs to write to the Chancellor if inflation exceeds that band of 1% either side of 2%. That's there to help get the right balance between bearing down on inflation and the wider economic issues. So I think the FPC's objectives do need to take into account both the maintenance of financial stability but also the wider economic consequences.

Q822 Mark Garnier: There was quite an interesting political element in the MPC's remit, which, of course, is 2.5% of inflation. Originally it was on the RPI and then it moved to the CPI. Of course one includes and the other doesn't include household costs, and at the time, as I remember it, when it moved from one to the other, there was a lot of tooth-sucking and saying that the then-Chancellor was doing it because it was getting rather uncomfortable with the RPI and moving to a less broad measure would get around that.

There are going to be dynamics between the MPC and the FPC, which I find slightly worrying. You can almost liken it to the MPC having its foot on the accelerator of the economy and the FPC having its foot on the brake. If both organisations are applying their forces at the same time, you have some quite conflicting dynamics. If it's going wrong, how is the Treasury going to be able to signal the fact that it is not happy with what is happening and then subsequently deal with the problems? It may be that the Treasury then has to step in, in another way, in order to sort things out.

Mark Hoban: I think that is why it is important to make sure you have the objectives right. We need to think very carefully about the distinction between the MPC and the FPC, and I know this discussion has taken place in the evidence sessions you have had to date. The role of the MPC is to deal with inflation and it clearly has a broad impact as a consequence. The role of the FPC will be to tackle issues around financial stability. Now, the prevailing wisdom, prior to the financial crisis, was that if you had stable inflation rates you would have a stable economy. What the financial crisis demonstrated is that stable interest rates don't necessarily lead to a more stable economy and financial sector.

That is why I think it is important the FPC is set up with that broader remit around financial stability, and

because they have different remits there will be different responses they will need to make at different times. The fact that there is cross-membership between the two committees will help resolve some of those things. But there may well be times where, because inflation is low, the interest rates are low but, at the same time, the FPC is concerned about threats to financial stability and that may lead it down a different route.

Q823 Mark Garnier: The four external members are therefore very important to this whole thing. What is the selection process for these four external members and what qualities do you think the candidates should have?
Mark Hoban: The external members for the FPC will be appointed by the Chancellor, obviously going through the same process he used for the appointment of members of the MPC. But clearly you want people who understand the financial services sector, understand its wider economic impacts and draw upon a range of experience; in the same way as the external members of the MPC clearly demonstrate their experience.

Q824 Mark Garnier: That could mean that you end up with a City-based type of people. Do you see that as an advantage or a disadvantage? In your personal opinion, what do you think is the right profile of the candidate?
Mark Hoban: I think you need to make sure you have people on there who are knowledgeable and understand the area, but are in a position to challenge the prevailing consensus and add value to the whole process. I think you can see that in the MPC, where there is a variety of voices, there is clearly very vigorous debate. We would want to make sure the same qualities exist in the FPC.

Q825 Mr Mudie: I think at the end of the debate last night we all had our first taste of this accountability to Parliament, in terms of the regulator doing something that caused a great number of MPs to turn up and speak on behalf of their constituents. Now, at the end of the day, apart from making those statements in the House, it appears that the last word is with the regulator. Is nobody in the Treasury or in the Government uncomfortable about what even the bankers call "the democratic deficit"?
Mark Hoban: There are a few points I would make in response to that. The first is that the regulators—and I know this is the case both for the Bank of England and the FSA—take their accountability to Parliament particularly seriously. They are focused on the way in which they are accountable to the Treasury Select Committee, and that does have an impact on the way they conduct their work. So I think they do listen very carefully to views expressed in this Committee, and in Parliament, and are always willing to engage with Members of Parliament on this. But I also think that Parliament has set up regulators to be independent of Government, and there is always a risk that their independence, credibility and authority is undermined if it's seen that they are becoming politicised. So I think we need to get that balance of scrutiny and accountability right, and also recognise that we should be setting out the framework for the regulators but leaving them to get on with their job.

Q826 Mr Mudie: A worry I have is getting that balance right. Where is the balance? The Governor told us last week that the Treasury should not get involved with decisions made by the FPC. He claimed, "If the Chancellor doesn't like it, don't set up the FPC". Now, that doesn't seem to me a very collaborative, listening or empathetic statement. Vast powers have been given to regulators, and to the Bank, and the Treasury doesn't seem to have much power, apart from raising an eyebrow, which used to be the Bank of England's job in the past. Now, we are in that position. It seems to me a bit—a lot—out of balance.
Mark Hoban: The process we are going through at the moment, consulting on the new regulatory framework, is very helpful because it gives us an opportunity to re-assess the objectives, the methodology and the powers of the regulators. But I would say this: I think that we have benefited hugely from the independence of the MPC and the fact that there has been de-politicisation of the interest rate-setting process. I think those same consequences flow from other independent regulators. One of the reasons why the regulatory structure in the UK is highly regarded elsewhere is because of its independence. One of the reasons why we want to set up the FPC is to ensure that where there are threats to stability action can be taken—that somebody is responsible for taking away the punchbowl when the party gets out of hand. There is a scepticism about the willingness or ability of governments to do that.

Q827 Mr Mudie: I understand that, but, with Mark's description of that situation where the punchbowl has been taken away, the Chancellor is outside that. They can take the punchbowl away by their own power without reference to the Chancellor. Now, that just sounds an empty phrase but, as we mentioned last night in the debate, it is not only the RDR that is causing great excitement. The full horror of the FSA's reign of fear on mortgages has not really percolated and people don't understand why mortgages are starting to be rather scarce. It would be very difficult to get a mortgage without a very big deposit if you were a first-time buyer and if you were self-employed, "hard luck" seems to be the phrase. At a time when the construction industry desperately needs the market to pick up—not a bubble, just a normal market to return—that's the early actions and early warnings of an independent regulator. Are you confident about giving even bigger powers over to regulators and the bank, without hesitating and saying, "Is this wise?"
Mark Hoban: That's why I think, Mr Mudie, we need to make sure that we get the objectives of the new bodies right; that is why we need to make sure we get their powers and also the process in which they engage with industry right as well. On the objectives, the FPC will have responsibility for financial stability but I think it is important that that objective is bounded by consideration about the impact on the wider economy. I am not saying there should be

tension in the system, but a recognition that financial stability should not be seen in isolation from the broader impact upon the economy.

Q828 Mr Mudie: The comfort you sought to give Mark was transparency and accountability to this Committee. But—and I say this genuinely as a member of this Committee, because I have a lot of time for the abilities of the members of the Committee—that doesn't fill me full of happiness. Because they come here, they sit there for two hours and then we don't see them for six months. What about accountability to the Government; accountability telling us why they did something when they've caused chaos out there and we politicians are taking the responsibility for it? It's not acceptable. Surely we want some involvement in the decisions. We want to strike a balance.

Mark Hoban: I think we would be then moving away from the way in which regulation has been developed in this country since the setting up of the SROs. We would be back to a situation where government departments shared some responsibility for financial regulation. I think that would lead to some confusion as to who was in charge, and one of the lessons from the financial crisis—going back to that great question that was asked of Mervyn King, "Who is in charge?" And he said, "It depends what you mean".

I think one of the great merits of this proposal is to make sure there is much more clarity and focus about responsibility. I think the blurring of that boundary between what is the responsibility of Government and what is the responsibility of regulators will lose that focus and responsibility.

Q829 Mr Mudie: That response, after all that's gone before, rather suggests the Treasury thinking it is right and proper to give this all away; not to blur it; not to give the Chancellor or the politicians any say in decisions that will directly affect their constituents. That really worries me. Is there no doubt in the Treasury that this step should be rethought?

Mark Hoban: We think very carefully about accountability, and about transparency of the new regulatory architecture. That is why we have spent a lot of time getting this right and there is a variety of tools we will use to ensure that we do get the system right and that Parliament does set the right boundaries for regulators—both in terms of the activities they regulate and their objectives. I think that's the best way in which Parliament can influence the work that they do.

Q830 David Ruffley: This alphabet soup of acronyms for the new regulators with overlapping responsibilities is troubling. You're a practical man, Financial Secretary. Can you help the Committee by giving us a worked example, if you will? Take the Northern Rock debacle. We all know the basic facts of what went wrong and when it went wrong. Could you just take us through, if that scenario were replayed, what the Financial Policy Committee's role would be; what it would be doing during and in the run-up to such a crisis; what the PRA would be doing; and what the CPMA would be doing—each one in turn?

Mark Hoban: Yes, and that is a very good way of looking at it. The FPC does have responsibility for assessing system-wide risks to financial stability and so—if we go back to the Northern Rock crisis—it perhaps would recognise that there was increasing dependence in the financial markets on wholesale funding and it would ask the question, "What are the risks that attach to that and what action should we take on a system-wide basis to address those risks?" The PRA, because it is tasked at looking at the safety and soundness of individual institutions, would, I think, look at the business model of a bank and would express concerns about the appropriateness of that business model. I think one of the differences is that we would expect the PRA, where it identified particular risks flowing from a business model, to intervene earlier than the FSA would have done historically, to discuss with management the consequences of the model that they are following and outline the sort of actions they would expect that firm to take. So I think that is a very clear difference between the FSA's approach and the PRA's approach: the PRA would look at the business model, challenge them and talk about the remedial action that should be taken to mitigate the risks.

In terms of the CPMA, there is a series of issues within a firm that will express themselves in different ways. So obviously there is a prudential risk and that would flow from the business model. But clearly the business model also affects the relationship that a bank or financial institution would have with its customers, and the CPMA would use that understanding to look at the relationship. For example, it may decide that one of the problems of a particular institution was that its approach to affordability—say, for mortgages—was creating a risk that had an impact on consumers but perhaps it would have an impact on prudential stability as well.

So there would be a relationship back to the PRA. It would identify some of those issues and think very carefully, perhaps about the sales practices, whether or not the institution was following best practice, and respond in that way. So I think you look at what is a system-wide issue, what is the impact of a particular business model on the stability and soundness of a particular firm and what is its relationship with the customers. In the new system you have a very clear focus on each of those areas that comes from the way in which we are structuring the regulatory architecture.

Q831 David Ruffley: That is helpful. So, in the Northern Rock case, you have delineated which regulator would be tackling which problem with Northern Rock. Out of all those three bodies, who is accountable?

Mark Hoban: Perhaps I could step back a bit on why we are delineating these responsibilities? Clearly the FSA had a dual mandate for both prudential supervision and also for conduct of business and I think we'd all agree, with the benefit of hindsight, that the problem with the FSA was it prioritised conduct of business to the detriment of prudential stability. So

I think that the structure deals with that confusion in mandate. So, for example, if you take—
David Ruffley: Can we just keep it practical? If the Northern Rock scenario were replayed, which of the regulators would ultimately be accountable to this Committee, to Parliament and to the public for the disaster?
Mark Hoban: If the view was that the business model of Northern Rock was fundamentally unsound and that put its financial stability at risk, it would be the PRA that would be accountable. Of course, the PRA is also the body that would be responsible for determining whether or not the institution would go into the special resolution regime for which the Bank is responsible for. But if it is a failure of business model, a failure of prudential soundness, then it is the PRA that is accountable when it is looking at individual institutions.

Q832 David Ruffley: But we have a situation where there are three failures in the Northern Rock scenario because each of the regulators will have detected, we hope, a problem, as you have set out. But we have three lots of accountability there, haven't we?
Mark Hoban: No. I think the role of the FPC is to look at system-wide risks, not to take judgments on individual firms. So if a firm failed in isolation then very clearly the PRA would be accountable for that. But the FPC would be accountable for its actions, in terms of trying to identify the risks that are there and responding to those risks on a system-wide basis.

Q833 David Ruffley: Okay. Can you define regulatory success?
Mark Hoban: Clearly, it would be judged by the extent to which the regulators deliver on their outcomes and their objectives. That is what they will be measured against and clearly the regulators will need to think very carefully about how they report against those objectives.

Q834 Chair: Just to go back to this Northern Rock example, public money was put at risk. Who is in charge of running the bail-out?
Mark Hoban: The Bank of England is responsible for the special resolution regime and the tools that were put in place in the Banking Act 2009, but, as is clear from our consultation document, where public money is put at risk, or is likely to be used, then the Chancellor has to make the final decision because he is accountable to Parliament for the use of taxpayers' money.

Q835 Chair: The question is: who is in charge? Who brings together the people around the table to take the strategic decisions to solve this in a timely manner? Saying he has overall responsibility for the cash doesn't take us anywhere. What we need to know is: who is running this crisis? We have moved out of peacetime. We are in wartime. If I may say so, I have experienced one of these events myself in the Treasury and I have seen exactly this take place. What I want is reassurance that these new arrangements have in place someone in charge in wartime, and I'm not getting that reassurance from you today, Minister.
Mark Hoban: I think we have moved from a situation where there's lack of clarity about who is responsible under the previous architecture to one, I think, where there is much greater clarity because it is the PRA that will be responsible for prudential supervision of an institution. It will be responsible for pulling the trigger for the special resolution regime. The Bank of England is responsible for determining which of those tools is appropriate—whether it is a bridge bank, or whether there is a sale to the private sector—but where public money is used in the resolution, ultimately the Chancellor will have to decide whether or not to use public money to do that.
Chair: That arrangement fills me with foreboding. I'll bring in Michael Fallon and then I'll come back to David Ruffley.

Q836 Michael Fallon: In your paper the Consumer Protection and Markets Authority is described as "a strong consumer champion" and "a regulator". How can it be both?
Mark Hoban: I think what the CPMA will bring is a clear focus on conduct of business issues, whether you are a customer of a high street bank or you are trading with big international investment banks. So because it is a pure focus on conduct of business, it will act as a champion for consumers.

Q837 Michael Fallon: But a regulator ensures that people comply with rules. A consumer champion lobbies for consumers.
Mark Hoban: No, it's not a consumer advocate. It will expect to—
Michael Fallon: It says "strong consumer champion" here.
Mark Hoban: Yes. But I think it's by virtue of the fact it is entirely focused on conduct that it will become a champion for consumers.

Q838 Michael Fallon: But if it is a strong consumer champion it is not likely to advocate caveat emptor, is it?
Mark Hoban: The CPMA will need to look at how it delivers its outcomes. I think that it's right that it is independent and impartial, and that it acts in the best interests of the financial services sector in general. But I think its focus on consumer issues does mean it would be a consumer champion. I do not think that is the same, though, as being a consumer advocate. There are plenty of other bodies out there—like Which?, the CAB and Consumer Focus—who act in that role.

Q839 Michael Fallon: What kind of duty will it have to promote competition?
Mark Hoban: That's a very good issue and we would all recognise that competition plays a significant role in delivering better outcomes for consumers. I do not believe that regulation is enough to deliver those outcomes and, in framing the objectives of the CPMA, we think very carefully about how competition is reflected in those; and also what we mean by competition. We can have situations where there are relatively few providers in the market but it is very competitive because of, say, the ease of switching

between those providers; for example, in the supermarket sector there is a lot of competition but relatively few providers. Equally, we could have a sector where there are lots of competitors but, because of the high cost of switching, people are locked into those providers.

So we need to think very carefully about what we mean by competition and how that works best in this sector. Clearly, we need to make sure that the market is competitive and that means looking at a whole range of issues around transparency, the cost of switching, and about the number of players in the market.

Q840 Michael Fallon: I understand all that, and you said you would think carefully about it, but what I want to know is: will competition, in fact, be a primary objective of the Authority?

Mark Hoban: Well, we want to make sure it's reflected in its objectives and we need to think very carefully about how we—

Michael Fallon: Yes, but will it be a primary objective? What does "reflected" mean? Will it be a primary objective or not?

Mark Hoban: I think there are issues about the boundaries between the FSA and the Competition Authority; so there are some sector regulators that have competition as an objective and take over the powers of the OFT. But I'm clear that we need to make sure we have a competitive financial sector.

Michael Fallon: Sure, but will it be a primary objective of the Authority?

Mark Hoban: Its primary objective is around ensuring confidence in markets and the integrity of markets, and I think that competition flows from integrity in markets.

Q841 Michael Fallon: So in fact it won't be a primary objective?

Mark Hoban: Well, the primary objective—

Michael Fallon: To secure and promote competition will not be a primary objective. You're seeing it as some kind of beneficial side-effect of its other duties?

Mark Hoban: I think we need to make sure these institutions have very clear focuses and one of the problems of the previous regime was a lack of clear focus. That is why we want to make sure that each of the three bodies does have a clear objective that it can be judged against. But I do believe that if we are talking about the integrity of markets that does imply there has to be competition in those markets.

Q842 Michael Fallon: Yes, but that is an implication. What would be wrong with just putting in, as one of its primary objectives, a duty to promote and secure competition at all times? What would be wrong with doing that?

Mark Hoban: I believe it will be reflected in its objectives, but I think we need to be very careful that we don't end up having a series of objectives that means that the regulator loses focus on its primary responsibility. What we have said when it comes to the CPMA is that it must ensure there is confidence in markets and integrity in those markets.

Q843 Michael Fallon: So competition would be a secondary objective?

Mark Hoban: I think it flows from those objectives.

Michael Fallon: Thank you.

Chair: David Ruffley has a very quick rejoinder and we would be grateful for a quick reply.

Q844 David Ruffley: Just to sum up this question about accountability. Would you accept that, in the Northern Rock case, it was totally unacceptable that the public and commentators were wandering around and they didn't know who to blame: was it the Treasury; was it the FSA; was it the Bank? Do you accept that was unacceptable?

Mark Hoban: Yes, and that's why it is very clear—

Q845 David Ruffley: Okay. On that basis, if Northern Rock was played out again, what I'm seeing and hearing is that we would have three people to blame: we'd have the head of the FPC; we'd have the head of the PRA, and probably the CPMA as well. Who will we blame out of all those three? Who will be the one person accountable if a Northern Rock situation is played out again?

Mark Hoban: If it's about the stability and soundness of Northern Rock itself, it would be the responsibility of the PRA.

Q846 Mr Umunna: May I pick up on David's line of questioning, because I'm still not sure we have a clear answer to it. To repeat the question: who would be the one person, in the scenario that has been given, who would be accountable?

Mark Hoban: I'll repeat my answer. If it is about the stability and soundness of Northern Rock, it is the PRA.

Q847 Mr Umunna: As David has just said, there could be three different parts to it where there has been a falling down and there have been problems in each of the three areas. Which one person is responsible? If the answer to the question is, "There isn't one person who is responsible", perhaps you could just confirm that.

Mark Hoban: No, I think that we are moving towards a regulatory structure where there are, unlike the previous structure, clear responsibilities for the regulators.

Mr Umunna: But it doesn't seem that there is clear accountability and I think that is the point that David was making.

Mark Hoban: If you look at the remit of the three bodies, it is very clear what they are accountable for. If the FPC failed to identify a system-wide risk, then it is the FPC that would be accountable for that failure and would be held to account through the transparency operation—in fact it is accountable to the TSC—and it would be very clear that they failed to identify a threat to our financial stability.

Q848 Mr Umunna: So in that Northern Rock situation, who would we be looking to fire?

Mark Hoban: If it's about the stability and soundness of Northern Rock itself, it would be the responsibility of the PRA.

Q849 Mr Umunna: Isn't the real answer to the question, to the extent that we would be looking for one individual, that in some sense the one individual who sits atop the entire system is the Governor of the Bank of England? Has not this system, in reality, put a huge amount of responsibility and power in the hands of one unelected individual?
Mark Hoban: I think you need to look at the bodies that are engaged in this. With regard to the FPC, the Governor is one of 11 members. If you look at the PRA, it is the chief executive who will be responsible for running the PRA and the Governor is the chairman. The CPMA is outside of the structure completely. So I don't see power as being concentrated in one person as you suggest.

Q850 Mr Umunna: In some senses he is the one person with the most hands in lots of different pies. So if you were looking for one person to hold responsible you would probably look to the Governor of the Bank of England, would you not?
Mark Hoban: I think it's an issue about the institutions and how they would make decisions, and I think that the PRA would make a whole series of decisions on prudential regulation. Not all of them will be taken by the Governor.

Q851 Mr Umunna: How much will the transition to the new system cost?
Mark Hoban: The estimate put forward by the Bank and the FSA is for about £50 million.

Q852 Mr Umunna: Right. What comfort can you give us that those costs are not going to be automatically passed on to the consumers?
Mark Hoban: The costs will be borne by the levy pay in the first instance. So it's the financial services businesses that currently fund the regulatory arrangements that will pick up those costs.
Mr Umunna: How can you be sure that they won't pass it on to the consumer?
Mark Hoban: Inevitably, the costs of regulation are borne either by the consumer or by the shareholders of these organisations. I'm not sure whether you are suggesting that the taxpayer should pick up these costs.
Mr Umunna: No, what I'm asking you is what comfort can you give that the industry won't pass on the costs? That is what I was getting to.
Mark Hoban: I think if we have competitive markets, where there is pressure on price, the industry won't be able to pass on those costs to consumers.

Q853 Mr Umunna: Have you carried out a cost benefit analysis of the costs of putting in place the reforms and the actual difference they will make? Maybe I could just put my question in context. We took evidence from Lord Turner last week—you may have read some of it—and it was put to him that we could produce the outcome that you're seeking to achieve with the new regulatory structure by tweaking the existing system, as opposed to doing the wholesale reform that the Government is embarked upon at the moment. Do you think it is worth this £50 million?
Mark Hoban: Yes, I do and I think that simply tweaking won't answer the fundamental problem about the clarity of responsibilities and accountability. The problem we have with the FSA is one of design. It has two mandates: one is around prudential supervision and one is around conduct of business. I think as long as you have that tension in there, I don't think it's going to deliver the regulatory outcome that we need. There is no macroprudential regulator in place at the moment. It is clear from the crisis that we need one. So I think we do need these reforms to bring clarity to the system.

Q854 Mr Umunna: I have to say, Minister, in some ways I was quite sympathetic to the new system, but the answers that you have given today—and the questions that were posed by Mr Ruffley have highlighted that there is still not a great deal of clarity, in terms of who will be accountable—demonstrate that some of the same problems that we had with the old system may be present with the new system that you are seeking to put in place.
Mark Hoban: No, I don't agree. I think that there is much greater clarity of responsibility now than there was in the previous regime, where I think there was lack of clarity and responsibility when it was dealing with the problems at Northern Rock. Now it is very clear about exercises the special resolution regime. It is very clear who puts a business into the special resolution regime. It is very clear what the responsibilities of the regulators are. I think it is a much clearer system than we had before.
By the way, I don't think that next time there is a crisis Mr Fallon can ask the same question about who is in charge and not get a clear answer.

Q855 Mr Umunna: Okay. May I just ask one final question—and I ask this since you are the Minister responsible—in relation to the bank levy. There has been some speculation, and I believe your officials have been in contact with the media, about the rate at which the levy is going to be imposed, and some concern has been expressed in the Treasury about the sum that the levy is likely to raise. We are aware that the aim was to raise £2.5 billion a year with it, and there is a concern that it is going to raise more. Could you confirm to us—on the record now—whether you will moving to reduce the rate that was consulted on, and when can we expect to know at what rate the levy will be imposed?
Mark Hoban: The question was raised last night at the tail end of the debate.
Mr Umunna: I know.
Mark Hoban: We're very clear that in a full year the levy will raise about £2.5 billion.
Mr Umunna: So you will go for a rate that will get you that amount.

Q856 Andrea Leadsom: I'd like to come back to the question of the CPMA, Financial Secretary. The first question is a very simple one: should it be called the MCPA? There is an issue around the public understanding of what its role is. You said it is not going to be a consumer champion; it is there for consumer protection, which is more of a regulatory

focus, and predominantly the key job—the thing that it spends most of its time on, I would imagine—is market supervision. Is it right to be calling it the CPMA?
Mark Hoban: I think this is the body that will have the greatest relevance to the vast majority of people in this country who buy financial services products. Many people will see it as being primarily a consumer body rather than a markets body, but it will fulfil both roles.

Q857 Andrea Leadsom: But, for example, in its activities in the European sphere, calling something a Consumer Protection and Markets Authority is slightly misleading, isn't it? Do you not think there is an issue with the understanding of its brand, its purpose?
Mark Hoban: I am always happy to listen to suggestions about how it might be better named, and people have expressed views about its name. I think it is going to cover both consumers and markets and, of course, increasingly we see in the European debate much more emphasis on consumer issues as well as market issues.

Q858 Andrea Leadsom: Thank you. I'd like to address one very specific point. We've just had a very interesting session with Sir Donald Cruickshank. One of the key issues he was proposing was that the CPMA ought to have the responsibility for licensing money transmission systems. In other words, so that if you, as an owner of a retail bank account, wished to switch between banks, you would take your account number with you. You would change the sort code and the CPMA would license banks to provide money transmission services. For example, now you can transfer your phone number and in the future you could transfer your bank account. That, at a stroke, would remove the inertia and the disincentive to switch bank accounts and would create much healthier competition, also enabling new entrants to come in without that massive hurdle of building their brand and their customer base. Can you comment on that?
Mark Hoban: It is an interesting idea. One of the things that concerns me is the difficulty that consumers have in switching personal current accounts. If you look at retail financial services, the level of competition varies from product to product, and clearly in those areas where the cost of switching is lower you see greater competition. I am keen to explore ways in which we can encourage—

Q859 Andrea Leadsom: But it's not just the cost, is it, it's the complication of moving your standing orders and your direct debits and forgetting to pay your mortgage and that sort of thing?
Mark Hoban: Yes. It is really about the difficulty of doing so and it is not necessarily just the financial cost. It's the emotional cost and the concern that a standing order might be bounced if the transfer hasn't gone across. We need to look very carefully at how we can reduce the barriers to switching. It's an interesting idea that Sir Donald Cruickshank has put forward and we will look at that. But there are international standards around bank account numbering, for example, that might act as a brake on doing that and, of course, you have to make sure that the other bank hasn't already issued the account number that you have.

Q860 Andrea Leadsom: Yes, absolutely. Can I press you once more on the competition objective of the CPMA? We have heard a lot of evidence on the need for greater competition and it's still not clear who is going to be incentivised, among these three new bodies, to ensure that at least regulation doesn't trump competition as it has done for the last 15 or 20 years.
Mark Hoban: It's an interesting question you raise because there are areas where regulation helps competition. One of the things that illustrates some of the challenges about delivering competition is that it was the responsibility of the OFT to look at some of the practices in the ISA market. It was the OFT that recommended that ISA providers should put the interest rates on statements. I think that is the right thing to do. It surprised me it took it so long to get to that point. This division of responsibilities between the OFT and the regulators needs to be looked at. But I do think we need to make sure that competition is the centrepiece of how we improve outcomes for consumers alongside increased consumer responsibility and education, but also better and more effective regulation.

Q861 Jesse Norman: Minister, can I briefly return to the issue of a Northern Rock going under. From the way you've described it, I take it that the FPC is not going to be involved at the point where Northern Rock is going under. Its job is to make sure that the system is appropriately stable before that. Therefore, it is the PRA and the CPMA that would be engaged. Now, what is actually going to happen? As you know, sometimes you have 24 hours or very short periods of time to make a decision on these things. Will the chairman of the PRA be pulling together an ad hoc team from his own organisation and from CPMA? What will be the process by which meetings are had with the institution concerned to try to resolve some of these issues?
The reason I focus on it is that many of these institutions are massively complicated and, therefore, there will be huge numbers of different businesses that fall under each of those regulatory structures. Is there a protocol as to how that happens?
Mark Hoban: There is a whole range of responses I could give to that question but let me say, first of all, that where an institution is regulated by both the PRA and the CPMA. there will be protocols about their engagement. We would expect there to be a college of supervisors for that body. But clearly the responsibility for the safety and soundness of a body rests with the PRA, who we would expect to work very closely in the event of a crisis to identify what the issues are. But it would be responsible for pulling the trigger and putting the institution in a special resolution regime, and the special resolution regime is the responsibility of the Bank of England.
The other thing I would just say is—and this is based on my experience over the last six months as a Minister looking at these areas—that there shouldn't

be a surprise to the regulators, or indeed to the Treasury. There is continuing engagement around contingency planning and I think that helps ensure that the Treasury is well sighted on these issues. That will mean that when the decision comes as to whether or not you should commit public money, it is not something we should be asked to answer in an instant. There will be a lead-in to that point that we would be aware of.

Q862 Jesse Norman: I wish I shared your confidence. It is always the contingency you're not planning for that is the one that comes and gets you. Anyone could see that the Northern Rock balance sheet was expanding massively in the money markets over a period of time—that was why it was able to ramp up its market share so quickly—and yet it did still seem to come as a tremendous shock to the authorities involved. But what you said is very helpful, in terms of clarifying matters. There is a college of supervisors; and the PRA is pulling the trigger, convening these people together. I take it the thinking is that you'd like it to be done quickly and effectively?
Mark Hoban: Yes, and I think you are also right to say that people should have identified the problems with Northern Rock sooner. I think the much more intrusive approach that the regulators will adopt will help us identify those problems at an earlier stage, and that will aid the ease of resolution.

Q863 Jesse Norman: Thank you. Is it a concern for you, as it was for me, that the corporate governance systems in the banks should have been so ineffective in the run-up to the crash? What I mean to say by that is that these were institutions that seemed to have tremendous non-executive directors, supposedly doing their job, very high-profile figures in position, and they were all caught completely napping. They looked utterly foolish. They weren't in touch with the organisations. They were at least, as it were, involved in their own positions as they were in managing the institutions for which they normally had responsibility. How do we strengthen the issue of corporate governance in those financial institutions? I think that is foundational to the issue of regulation.
Mark Hoban: It is. I think it's a very good point and it is an issue that we need to think about quite carefully, because it's not only the directors but also the shareholders of institutions. One of my predecessors, Lord Myners, spent a great deal of time thinking about both of these issues after the financial crisis. But your question points to the fact that there is a range of responsibilities for this and we do need to make sure that directors and shareholders exercise their responsibilities properly. We have seen some major reforms. The FRC has done some excellent work on stewardship, which I think will help underpin the responsibilities of institutional shareholders, and we have seen work done in the aftermath of the financial crisis around corporate governance led by Sir David Walker.
I know that Michel Barnier, the European Commissioner, is particularly interested in corporate governance and has published a green paper on that. I have to say, looking at the green paper, that we have made quite a lot of progress in improving corporate governance and we do have comparatively high standards of corporate governance, and I want to see those standards applied elsewhere, too.

Q864 Jesse Norman: Especially in the financial sector. A very quick final question, and that goes to your gentleness in dealing with George Mudie on the issue of political interference. It seems to me, when you look at Bill Clinton and the expansion of mortgages in America in the 1990s, or the political interference we have had to deal with in the last few years, a degree of insulation is rather important in the management of our financial affairs. It seems to me this regulatory system tries to build that in.
Mark Hoban: Yes. Regulatory systems and structures that are seen to be independent have much more credibility in the eyes of the market and in the eyes of consumers than those that are seen to be politicised. So we need to think very carefully about that balance and about how Parliament puts boundaries around the activity of regulators, but I do think that independent systems do have that credibility.

Q865 Stewart Hosie: Minister, in relation to managing a systemic risk, the general picture is now we'll have tougher macroprudential regulation, higher capital ratios, and we have the new architect. But at the back end, should a bank fail, there will be a resolution mechanism where it would be allowed to fail. Is that the broad shape of where we are with the new regime?
Mark Hoban: One of the comments I took from last night's debate on regulation was that there needs to be a range of interventions to tackle some of these issues. I think you're absolutely right, Mr Hosie, to identify that there is a macroprudential piece to this. You need effective supervision. You need to make sure there are standards in place around capital and liquidity, but you also need a resolution regime that, in the event of a failure, minimises the impact on consumers and, indeed, taxpayers.

Q866 Stewart Hosie: That's fine. You talk about this range of interventions and you have spoken earlier about the PRA and what they could do with individual institutions. You said they would be concerned with their stability and soundness; they would challenge management; and they would mitigate risks. That sounds like a fairly active supervisory role and I presume that is what you would like to see the PRA do, in particular?
Mark Hoban: Absolutely, and I am very clear—it is one of the guiding factors behind the regulatory reforms we are introducing—that we want both the PRA and the CPMA to engage much earlier in the process, to identify risks at an earlier stage and to be proactive in trying to tackle those risks. We go back to the point that Mr Ruffley raised: that people should have been aware of the problems at Northern Rock. It is being aware and then doing something about it that's important.

Q867 Stewart Hosie: In terms of early intervention and identifying risks, I'm much more confident with those answers than what we heard from Hector Sants. He gave the impression he would be much more reluctant to have active supervision. He said if you're going to have a failure where the cost only falls on those who provided the capital, there is no adverse impact on the rest of the system for systemic purposes, and so on, then the bank would be allowed to fail and enter the resolution regime. He confirmed that he would not have put £37 billion into Bradford & Bingley and confirmed, likewise, that Northern Rock and Dunfermline would simply have been allowed to fail. There seems to be a chasm between the active supervision to mitigate against risk in advance which we are hearing from you today and the impression we got from the soon-to-be-head of the PRA only a week or so ago. Are you concerned about that?
Mark Hoban: No. I think that there are a range of points in a supervisory process where you require intervention. I do believe that early intervention is important but I also recognise that this is not a zero failure regime. Regulators aren't going to get it right all the time and clearly they didn't get it right with respect to Northern Rock or Bradford & Bingley. But when those failures came there was a significant cost to the taxpayer, so I do think we need to make sure, when there is a failure, that mechanisms are in place to resolve that failure as cheaply and as effectively as possible with the least possible impact on the taxpayer.
I have to say that the previous government introduced a special resolution regime that we supported. I felt it was a very good way of trying to reduce the cost of failure and to make sure there was an auditing process in place. More work is being done at the moment. As Mr Norman pointed out, some of these institutions are quite complex and that is why there is work going on at the moment—both in the UK, which the FSA is leading, but also internationally—on resolution and recovery plans looking at what you need to do in the event of a crisis to resolve these problems without recourse to the taxpayer.

Q868 Stewart Hosie: I couldn't agree more. This isn't a zero fail game. That is a very good way to put it. Of course, we need a resolution regime in place, and we now have one and that is also very helpful. But the broad focus of my questioning is this, and Mervyn King, the Governor of the Bank, said something broadly similar. He said, in terms of the FPC, the focus would be on big risks and not trying to chase round each and every individual institution to make sure that everything they do is sensible. Of course, no one would expect that. But, nonetheless, there does appear to be uncertainty in the balance between pre-emptive supervision to stop the overtly risky things happening. Let us remember, even conduct risk can morph into systemic risk. There seems to be a chasm or a difference between that pre-emptive work and of relying simply on the macroprudential, the capital ratios, and ending up with a resolution regime. I'm just wondering how we might get a little more clarity in terms of the specific rules the FPC and the PRA will have, in terms of pre-emptive, active supervision to stop the risks occurring, as best they can, in the first place.
Mark Hoban: I think if I just focus for a moment on the FPC, Mervyn is absolutely right. It is not meant to chase around problems in individual firms. It is system-wide and, of course, it is meant to identify risks emerging to the stability of the financial system and to indicate what the response should be to those risks. So that is pre-emptive. It is also the case, in the conversations we have had with the Bank and the FSA in moving this model on, that the PRA is looking to have the judgment and discretion available to it to enable it to intervene early. I think the point that Mr Sants was making is that it is important, given there isn't a zero failure regime, that the tools are in place to ensure an orderly wind-down. I think that if those tools had been in place at an earlier stage we might have had a slightly different crisis from the one that we had.

Q869 Mr Love: Minister, earlier this month you made a very public U-turn by allowing the FSA to retain its powers of criminal prosecution. Why?
Mark Hoban: We had been thinking about this quite carefully for some time, and we believe that there needs to be increased focus on the prosecution of white collar crime. There are a number of different bodies that are engaged in that at the moment and we thought it was best to draw those together in a single agency, the Economic Crime Agency.
The particular challenge that we were faced with in relation to the FSA was twofold: the first is around the nature of the FSA's powers when it comes to tackling market abuse. It has both civil and criminal powers and what we were proposing was to tease apart those criminal powers from the civil powers. I think that is quite a complex exercise to do, and for example there were concerns about the duplication of investigatory staff and the detection of market abuse, and a sense that we needed to spend a bit more time to look at this. The other aspect is that—in the context of where the FSA is at, at the moment—it would be best to delay that decision until the new regulatory structure has been bedded down.

Q870 Mr Love: That answer leads me on to the second question. You have just repeated what a Treasury spokesman said: "After much consideration, we have decided that, for the moment—" You have hesitated as well. Could we see a further U-turn taking it back into the Economic Crime Agency?
Mark Hoban: What we have said is we believe there should be a single focus on tackling white collar crime. There are issues around how you disentangle the FSA's criminal and civil powers. It is right to give that consideration and we have decided to put that decision on hold for the time being.

Q871 Mr Love: If I may say so, there's a tremendous lack of clarity which, of course, means uncertainty for the markets. FSA officials haven't been anything less than absolutely clear about this. They say that, to achieve the primary objective of confidence in financial services and markets, they must maintain—

and I quote—"a strong and effective enforcement function with a full range of powers". Aren't you convinced by that argument?
Mark Hoban: I think the FSA would look at it from its own perspective. We look at it from a slightly broader view, about the range of bodies currently engaged in tackling white collar crime, and we believe there is some benefit to come by focusing those skills and expertise in one place.

Q872 Mr Love: Let me see if I can gain some clarity for the Committee. By 2012, when all of this is supposed to be up and running, where will criminal prosecutions lie?
Mark Hoban: It will still rest within the FSA, or rather the CPMA at that point.

Q873 Mr Love: And when the Economic Crime Agency is fully up and functioning, will it then take over those powers? I'm not at all clear about where you're at.
Mark Hoban: We haven't set a timetable for this, and clearly what we need to look at very carefully is how you would disengage those criminal and civil powers and whether moving those criminal powers to the ECA would make it a more effective body or not.

Q874 Mr Love: But from that it seems clear that, while the senior officials at the FSA responsible for these matters say it is critical for the future of the CPMA that criminal prosecutions are retained within that new structure, you seem to be both hesitant but also suggesting that, in principle, you would prefer to move them to the ECA.
Mark Hoban: I think that we need to look at this quite carefully. It's quite a complex area and I think you would be equally critical of us if we had rushed into this too quickly.

Q875 Mr Love: Well, you did rush into it before the election, and subsequent to the election, because you were clear that the Economic Crime Agency was going to take over all these powers.
Mark Hoban: We said it was a matter to be discussed and I think that we need to get this right. We want to see effective enforcement when it comes to the CPMA's responsibilities for conduct. We also want to see effective prosecution of white collar crime. But I think we need to find a structure that tries to deliver both of those objectives.

Q876 Mr Love: Although the FSA has had some modest success in prosecutions for insider trading, I think there are a lot of people who would suggest that they have to do better. Are they going to do better with this uncertainty hanging over them into the future?
Mark Hoban: I don't believe this should distract them from doing that job but, of course, it is that concern about the effectiveness of their criminal prosecutions. I think it is potentially a historic issue that led to careful consideration of whether or not we should bring these powers into one body, the ECA.

Q877 John Thurso: Can I return to the question of corporate governance. Our predecessor committee in the last Parliament, in looking at Northern Rock, Bradford & Bingley and various others, were very clear that, while the crisis became the failure of regulation, it was first and foremost a failure of management and, above all, a failure of boards adequately to control their management. Who in the regulatory system is going to be looking at the way in which boards of banks operate and whether they are adequately controlling their executives?
Mark Hoban: Broad responsibility for corporate governance rests with BIS and, obviously, within that, it's the FRC that leads most of the work on corporate governance. You had Baroness Hogg and Stephen Haddrill before the Committee. Clearly, in the light of the crisis, the FSA has taken a more proactive role in this area and, for example, does interview senior appointments—at board level as well as more junior levels—and so they are much more engaged in that.

Q878 John Thurso: There were two particular areas that we looked at: one was the area of the operation of the risk committee and—particularly, with regard to Northern Rock—that appeared to us to have been pretty inadequate. Do you foresee, in the regulatory framework, any of the regulators looking particularly at how the risk committees are working? Obviously the aggregate of poor management in risk committees would be one for financial stability.
Mark Hoban: I think that is a very good point, and one of the things that has struck me recently is the variability in the approach to risk by financial institutions. I think it is important that regulators understand the sort of processes that are in place to manage risk, and control risk, as a way of delivering financial stability. It's not just about numbers and ratios. It's about culture and processes within firms as well. I think that is a very important point for them to follow through.

Q879 John Thurso: The Bank has very recently said to me that if you looked at RBS and the way it was run, they were making mistakes, as they described it, straight out of Banking 101—in other words, the course on banking that they do in America—and saying that those mistakes should not have been made. So if we have a serious problem in this crisis that came through the failure at that level that is clearly something that needs to be taken into account.
Mark Hoban: I think that's right, and I think about my own experience, prior to coming to this place, as an auditor. Clearly the controls that are in place in businesses to manage risk are important. I think that the regulator needs to look at those processes and controls very carefully, and ensure there is a strong culture in firms enabling them to deliver accurate assessments of risk.

Q880 John Thurso: The second area we looked at was the remuneration committees and the question of remuneration, and that is something I think the Government is looking at. Who should set the rules for compulsory disclosure of salaries and bonuses?

Mark Hoban: You have a range of points of intervention there because clearly company law dictates a certain level of disclosure for listed companies. But you also have increasing international debate about the disclosure of salaries. So we're in the process of implementing CRD3, for example, in the UK, which includes quite a lot of disclosure on remuneration; not just salaries but severance pay, sign-on fees, and so on. There's a G20 debate to be had, too, on disclosure around remuneration. So there are various points, in the debate, where discussions can be had about disclosure standards and their implementation.

Q881 John Thurso: When he came before us, Lord Myners suggested that what we ought to be focusing on was not so much the level of the bonus but the method of payment and that equity was wrong, and we should be making bankers get subordinated debt in order to tie them into the future of their institution. Do you think that idea has any merit?
Mark Hoban: It's an idea that a number of people have come up with. I think the important thing is to ensure that there is a strong correlation between risk and reward and there is a claw-back for bonuses where performance has not been as good as it was alleged to be in the first place. I think the Swiss came out with this concept of malice as being the reverse of bonus and I think those sort of measures are important. We are moving to a system where, more and more, a higher proportion of bonuses will be paid out in shares. But in terms of whether we should be replacing shares with subordinated debt is a broader issue.

Q882 Mr Umunna: I have a question in relation to remuneration disclosure. Sir David Walker has obviously changed his position, in the sense that he said that he doesn't think we should do this unilaterally, having said so in his report in terms of implementing his recommendation. It seems slightly inconsistent to push ahead with the bank levy unilaterally—which I think is a good thing, by the way—but not to do so with remuneration disclosure. Why?
Mark Hoban: I think Sir David Walker made the point in his article—and he's responsible for his words, I'm not—that he assumed that the international debate on disclosure had moved further than he thought at the time he wrote his report. Very clearly, there is a range of views internationally on disclosure but we are seeing, in CRD3, some significant progress on levels of disclosure in the European Union, where the European debate is going further than the debate on a global basis. I think that is a good thing.
Mr Umunna: I'm not sure that is an answer to my question. What I was saying is: why unilaterally on a bank levy but not on remuneration disclosure? Are you saying that the debate has not moved on around a bank levy and it has on remuneration disclosure, or vice versa? I'm confused about the lack of consistency.
Mark Hoban: I'm just reflecting back Sir David Walker's remarks in the article last week.
Mr Umunna: But I'm asking what you as a Government—
Mark Hoban: Yes. I thought it was absolutely the right thing to introduce a bank levy on a unilateral basis. Banks do pose a risk to the economic stability of this country. It's right that they should make a contribution towards—
Mr Umunna: But you don't think that remuneration practices—
Mark Hoban: No. I think it was right to make them contribute but I think it was also right to set the levy at a level that didn't impact upon our competitiveness.

Q883 Michael Fallon: While you've been sorting out the regulatory mess here that you inherited, you have also been negotiating on our behalf with the European proposals. What are the arguments you have won since May and which arguments have you lost?
Mark Hoban: I think one of the big examples of our success in Europe has been the debate on AIFMD—the Alternative Investment Fund Management Directive—where in May we were given a bit of a hospital pass by our predecessors and were left with a directive that would have had significant consequences on the investor community here in the UK. When we came into office the passport for non-EU funds was not on the table. We were outnumbered 25 to 2. When we reached a final conclusion on the directive in October we had turned the debate around: passports were there and we had the support of 25 other member states in that. So I think that's a good example of how our effective engagement in the debate in Europe, working in parallel with the industry, delivered some significant benefits.
Michael Fallon: And which have you lost?
Mark Hoban: I think we have made progress on all fronts. For example, I think we had a better outcome on the supervisory arrangements than we expected back in May. I think we have managed to constrain the roles of the supervisory authorities, while we have ensured that the new European Banking Authority would be based here in London. There was a move by the Parliament to base all the authorities in Frankfurt. We defeated that. So I think we made some good progress.

Q884 Mr Love: Why is it right that we have to publish the rather modest salaries in the public sector, the BBC and all sorts of public institutions, but we suddenly don't have to publish them for the banking industry, when public interest in these matters is clearly focused on the banking sector?
Mark Hoban: We are committed to improving the disclosure regime for all salaries in the banking sector. There are already moves afoot in CRD3. We'll make further announcements about other matters on disclosure. Of course, the salaries of directors in public companies are already disclosed. There is quite extensive disclosure in company accounts about their salary packages, their bonuses, their pensions, and so on.

Q885 Mr Love: So why is there such equivocation over the matter? Why don't you just publish them? That is what you said you would do.

Mark Hoban: We said that we would implement the findings of Sir David Walker's report and we will make announcements in due course.

Chair: Minister, thank you very much for coming before us today, and for giving us such crisp clear answers, even if you haven't satisfied us on all points. I thank you particularly bearing in mind you have had a very busy 24 hours. Of course, you have had a very busy few months but it has been a particularly busy 24 hours. So thank you for coming before us.

Written evidence

Supplementary written evidence submitted by Professor Charles Goodhart

At the Treasury Committee hearing the Chairman asked me to expand on two issues. These are whether either Basel I or II ever achieved anything positive, and my views on CoCos, Conditional Contingent Capital, and Bail-in proposals. If I may, I will add a third brief comment on the coordination problem of reforming remuneration.

Basel I and II

The main purpose of Basel I was to reduce the, previously quite rapid, drift down in bank capital ratios. In this it succeeded, and a time-series chart of such ratios show that the downwards trend halted in 1988–91, (the transition period). This success, however, was partially, perhaps largely, later vitiated by banks' ability to replace core equity by various kinds of hybrid, and less loss-absorbing, capital instruments, so that core equity, by 2007, was often in many banks not more than 2% of total assets.

The main purpose of Basel II was to make regulatory capital more sensitive to risk. While it had some success, it failed overall both because risk was poorly assessed by both bankers and regulators, and because risk always appears to decline in booms (asset bubbles) and to increase in busts. In conjunction with the greater use of "mark-to-market" accounting, this made the whole regulatory system far more procyclical, almost a "Doomsday machine".

CoCos and Bail-ins for Failing Banks

I attach my article (Central Banking, August 2010) on CoCos.

The "bail-in" proposal is somewhat similar. Assume that Bank A has a loss, too big for its equity shareholders to absorb. The idea is that the regulator should then, starting with the most junior creditor, forcibly require such (subordinated) bonds be transformed into equity, until the bank is sufficiently well endowed with new equity to carry on as a continuing entity. There is no bankruptcy, nor cost to taxpayers. The previous shareholders are diluted into oblivion, and the "hit" to bondholders varies according to the scale of loss, but could be large, especially for the most junior.

If only one bank was in trouble (an idiosyncratic shock), this would be wonderful, the way to go. The problem is that, with a systemic shock, all banks are, more or less, in difficulties. The shock to the bond holders of the failing bank would be transmitted to the bond market and bond prices of all other banks. No bank would then be able to raise new bond (or equity) finance to recapitalise themselves. Thus in the recent crisis, to facilitate raising new long term capital, governments have felt forced to guarantee all bonds.

If a bail-in system was to be used, whenever a crisis struck, governments would have to accompany losses to existing creditors with guarantees for "new-money" creditors, resulting in a complex mixture of both guaranteed and non-guaranteed debt. Such non-guaranteed debt would be subject to equity-style downside risk with no upside countervailing option value. So if we were to move explicitly to a bail-in system, the cost, or interest rate, that would be required on such non-guaranteed debt would, almost certainly, rise very sharply.

Overall it would just seem simpler, and just as efficacious, to require much higher holdings of equity capital.

Reforming Remuneration

There is a major coordination problem. One bank, trying to cut back on bonuses, etc, would lose all their top traders to other banks, as D Maughan found when he tried this at Salomons.

Similarly one country trying to do so would lose all its top banks/bankers to other countries.

It would be extremely difficult to get effective international agreement on this subject, partly because it is so politically sensitive, with different countries having differing positions, and partly because being the stand-out bank/country paying more than the rest would be so advantageous.

So nothing can/will be done.

15 September 2010

Written evidence submitted by the Financial Ombudsman Service

Executive Summary

1. The Treasury Committee has called for evidence as part of its inquiry into the Government's proposals to change the system of UK financial regulation, as set out in *a new approach to financial regulation: judgement, focus and stability* (Cm 7874). The Financial Ombudsman Service welcomes the opportunity to contribute to the Committee's evidence.

2. The Financial Ombudsman Service welcomes the Government's proposals to establish the CPMA with a responsibility to promote confidence in financial markets and services and with a clear consumer protection function. We also welcome the Government's acknowledgement that it is critical to the credibility of the ombudsman service that it is, and is seen to remain, impartial and independent from both consumer and industry interests.

About the Financial Ombudsman Service

3. The Financial Ombudsman Service is the statutory-based scheme for the resolution of complaints that have not been settled between financial businesses and their customers. In addition to dealing with complaints involving banks, insurers, advisors and other businesses that are (or used to be) regulated by the Financial Services Authority (FSA), the ombudsman service also resolves complaints made against consumer credit businesses licensed by the Office of Fair Trading. The service handles complaints made by both individual consumers and small businesses.[1] Since it was established in 2000 from a merger of eight predecessor ombudsman schemes, the Financial Ombudsman Service has received over one million complaints. In consequence the ombudsman service has a unique and impartial insight into where things go wrong in retail financial services.

4. Further information about the Financial Ombudsman Service and its work is contained in *Annex A*.

Government's Proposal

5. The focus of the Government's proposals in Cm 7874 is in maintaining financial stability and restoring confidence in the ability of regulators to identify and avoid macro-prudential risks to financial stability in future. Conduct issues in the retail sector receive less attention. However, the past 10 years have seen a mixed picture for firms, customers and regulators. Past failings have resulted in widespread customer detriment and have damaged customer confidence in retail financial markets—just two, mortgage endowments and payment protection insurance, have resulted in over 425,000 complaints to the ombudsman service and many more to the industry itself.

6. There is therefore a case for reform of retail market regulation. The ombudsman service welcomes the Government's proposals to establish the CPMA with a responsibility to promote confidence in financial markets and services and with a clear consumer protection function. A "*single integrated conduct regulator, taking a tougher, more proactive and more focused approach to regulating conduct in financial services and markets*" should be capable of working constructively with industry and consumer groups to identify and avoid significant conduct risks (like PPI) occurring in future [4.4].

7. Within this new framework the Government stresses that it will be important for the Financial Ombudsman Service to remain independent of the CPMA [4.44]. We strongly welcome this commitment. It is critical to the credibility of the Service that it is and is seen to remain impartial and independent from consumer and industry interests. It also must operate in close contact with but independently of regulation. As the Government notes, there are some risks here if the CPMA is to be a clear consumer champion. But the arms length regime presently in place between the FSA and the ombudsman service provides a generally acceptable model that could be applied to the new relationship between the CPMA and the ombudsman.

Further Issues

8. The Government says it will take the opportunity of the CPMA to consider further how consumer protection is enshrined in the existing legislation "*and what changes may be needed to update or strengthen the regime*". [4.50]. The Financial Ombudsman Service welcomes that commitment and looks forward to contributing to that review.

9. The review of FSMA consumer protection provisions and bringing into being of the CPMA should provide an opportunity to modernise the regulatory regime. A conduct regime will always have a balance of general principles and more specific rules, whilst in handling individual complaints it is often normal consumer law principles that have the greatest significance in deciding fair outcomes. The absence of a detailed conduct of business rules regime for consumer credit licensees has not restricted our ability to resolve complaints fairly. In our experience, an undue focus on what regulatory rules do and do not allow can lead to poor outcomes for customers.

10. As the Government notes, the Financial Ombudsman Service provides an important restorative role in the overall regulatory framework. By looking across the law, regulatory rules, industry good practice and taking an overall fair and reasonable approach, the service provides the flexibility required to deal with the

[1] Defined as "micro-enterprises" under Commission Recommendation 2003/361/EC.

individual circumstances of each case. And by giving customers access to a free and impartial service that delivers straightforward redress if things have gone wrong, the Ombudsman not just protects individual customer interests but also incentivises good behaviour by firms.

11. In developing the new framework for conduct regulation and redress, one area that warrants further attention is those circumstances where there has been widespread customer detriment because of past failings. It is now widely accepted that the initial FSMA regime did not do enough to provide tools to tackle issues like PPI. The first objective of course is to avoid such widespread areas of detriment occurring. The ombudsman service is working closely with the regulators through our joint co-ordination committee to help them identify and resolve emerging new areas of conduct risk.

12. But it would be unrealistic to assume that even with the improvements that are already underway there will in future be a "zero failure" regulatory regime for retail market conduct issues. Some systemic areas of detriment will arise in future that will require effective tools to resolve fairly and efficiently.

13. Another area that we believe will warrant further attention is transparency. There are difficult judgements here not least about the need to protect commercially sensitive or personal information and the impact greater transparency could have on the informality of our Service. But our approach—following an independent review carried out by Lord Hunt of the Wirral—is to seek ways of further opening up the work we do on behalf of firms and customers.

14. Our decision in 2009 to publish for the first time firm specific data about the number and outcomes of cases referred to us was controversial at the time. But we believe it is having a beneficial effect in encouraging firms to look again at how they handle customers who have a complaint about the service they are receiving. We already publish extensive information about our approach to cases—although not presently the individual decisions we make.

15. Finally we note that the Government says it will in due course review whether or not the consumer credit functions of the OFT should transfer to the CPMA. We can see the logic in such a move. At present we provide a redress service for both OFT and FSA regulated businesses as well as to businesses that are not presently regulated by either authority.

16. But it should be noted that, more generally, the dividing lines between traditional financial services and other retail markets are blurring. In areas like subscription media, communications and utilities, customers find it difficult to know whether their problems with payments are with the service provider or the financial business. Similarly, in significant transactions like house purchasing a range of parties with different redress and regulatory structures can often be involved. There may be scope to simplify and improve access to redress in these areas.

Annex A

BACKGROUND ON THE FINANCIAL OMBUDSMAN SERVICE

1. The Financial Ombudsman Service was established under the Financial Services and Markets Act 2000. It is an impartial body that provides an informal alternative to the courts, resolving complaints by individual consumers and small businesses who remain dissatisfied after complaining unsuccessfully to:

- a retail financial services business regulated by the Financial Services Authority;
- a consumer credit business licensed by the Office of Fair Trading; or
- a range of other businesses who submit to the service's jurisdiction voluntarily, including National Savings & Investments.

2. We currently handle more than 160,000 new cases (and more than 900,000 consumer enquiries) per year. Around half of all the cases we have handled related to "mass claims" about just six topics. As shown by our published data,[2] around half of the new cases we receive relate to financial businesses belonging to just four large financial groups.

Financial Ombudsmen

3. In the 1980s the insurance and banking sectors set up ombudsman schemes. They recognised that access to independent redress if things went wrong would increase consumer confidence in financial services—and that consumers see the courts as costly and off-putting. The sectors volunteered to pay the cost of the ombudsmen schemes, creating a free service for consumers, and established independent governance to secure the ombudsman's independence.

4. In 2000 the Financial Services and Markets Act created a comprehensive independent Financial Ombudsman Service, merging into it the insurance and banking ombudsmen together with other financial ombudsman that had subsequently been established. The financial regulator acted as an arms-length sponsor, and the financial industry continued to meet all of the cost.

[2] www.financial-ombudsman.org.uk/publications/complaints-data.html

5. The ombudsman service links the regulatory system with the justice system. It resolves individual cases about financial services and consumer credit as an informal alternative to the courts. It is not a regulator or policy-maker. Like the courts, the ombudsman service is independent of the parties in dispute, and operationally independent of government and regulators.

6. Its specialist expertise allows the ombudsman service to resolve individual disputes at a fraction of the costs incurred in court, and with no charge to the public purse. Decisions made by the ombudsman service on individual cases—coupled with the service's commitment to openness and transparency—encourage fair behaviour by financial businesses, enabling regulators to focus on major and systemic issues.

7. The ombudsman service engages with regulators, the financial industry and consumer bodies about the lessons learned from its work, so all can benefit. The availability of the ombudsman service—and the information it makes publicly available—empowers consumers, helps financial businesses that want to treat their customers fairly and improves access to justice.

Mass Claims to the Ombudsman

8. The number of new cases referred to the ombudsman each year has grown from around 31,000 (in 2000–01) to more than 160,000 (in 2009–10). A key feature of this has been the growth in "mass claims"—large numbers of similar cases about a particular financial product, often in relation to a limited number of financial businesses.

9. From 2000–01 to date there have been more than one million new cases in total. More than half of these related to just six topics:

- mortgage endowments — about 301,000 cases;
- dual-variable-rate mortgages — about 7,000 cases;
- split-capital investment trusts — about 5,000 cases;
- unauthorised-overdraft charges — about 46,000 cases;
- credit-card default charges — about 39,000 cases;
- payment protection insurance — about 124,000 cases

Cases on payment protection insurance are still coming in at the rate of about 1,600 per week.

10. In all of these "mass claim" cases, the individual consumer had complained unsuccessfully to the financial business and then referred their complaint to the ombudsman.

22 September 2010

Written evidence submitted by Consumer Focus

Executive Summary

Consumer Focus is the statutory organisation campaigning for a fair deal for consumers in England, Wales, Scotland, and, for postal services, Northern Ireland. We are the voice of the consumer and work to secure a fair deal on their behalf.

Consumer Focus has been active in the debate on regulation, developing sector-specific expertise on regulatory structures, cultures and methods and applying these in our work across the economy. We welcome the opportunity to contribute to the Treasury Select Committee's inquiry.

Our assessment is that the proposed changes to financial regulation do not place the consumer at the heart of the new structures. Unless there is a significant change of approach, this will be a missed opportunity to remedy the lack of focus on consumers, which has long been a problem in this sector and its regulatory arrangements.

Effective regulation of financial services must include the following elements:

- The primary objective of the new CPMA must be to protect and promote the interests of consumers and the PRA must also have regard to consumer interests.
- Regulators should ensure that industry becomes greatly more transparent and accountable with its customers and use reputational regulation as a tool for driving changes in the market.
- The CPMA must tackle unsafe and unfair practices or profit structures before they become widespread and entrenched.
- Responsibilities between the different bodies must be clearly defined and the government should periodically issue a strategic statement setting out what it expects regulators to deliver.
- The engagement strategy should enable both consumer bodies and consumers themselves to influence the agenda and priorities of the new CPMA.

1. Introduction

1.1 Last year we published an analysis of six key regulators, including the Financial Services Authority, in our report *Rating Regulators*.[3] Our response to the Committee draws on this analysis and we use the indicators from the report throughout. Our assessment framework consisted of twenty indicators which together form the essential building blocks of a consumer focused regulator. These are:

1.2 *Legal framework*

— statutory objectives and duties enable the regulator to adequately promote the interests of all consumers;

— responsibilities between different actors are clearly defined, without gaps or overlaps;

— structures are sensitive to devolved contexts; and

— the right tools for the job.

1.3 *Culture and accountability*

— translates statutory objectives into consumer-focused priorities and values;

— embeds a consumer focus across all levels of the organisation;

— transparent about its activities;

— accessible to the general public, including disabled users; and

— works effectively in a devolved setting.

1.4 *State of readiness*

— identifies likely sources of consumer detriment, both now and in the future, which shapes work priorities;

— uses effective mechanisms to understand the consumer perspective and translate this insight into sound decisions;

— works effectively with others, including with consumer organisations; and

— influences the wider regulatory agenda.

1.5 *State of action*

— empowers consumers to help achieve regulatory outcomes;

— has effective incentives to encourage compliance with its rules;

— chooses the appropriate regulatory approach in the circumstances, and intervenes in a timely fashion when needed;

— gives priority to, and intervenes effectively on behalf of, consumers who are vulnerable; and

— uses enforcement tools when appropriate to protect consumers.

1.6 *Impact and learning*

— defines and measures its impact on consumers in terms of outcomes; and

— evaluates its work and embeds learning.

2. Overall

2.1 *What costs will the regulatory structure place on consumers?*

2.1.1 Lack of competition has meant little competitive pressure on pricing and consistent profit margins. Consumers have faced a squeeze through negligible returns on savings and limited and expensive lending facilities while many financial institutions have had the advantage of state support and cheap access to money through quantitative easing. At the same time, regulation has placed burdens on consumers, often with little obvious impact on industry actions. Where regulation is needed to provide protection from banks' irresponsible or inappropriate behaviour, we would expect the cost of this to be absorbed by the banks rather than passed on to consumers. Until such a time as markets are competitive and provide value for consumers, we would expect monitoring of issues such as margins and charges, with powers to intervene available and used where necessary to correct market failure.

[3] Consumer Focus, *Rating Regulators,* February 2009.

3. Power, Roles and Responsibilities

3.1 *Do the Government's proposals appropriately assign roles and responsibilities between the different regulatory institutions?*

— Statutory objectives and duties to enable the regulator to adequately promote the interests of all consumers and a consumer focus embedded across all levels.

3.1.1 The House of Commons Regulatory Reform Committee has recommended that the Better Regulation agenda post financial crisis needs "a greater diversity of input, including more accountability to citizens and end users".[4] All three bodies need clear public interest and consumer representation at Board level, and all need to be clear that they are regulating in the consumer and citizen interest.

— Responsibilities between different actors need to be clearly defined.

3.1.2 There are a number of areas where there are overlaps of powers, roles and responsibilities (such as in relation to supervision of firms where PRA and CPMA or the Bank of England and CPMA have an interest). It is not clear how these will be resolved and which organisation's objectives will apply. In others, there is a separation in relation to similar responsibilities which could compound current problems with consistency and co-ordination (such as the proposal for a split of licensing and prudential responsibility between PRA and CPMA, in addition to the existing separate system for credit licensing). And there is the blurring of the intended split between prudential and conduct responsibilities, with the COMA continuing to be the prudential regulator in those areas not covered by the PRA.

3.1.3 The overall system implies precedence, with the FPC and PRA having the stronger hand. The CPMA must have regard to the FPC and PRA objectives and is required to consult with the other bodies in relation to impacts on these but the obligation is more limited the other way. While we welcome the focused attention on consumer protection issues we are concerned that the separation of the area will see consumers sidelined.

3.1.4 Our experience across different sectors is that the high-level objectives of government are rarely fully articulated, even in statutes, with the result that decisions can too often be made on the basis of inter-organisational politics and individual regulators' preferences and cultures. This can create confusion, overlap and two significant gaps: a strategy gap and an accountability gap. These are dangerous enough when there is only one regulator, but their likelihood and impact are heightened in markets where there are two or more regulatory bodies, as will be the case in financial services.

3.1.5 We therefore propose that government periodically issues a strategic statement, setting out what it expects the regulators to deliver and what the government's own role will be. Implementation is then a matter for the regulators, working within the strategic framework set by government. This allows for clear accountability to the elected government, while making the most of the specialist skills and expertise within the regulator.[5]

3.2 *Will there be unintended consequences of the Government's proposals for regulation on the prospects for non-bank financial institutions?*

3.2.1 Lack of competition in the market means the monetary financial institutions have an advantage over specialist institutions and that those institutions may be driven to more marginal business.

3.2.2 Increasing capital requirements may impact on institutions that are considered risky but may also provide greater barriers to others who are genuinely offering different models. These requirements should better reflect and differentiate on risk (and rate favourably other factors such as sustainability and financial inclusion). We also seek the application of guarantees and assurances to non-banks, with contributions also determined according to risk based on an assessment of trading activities.

4. The Prudential Regulation Authority (PRA)

4.1 *Should the PRA be the lead authority over the Consumer Protection and Markets Authority (CPMA)?*

4.1.1 The PRA must have regard to consumer interests. There should be no implicit hierarchy in how the regulatory structure operates. The CPMA must have sufficient tools, independence and powers to carry out its consumer protection functions, and in this respect they should be at least equivalent to those of the PRA.

4.1.2 Financial stability is fundamental to consumers in terms of the provision of low risk sustainable products and services that are both essential to their engagement with society and the economy and fundamental to the long term recovery and restoration of confidence. In many cases consumer and financial stability interests will coincide. When they don't the matter becomes a public policy issue and should be referred to the Government of the day. For example, where a firm's survival or the survival of the prevailing business model of firms may be impacted by consumer protection measures or risk measures, should it really be consumers or citizens that suffer?

[4] House of Commons Regulatory Reform Committee, *Themes and Trends in Regulatory Reform*, Ninth report of Session 2008–09, July 2009.

[5] Consumer Focus Fresh Thinking, *Regulating in the consumer interest*, March 2010

5. Is it Appropriate for the PRA (and CPMA) to Adopt a Judgements-based Approach to Financial Regulation and Supervision?

— Right tools, right people for the job, and a willingness to use them.

5.1 It is important that a regulator is not only appropriately equipped but also ready to act. The FSA was characterised for a number of years by the mantra "we are not an enforcement-led regulator", where supervision staff were reluctant to refer firms to enforcement lest it reflect negatively on them.[6] While this has recently changed and enforcement actions and monetary penalties have significantly increased, powers in relation to mass harm and widespread practices remain largely unused, as do tools such as transparency that could empower consumers.[7] The post-crisis period saw a focus on prudential issues with consumer protection coming into focus much later almost as an afterthought.

5.2 The recession has seen significant adverse impacts on a market which was already not working optimally for consumers. Increased consolidation, barriers to new entrants, restricted availability of credit products, and issues around financial difficulties require a more pro-active response from the regulator both on a prudential and consumer level. The stated new approach to Retail Conduct of Business holds out the promise of intervention on price and products, recognising and responding to "some of the unique characteristics of retail financial services that call for a more intrusive approach".[8] The new approach will require a culture change from the regulator and new skills and ways of thinking. The new regulator should not be the same body with a new set of clothes.

— Chooses the appropriate regulatory approach in the circumstances and identifies likely sources of consumer detriment.

5.3 Changes to the regulatory approach are needed to:

— detect systemic risk issues before they become entrenched;

— enable early intervention in relation to unfair practices such as the mis-selling and unfair terms and conditions associated with PPI;

— investigate models that are unfair, hamper choice and obstruct good personal financial management, such as the hidden charges model in the provision of current accounts; and

— consider areas where uncertainty and lack of control over payments negates financial capability.

If this is not done then the consumer protection role is brought into conflict with the financial stability objective. Unsafe and unfair practices or profit structures need to be tackled *before* they become the foundation of a firm's or industry's business model, and not after, when the damage is done and the challenge could potentially damage the soundness of firms or the sector.

6. The Consumer Protection and Markets Authority (CPMA)

6.1 *Do the reforms provide adequate protection for the consumer?*

— Statutory objectives and duties enable the regulator to adequately promote the interests of all consumers and the regulator gives priority to and intervenes on behalf of vulnerable consumers.

6.1.1 The regulator should have clear statutory objectives primarily focused on the consumer interest.[9] The FSA currently has five objectives that are not weighted. The discretion as to which has priority is left to the regulator. Objectives should be clear and unambiguous and where there is more than one they should be prioritised so that there is sufficient guidance to, and accountability of, the regulator.

6.1.2 We propose the CPMA's primary objective should be protecting and promoting the interests of consumers.

6.1.3 To support this objective the regulator should have regard to broader public interest considerations that align with the consumer interest such as:

— promoting financial inclusion, and in particular the interests of vulnerable and disadvantaged consumers, by encouraging access to suitable and affordable products and services;

— acting to maintain and develop essential service provision;

— driving and facilitating innovation that promotes choice and fosters good personal financial management;

— promoting an economically, environmentally and socially sustainable market and services; and

— chooses the appropriate regulatory approach and has effective incentives to encourage compliance with its rules.

[6] Consumer Focus, *Rating Regulators, Financial Services Authority,* February 2009.
[7] For example, information on investigations and, until some progress recently, complaint data.
[8] HM Treasury, *A new approach to financial regulation: judgement, focus and stability*, July 2010
[9] Consumer Focus, *Regulating in the Consumer Interest*, March 2010.

6.1.5 The ambition of regulation must be to change the culture and norms of industry so that businesses start to act in the spirit of the governing rules rather than seeking to merely meet the letter of those rules and test the boundaries of what they can get away with. It is important that high level principles such as Treating Customers Fairly (TCF) actually deliver outcomes. More guidance in this area may be necessary, with some clear incentives or disincentives applied to encourage behavioural change. Similarly a "wider implications" power must be operable, effective and utilised to deal with the significant economic and social consequences of detrimental practices.

6.1.6 Issues such as PPI showed that the regulator was slow in acting and the industry was slow to respond to the regulator's warnings, allowing the harm to continue. Enhancing the own initiative variation of permission (OIVOP) powers to enable supervision to feed into regular review of authorisation of firms and to maintain standards will be significant in the CPMA's ability to provide effective consumer protection and to promote a sustainable market that better serves the public interest.

6.1.7 The PRA and CPMA framework needs to outline clearly how they will be able to deliver outcomes where the FSA has been unable to do so.

— Uses mechanisms to understand the consumer perspective and translate this into sound decisions.

6.1.8 Our perception is that under the previous model the regulator and the industry framed issues in the same way and there was a distinct absence of the perspective and experiences of the public, both consumers and citizens. One way of improving this area is to increase investment in consumer research and to include qualitative and deliberative as well as quantitative research, along the lines of Ofcom's Consumer Experience Report and Citizen Juries. Another is to ensure the staff and board have relevant expertise.

6.1.9 The new regulator has to reinvent itself and look at how it communicates and interacts with the broader community. It needs a diversity of staff from different backgrounds who are more attuned to the varied interests of consumers.

— Works effectively with others, including consumer organisations.

6.1.10 The regulator needs to adopt best practice in engaging with consumers and consumer bodies. The Financial Services Consumer Panel is seen as one of the FSA's strengths and it is important that thought is given to how it can most effectively function in the new structure. The new regulator also needs to engage more widely with other representative organisations particularly those working in the areas of financial inclusion.

6.1.11 A regulator needs to consult widely and decide openly on the basis of its consultation and information gathering. Consultations need to be clear and in plain English and mechanisms for getting input should consider outreach rather than only relying on written responses. Responses to public consultation should be published,[10] as well as any other information or evidence taken into account in decision making. It is sometimes difficult to see the weight of evidence behind decisions and there is the perception that decision making is very much behind closed doors.

— Defines and measures its impact on consumers in terms of outcomes.

6.1.12 Outcomes should be related to on the ground benefits to consumers. For example, supervision of the TCF principles monitored whether firms had policies in place in relation to customer services, such as dealing with customers in financial difficulty, but made no assessment of whether these were applied in practice. While the programme was stated by firms to have some impact on greater consumer consideration in product design and markets it has not influenced complexity and pricing structure.

6.1.13 Apart from sparsely used enforcement action there appear to be no disincentives for inadequate compliance with the TCF principles, there was limited feedback, and no incentives or accolades for those who did comply. This must change in the new structure.

— Evaluates its work and embeds its learning.

6.1.14 More could be done by the regulator to evaluate the work and embed learning. This includes defining outcomes to be achieved and monitoring them through consumer research. Complaints information and the firm's reports to the regulator are also (or could be) rich sources of information from which to identify problem areas and firm's performance against these. The complaints information currently available needs to be monitored and analysed to inform further actions.

6.1.15 The outcomes performance report currently produced by the FSA provides a good basis but needs more work in terms of how outcomes are measured. Once defined, we welcome reviews of these impact measures by the National Audit Office.

6.2 *Transparent about its activities*

6.2.1 The FSA has been a reluctant reputational regulator. It does not reveal details of investigations until concluded, nor does it provide information about the firms that are not satisfactorily complying with requirements.[11] The regulator should be open in its investigations and regulatory activity and therefore accountable. Positive steps have been made recently with the requirement on banks to publish complaints

[10] Consumer Focus, *Rating Regulators, Financial Services Authority*, February 2009.
[11] Consumer Focus, *Rating Regulators*, March 2009.

data but more and better information is needed so that consumers can make real choices and businesses are more motivated to treat their customers fairly. Reputational regulation may, in itself, help develop a trusted brand approach in the industry.

6.2.2 A culture of publishing and analysing complaints and enforcement actions to identify emerging risk and as a window on the industry is vital. It will also promote understanding of the role of the regulator. Performance measures are currently published by the Food Standards Agency in their scores on doors initiative and also by Ofgem as part of their quality of service reporting. These empower consumers to make informed choices about service provision.

6.2.3 We are supportive of the view that the CPMA "names and shames firms which break the rules. This will act as an incentive for firms to improve their behaviour."[12]

6.3 *Accessible to and engaging with the general public*

6.3.1 Engagement needs to provide real opportunities for consumers to contribute to the work on the CPMA. Its engagement strategy should provide:

- Opportunities to engage in the CPMA's corporate planning processes to allow consumers to help shape the priorities of the Authority.
- A "consumer radar" of emerging issues and areas of detriment.
- The ability to work both with representative bodies and directly with consumers themselves.

6.3.2 In order to be accountable to the public the regulator needs to be accessible to the public and provide information in a timely and comprehensible way for a range of audiences, not just for the industry.

7. To what Extent will the Regulatory and Administrative Burden Increase for those Firms who now have to deal with Two Regulators?

7.1 We do not support unnecessary regulation, as this is not in the consumer interest. However in the financial services it is not helpful to talk about regulation as a "burden", given that the case for intervention here is to correct substantial market failure, provide safeguards against any repetition of past industry irresponsibility and remedy a significant imbalance of power between industry and consumer.

7.2 In assessing this issue, the full cost-benefit analysis needs to be taken into account. Cost benefit analysis to date has often looked purely at whether there are measurable benefits to consumers and then quantified the costs to industry. Qualitative and quantitative measures are extremely hard to balance. Disincentives to unfair behaviour and the subsequent cost savings in supervision and enforcement this might entail are seldom considered, nor the relative cost burden in terms of a proportion of firms' profits.

7.3 Effective regulation will promote a better market place with more efficient product and service provision. Reduced risk taking may impose restrictions on current activities but will shift the industry itself to develop better operating models. The current system rewards inefficiency and entrenches advantage.[13] It is those models not responsive to change and geared to serving their own purposes, rather than the stability of the market and the interests of consumers, who will be impacted most with a movement towards a more sustainable regulatory model. New entrants and those who are more flexible and better able to innovate will be in a better position to serve the market.

22 September 2010

Written evidence submitted by the British Bankers' Association

Introduction

1. The British Bankers' Association welcomes the opportunity to give evidence to the inquiry by the Treasury Committee into the Government's proposals for changing the framework for UK financial regulation. We represent 220 banks from 60 countries and have 40 associate firms within membership.

2. As the inquiry notice observes, the Financial Services Authority (FSA) will cease to exist in its current form and will be replaced by two new bodies—the Prudential Regulation Authority (PRA), a new subsidiary of the Bank of England focusing on the regulation of banks, deposit-takers and insurers; and the Consumer and Markets Authority (CPMA), which will be responsible for consumer protection and market conduct. A new Financial Policy Committee (FPC) will also be made responsible for macro-prudential policy and will sit alongside the Monetary Policy Committee (MPC) within the Bank of England. Given the critical nature of these changes it is right that the Treasury Committee has determined that it should take an interest in their development from the earliest possible stage.

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[12] Conservatives Policy White Paper, *From Crisis to Confidence: Plan for Sound Banking*, July 2009.
[13] Andrew G Haldane, Executive Director Financial Stability, Bank of England, *The $100 billion question*, March 2010.

3. We have little issue with the broad institutional changes envisaged by the Government in that they:

— Create greater focus on the different regulatory disciplines of prudential supervision and conduct of business;

— Place within a single body—the Bank of England—responsibility for macro-prudential supervision; and

— Provide for better coordination between macro and micro-prudential regulation through the establishment of the FPC and the Bank of England's oversight of the PRA.

4. But we do believe that new institutional structures bring a new set of challenges to be addressed and it is not at all clear to us that the various issues raised by the proposed arrangements have been as fully thought out as they need to be. As matters stand, we see shortcomings in the democratic accountability of the proposed bodies, their proposed objectives, and the planned arrangements for due consultation process. We believe that the importance of the involvement of the Treasury may have been underplayed as a result of the falling away of the Tripartite arrangements and can also see imbalances in the arrangements for the PRA and CPMA. We are concerned in particular that insufficient emphasis may have been placed on the need to maintain a coherent markets division capable of representing the UK interest in European and international fora.

The Banking Reform Programme

5. The Treasury paper (Cm 7874) opens by explaining that there is an emerging consensus on the fundamental cause of the crisis and we would not disagree with the key factors identified: global economic imbalances; mispriced and misunderstood risk; unsustainable funding and business models for banks; excessive build up of debt across the financial system; and the growth of an unregulated "shadow banking" system. We would add monetary and fiscal policies to the list since the financial sector cannot be said to be the main driver of economic cycles and we would be missing a vital part of the picture if we were to overlook this.

6. Some of these factors have been the subject of the programme of banking reform begun by the then Financial Stability Forum (now Board) and subsequently adopted by the G20.[14] The reform of the regulatory and supervisory architecture undertaken to date can be said to have focused on two overarching objectives: reducing the probability and systemic impact of an institution failing:

— Measures to increase the resilience of the banking industry include banks holding more loss-absorbing types of capital, increased capital requirements against the trading book and putting in place better liquidity buffers. It also includes improvements in corporate governance, risk management, supervision, accounting, and product simplification, measures to reduce the interconnectivity of institutions and the "recovery" part of living wills; and

— Measures to reduce the potential impact of a bank failure include the special resolution measures in The Banking Act 2009, equivalent arrangements for investment banks and the "resolution" part of living wills which will help ensure that in the event of failure the authorities can act swiftly and effectively.

7. Considerable progress has been made in the delivery of the reforms needed to strengthen the financial system. Banks are already holding more, better quality capital and liquidity, international agreement has been reached on a new capital and liquidity framework, and concrete steps are being taken towards achieving a regime in which no institution need be viewed as "too big to fail". This has been a collective effort and the UK banking industry has engaged fully. Against this backdrop it is difficult to see why the Government would wish to build such a high degree of autocracy into the regulatory framework.

Structural Weakness in the Proposed Regulatory Arrangements

8. The changes proposed within the Treasury paper relate specifically to the UK framework for financial regulation and are intended to overcome identified weaknesses within the tripartite regime. Whilst we would not disagree with the thesis that these arrangements failed in important respects during the early part of the crisis, so did those of many other countries. We would also note that the individual authorities have each contributed substantially to the banking reform programme and that many engaged in this have brought an expertise that is widely respected.

9. In terms of the "twin peaks" approach proposed within the Treasury paper, we can see ways in which the model can be used to ensure that appropriate emphasis is placed on both prudential supervision and conduct of business and therefore have no objections in principle. The model can clearly be made to work. But we have a number of fundamental concerns with the arrangements as proposed in the consultation paper. These are not inherent to the "twin peaks" model of regulation and can be corrected providing the shortcomings are recognised and there is a willingness on the part of the sponsoring authorities to make substantial revisions to their proposals.

[14] Financial Stability Forum Action Plan April 2008; adopted by the G20 November 2008

10. As matters stand, we see a democratic deficit in the proposed structure, shortcomings in the proposed objectives for the various authorities, including insufficient alignment to the global and European environment, and the loss of proper due consultative process in comparison to the FSMA regime. We are also concerned about potential imbalances within the arrangements for the PRA and CPMA. We comment on each of these before turning to the specific questions raised by the committee.

Insufficient Democratic Accountability

11. It needs to be appreciated that in proposing the transfer of responsibility for prudential supervision to the Bank of England, the Government is not simply advocating a return to pre-1997 arrangements. At that time, the Bank was given independence over monetary policy—a powerful economic tool—and it has since been given responsibility for financial stability. The Treasury paper builds on this by setting out potential macro-prudential tools. This is in addition to the Bank becoming the lead authority for crisis management since under the new arrangements it will not only be the resolution authority, but responsible for the triggering of any special resolution regime.

12. When you consider the breadth of the Bank's new remit it is easy to see why many consider the proposed accountability to Ministers and Parliament to be undemanding. Accountability to Government Ministers for the activity of the FPC appears to be limited to the Governor briefing the Chancellor once every six months. Likewise, accountability to Parliament will rest with the FPC producing a six-monthly report for submission to the Treasury which will, in turn, lay copies before Parliament. Only in the case of crisis management and a possible call on public funds will the Governor be under an obligation to notify the Chancellor in sufficient time to ensure that all options can be considered and the Chancellor placed in a position to make the final decision on the use of public funds.

13. Few would argue with the need for a strong, independent central bank. In view of the broad responsibilities now being assigned to the Bank, however, we would see a greater need for a more interactive engagement between the Bank and the Government and Parliament. The six monthly reporting arrangements look lightweight. Whilst it may not be possible to develop the type of quantitative proxy for financial stability that can be set for monetary policy and the MPC, we would have thought that the involvement of Treasury Ministers in the work of the FPC should extend beyond the arrangements for the Chancellor to have the opportunity to comment on the risks in the system and the action being taken to address them. It is arguable, for instance, that prior approval should be required for the exercise of macro-prudential tools that may have significant socio-economic effect. We further believe that in drawing up the detailed arrangements we should foresee a need for a public debate about the significance that macro-prudential tools may have for households and businesses.

Shortcomings in the Proposed Objectives

14. The proposed intention is that the FPC and the authorities each be given a primary objective and for other factors to be expressed as secondary objectives or factors. While we can understand the need to give focus to each body, the approach proposed looks to us to be a major failing since it effectively detaches the respective bodies from responsibility for their actions.

The objectives of the FPC

15. If we take the FPC to begin with, paragraph 2.24 of the consultation paper proposes that its objective be to protect financial stability by:

- Improving the resilience of the financial system by identifying and addressing aggregate risks and vulnerabilities across the system; and
- Enhancing macroeconomic stability by addressing imbalances through the financial system eg by dampening the credit cycle.

16. It is recognised, in paragraph 2.26, that the use of certain macro-prudential tools "is likely to affect the levels of lending to businesses and families and the competitiveness and profitability of UK banks in relation to foreign competitors". The paper goes so far as to say that it will be important for the FPC to take factors such as these into consideration when pursuing its primary objectives. But the nearest we have to a commitment to the FPC being responsible for the consequences of its actions is an undertaking that the Government will consider whether the FPC "should be mindful" of these and other secondary factors when determining a particular course of action.

17. As discussed in the BBA's paper "A Possible Macro-prudential Approach",[15] the nature of financial stability is different to that of monetary policy and so we would not envisage the success or otherwise of the FPC being judged by reference to quantitative financial stability targets. The objectives for the FPC will need to be couched in much more general terms and its overall aim will be to ensure that the banking industry is better prepared to weather economic downturn. In the first instance, this will probably mean seeking to reduce the amplitude of economic cycles rather than attempting to prevent asset bubbles emerging, which may develop more over time.

[15] A Possible Macro-prudential Approach British Bankers' Association, March 2010

18. One concern is whether specific reference needs to be made to the countervailing need to maintain economic growth. The pursuit of financial stability, by definition, involves constraining credit supply (and influencing demand) and there is a risk that, if poorly calibrated, measures pursued could have a disproportionate effect on economic growth. When combined with the focused nature of the objectives of the Monetary Policy Committee you can see that without some recognition of the benefits of economic growth as the means by which businesses and families can prosper then there is a real risk that the natural conservatism of the central bank may result in a significant imbalance in the macroeconomic management of the UK economy.

19. This therefore begs the question of whether there will be the means by which consistency and inter-connectivity between monetary, fiscal and financial policy can be achieved. Previously, the Tripartite Standing Committee provided that forum even if it appears that it was under-utilised in this regard. Under the new framework, fiscal policy is put to one side and the link between the MPC and FPC is embodied principally in the Governor of the Bank of England, with the Treasury afforded no formal role beyond "observer" status. It is difficult to see where aspirations for economic growth fit within the arrangements proposed.

20. Whilst we appreciate that international discussions on the nature of macro-prudential regulation are still at a relatively early stage, we believe that it would be helpful for the FPC's objective(s) to be set into the context of the European Systemic Risk Board and the way in which domestic measures would fit within the European and international framework.

The objectives of the PRA

21. The setting of the primary objective for the PRA is similarly misguided. Paragraph 3.5 of the consultation paper proposes that the PRA has a primary objective to promote the stable and prudent operation of the financial system through the effective regulation of financial firms in a way which minimises disruption caused by any firms which do fail. Factors which are reduced to a status of something that the PRA must "have regard" to include the principles of good regulation and "important matters which relate to the public interest". In fact, paragraph 3.10 goes as far as to say that the Government is seeking views on whether the PRA need be troubled by secondary considerations such as the importance of it using its resources in the most efficient and economic way or the principle that a burden imposed should be proportionate to the benefits which are expected to result. We find it a matter of some considerable concern that the question needs even be asked.

22. We further disagree with the conclusion that the failure of "light touch" regulation necessarily means that the prudential regulator should not be placed under an objective to maintain international competitiveness. As far as we are concerned, competitiveness is the lifeblood of the UK financial services marketplace and respecting the need to maintain a competitive edge provides a natural check and balance. Good regulation, as measured by international competitiveness, provides a counterbalance to ever increasing regulatory demands and encourages the presence of the best global institutions in the UK marketplace. It is difficult to see the justification for this being viewed so negatively.

23. We are also concerned with the proposed governance arrangements for the PRA. We are not convinced, for example, that it necessarily achieves the right balance for the PRA to be a subsidiary of the Bank and for the Governor to chair the authority. It would be interesting to understand the extent to which consideration was given to alternative arrangements, for instance, relying more on the provision of powers to the FPC to direct the PRA in the execution of macro-prudential tools. This would have avoided what may be an undue concentration of power within the hands of the Bank and permitted the specific responsibilities of the PRA for the micro-prudential supervision to have a clear identity without losing any of the benefits of setting micro-prudential supervision within a broader macro-prudential framework.

24. We would also question the proposition that the non-executive directors of the PRA be stood down collectively for decisions on significant regulatory or supervisory decisions concerning individual firms. This to our mind creates a two-tier board and results in a loss of perspective and experience that would result from the involvement of the non-executives in such decisions. Whilst, by definition, their involvement would involve addressing potential conflicts of interest, it should be possible to achieve this through a combination of the selection process and the ability for non-executives to excuse themselves as necessary from discussions.

The objectives of the CPMA

25. The same can also be said of the proposed objectives for the CPMA. Its primary objective will be to ensure confidence in financial services and markets, with a particular focus on protecting consumers and ensuring market integrity. This leaves the following expressed as secondary considerations, explicitly referred to as "have regards" in chapter 4 of the consultation paper:

- — the principles of good regulation;
- — the potential impact of policies or regulatory decisions on consumer and business lending; and
- — the need to maintain diversity in the financial services sector.

26. We are concerned about the CPMA being described as a consumer "champion". This, to our mind, has the potential of creating an imbalance in its objectives from the outset and also reinforces the concern that we have of the CPMA somehow being detached from responsibility for its actions. We would prefer therefore a description based more on the development of a marketplace in which consumers are provided with clear and understandable product information from which they can make informed choices. This involves placing consumers in a position where they can take responsibility for their financial decisions. The implication that the new authority will somehow become their advocate does not help this.

27. The objectives as expressed heighten our concern about the lack of due process to be built into the system. As far as we can see, the intention is that the bodies be exempted from the usual standards of consultative due process applicable to other arms of government and excused from any responsibility of the consequences of their actions on the wider economy and society.

28. We view the primary function of the UK Listing Authority in a market regulation light given its responsibility for overseeing consistency in disclosures and processes for listed securities. As a result, we believe that the UKLA should remain within the markets division of the CPMA as we see its function as integral to the regulation of the markets on which securities are admitted to trading. This would keep primary markets regulation and secondary markets regulation in the same place and enable a smoother transition to the new arrangements.

29. We see merit in the opportunity being taken to place responsibility for consumer credit in one place by transferring responsibility for regulated consumer credit from the OFT to the CPMA.

Insufficient Emphasis on European and Global Interaction

30. It is arguable that the objectives for the key bodies, and potentially aspects of the reorganisation, do not place sufficient emphasis on the inter-relationship between the bodies and the European and global financial infrastructure. In the case of the PRA and the markets division of the CMPA, large parts of their activity are governed by European directives and plans are in place for national rules to be superseded by mandatory European rules. It is therefore essential that the authorities give priority to representing the national interest in the relevant European authorities and for their activities to be organised in a way that creates natural "hubs" for the implementation of the new European rulebooks. It is disappointing therefore to see so little reference given to the European process in the Treasury paper.

31. We believe, in particular, that there would be merit in the responsibilities of the markets division of the CPMA mirroring those of the European Securities and Markets Authority (ESMA). For this reason, we would not view the potential transfer of responsibility for the UK Listing Authority from markets division to the Financial Reporting Council as being consistent with the need to ensure that the authorities be placed in a good position to represent the UK interest in European and international fora.

32. It is also the case that the FPC will, in some instances, need to take its lead from European and global bodies—whether the European Systemic Risk Board, the Financial Stability Board or the Basel Committee. Yet, again, there is scant reference to the European and global context in which it will work.

Loss of Due Consultative Process

33. A great deal of time and care was taken with FSMA to establish the right balance between providing the prudential authority the scope to take necessary action to act upon regulatory shortcomings and the need for appropriate due process and consultation usually associated with changes to the rule of law. These processes are essential to the maintenance of market confidence in the regime in which financial institutions operate and are the bedrock of the type of certainty that institutions look for in determining where to locate business. This is as true an expectation for a UK financial institution as it is for the many overseas institutions that decide to locate financial services operations in the UK.

34. It is also the case that there are many instances in which consultation has proven an essential mechanism for identifying major unforeseen consequences in planned regulatory changes—a recent high profile example being the inadequate nature of the creditor protections within the Special Resolution Regime first proposed within the Banking Bill. It took a substantial effort on the part of the banking industry and the legal profession to persuade the tripartite authorities, including the Bank of England, that there were seismic shortcomings in the proposed arrangements. Due consultative process provided the time and opportunity to make the case for strengthening the inadequate safeguards which were maintained through many Parliamentary stages.[16]

35. In contrast, the Treasury paper makes clear that the authorities need no longer be bound by a commitment to due consultative process. Paragraph 3.22 in the chapter on the PRA explains that the Government "is considering whether the rule-making function should continue to be subject to statutory processes, including consultation with a practitioner panel, wider public consultation and the duty to carry

[16] BBA Parliamentary brief—Banking Bill, second reading, October 2008

out detailed cost-benefit analysis prior to the introduction of any new rules"; paragraph 4.23 in the chapter on the CPMA observes that similar considerations apply to the CPMA and, in addition, that the Government may enhance the own initiative variation of permission powers for the CPMA.

Specific Questions Raised by the Committee

36. We would comment as follows on the overall issues raised by the committee:

Will the Government's financial regulation proposals improve the framework for financial stability in the UK? Will they work in a crisis?

We believe that the proposed structure can be made to fit with the broader regulatory environment but see major shortcomings in the arrangements proposed and believe that unless corrected we could be preparing fertile ground for a future crisis.

Do the Government's proposals get the balance right between tackling the problems of the last crisis and preparing the UK financial system for the next one?

No. We believe that there are fundamental shortcomings in the proposed arrangements and that these have the prospect of building in structural weaknesses of a different, but equivalent, nature to the identified failings in the current system that the Government is seeking to address. As explained above, the new arrangements are poorly defined in key respects and inexplicably autocratic. We see this as a significant failing in the proposals as set out so far.

How do the Government's proposals dovetail with initiatives currently being undertaken at European and the global level?

We believe that a major theme for the assignment of responsibilities within the differing authorities should be their need to represent the national interest in European and global bodies. While recognised within the Treasury consultation paper, we do not believe that this has been given sufficient emphasis. This is evident in the order of priorities set out in the draft objectives for each of the authorities.

What costs will the regulatory structure place on consumers?

This depends upon the nature of the macro-prudential tools handed to the FPC, the way in which the differing authorities work together and the awareness on the part of both the PRA and the CPMA of the extent to which their actions may change the supply of financial services. Unless identified issues are addressed we would consider there to be a significant risk of regulatory action bringing about unforeseen consequences for the price and availability of key financial services.

37. We would comment as follows in respect of the questions asked on power, roles and responsibilities:

Do the Government's proposals appropriately assign roles and responsibilities between the different regulatory institutions?

Whilst the roles would appear reasonably well assigned, we fear that the proposed objectives will fail to instil appropriate responsibilities.

Will there be unintended consequences of the Government's proposals for regulation on the prospects for non-bank financial institutions;

An unintended consequence of not achieving the right balance in regulation, including the deployment of macro-prudential tools in the regulated sector, may be flight to the unregulated sector and less heavily regulated jurisdictions.

38. We would comment as follows on the questions asked in respect of the Financial Policy Committee (FPC):

Should the FPC have a statutory remit? If so, what should that remit be?

We believe that the remit should be qualitative in nature and modest at inception; based on an objective to moderate exuberance in economic boom years and enhance the resilience of the banking sector to economic downturn. We would agree that there is a need for this to be encapsulated in an appropriately defined statutory remit and would argue that this should be premised upon a need to balance financial stability with economic growth.

How should the success of the FPC, both in and out of crisis, be measured?

Whilst the success of the FPC should primarily be measured against criteria born out of financial stability, such as dampening credit cycles and, at some future, stage, the avoidance of asset bubbles, we believe recognition should also be given to the generation of conditions suitable for sustainable economic growth.

Given the international regulatory framework, what macro-prudential tools should be granted to the FPC?

The FPC should take its lead from any directives made by the European Financial Stability Board and others such as the Financial Stability Board or the Basel Committee. Should these advocate the adoption of clear, prescriptive macro-prudential tools, such as the introduction of a counter-cyclical capital buffer, then the FPC should act upon these without gold-plating. In other instances it may be that the FPC should recommend for Government consideration action based on the particular circumstances of the UK market. This for instance could at some point include measures aimed at addressing asset bubbles in particular sectors of the property market, whether buy-to-let or commercial. In these circumstances, however, it is unclear whether it would be for the FPC to act or whether it would be more appropriate for the committee to make observations which Treasury Ministers may wish to pursue in devising public policy initiatives or in making adjustments to government spending or fiscal policy.

Has enough been done to mitigate the risk of conflict between the FPC and the Monetary Policy Committee (MPC)? Is the FPC appropriately structured in terms of: the balance between internal and external members; and the size of the Committee?

Whilst we support the creation of the FPC and believe that the role it has to play is of the magnitude of the MPC, we are not as yet convinced that sufficient thought has been given to their interaction. This said, we believe that it would be beneficial for the FPC to aspire to achieving an equivalent status to the MPC and consider that the two committees should be complementary.

A membership based on five executive members and five non-executive members, plus the Governor of the Bank of England as Chair, would not seem excessive. Of course, it would mean that the FPC (in common with the MPC) will have "strong, credible external representation" (paragraph 2.39), but this will fall short of the expectation placed on UK corporates for a majority of board members to be independent, including the chair, and for this to be replicated for key board committees overseeing executive performance.[17]

What characteristics, experience and qualities should the Government look for when appointing external members of the FPC?

While the FPC, as with any senior committee or board, will benefit from diversity within its membership, core characteristics must be independence of mind, financial experience and socio-political awareness.

39. We would comment as follows on the Prudential Regulation Authority (PRA)

Should the PRA be the lead authority over the Consumer Protection and Markets Authority (CPMA)?

We would envisage that it is more the case that the PRA should lead in respect of prudential supervision and the CPMA in respect of consumer protection. Work should be undertaken to avoid "underlaps" and an attempt should be made to understand which will lead and in what instance in the case of overlaps.

Is it appropriate for the PRA (and CPMA) to adopt a judgements-based approach to financial regulation and supervision?

Yes. The adoption of judgement-based supervision is about employing people of a caliber capable of questioning institutions about their strategy, business models and culture. This is more in keeping with the more macro-prudential view that is being put in place and has to provide the supervisor with a better means of understanding the real drivers of the business than a tick box approach to a detailed rulebook.

40 We would comment as follows on the questions concerning the Consumer Protection and Markets Authority (CPMA):

Do the reforms provide adequate protection for the consumer?

One of the arguments in favour of a "twin peaks' approach to regulation is that it allows regulatory responsibility for consumer protection to come out of the shadow of prudential supervision. Whilst we have no difficulty with this, we regard early references to the CPMA being the consumers' champion" as misguided. A more constructive positioning surely would be for the regulator to work in favour of fair and reasonable outcomes for consumers in which they take responsibility for the decisions they take and in which financial institutions commit to providing clear and understandable information on which to make those decisions.

To what extent will the regulatory and administrative burden increase for those firms who now have to deal with two regulators?

There will clearly be cost and bureaucracy involved in having to deal with more than one regulator. The answer to this, we believe, is early consultation on a memorandum of understanding setting out the way in which the PRA and CPMA and others will interrelate. There may also be a case for some form of common services group to undertake such activities as licensing applications, regulatory permission changes, regulatory information requests and the collection of levies.

[17] The UK Corporate Governance Code, June 2010; Walker Review final recommendations, November 2009.

41. We would comment as follows on other issues identified:

Should any of the proposed bodies be given responsibility for promoting competition in the banking and financial services sector?

We believe that the need is more for the authorities to be given responsibility for maintaining a competitive marketplace. This is sadly missing from the outline objectives set out in the Treasury consultation paper. We do not see a competitiveness objective as sitting on the opposite side of the scale to strong regulation and instead believe that it creates an obligation on regulators to consider the practical consequence of their actions. This is relevant not only in a domestic environment, but within the context of European negotiations where global imperatives are often seen as secondary to regional considerations. We find it highly surprising that the need for an international competitiveness test should not be readily understood as being in the national interest.

Should any of the proposed bodies have a role in promoting the City of London?

We do not believe that regulators should have a promotional role as such. But we do believe that they should have responsibility for the maintenance of a competitive marketplace.

22 September 2010

Written evidence submitted by Lloyd's of London

1. Lloyd's welcomes the opportunity to respond to the Select Committee's Inquiry into the Government's proposed changes to the system of financial regulation in the UK.

2. Lloyd's is the world's leading specialist insurance market and wrote more than £22 billion of premium income in 2009. It is the fifth largest reinsurer in the world and the second largest surplus lines insurer in the US. In 2010, 78 syndicates underwrite insurance at Lloyd's, covering all classes of non-life business from more than 200 countries and territories worldwide. Its headquarters are located in the City of London and it is regulated by the Financial Services Authority.

3. The Committee's website identifies a number of questions which the Committee may look at. We do not propose to address the questions individually but to provide both general and specific comments on some of the main issues which the proposed changes raise for the insurance sector and the Lloyd's market in particular.

General Comments

(a) *The current UK regulatory system*

4. The Government's motive for wishing to propose changes to the current UK regulatory system is explained in its consultation paper "A new approach to financial regulation: judgment, focus and stability". The paper states that "there were real and significant failings in the UK regulatory framework" and that the most obvious failing was "that no single institution has the responsibility, authority or powers to monitor the system as a whole, identify potentially destabilising trends and respond to them with concerted action".

5. In light of this finding, we agree it makes sense that a Financial Policy Committee (FPC) be established to monitor the UK financial system's stability and to take action in response to rules and vulnerabilities in the system although we believe that the FPC should have at least one member with background and experience in the general insurance sector (please see specific comments below).

6. The Government's consultation paper explains that the financial turbulence of the last few years has exposed serious weaknesses in conventional micro-prudential supervision and regulation of the financial sector although it also notes that the FSA has taken "significant steps to improve its performance in this area" recently by implementing a more intrusive and proactive approach to the regulation of firms.

7. We would note that our experience of being regulated by the FSA has been a positive one. The FSA has been a leading insurance regulator with a strong reputation for the quality of its supervision of general insurance. We do however recognise that, due to the banking crisis, the Government has determined that fundamental change is required to the system of regulation in the UK. We do not seek to oppose this but are concerned to ensure that the system of insurance regulation that has served the UK industry well over the last nine years is not damaged as the Government seeks to address perceived inadequacies in the management of systemic risk within the banking sector.

8. Since the FSA assumed its supervisory responsibilities, it has established itself as a leading player on the global stage. Its influence can be seen in the EU's development of Solvency II, which is informed by the FSA's experience of its Insurance Capital Assessment System (ICAS) and in the Insurance Core Principles of the International Association of Insurance Supervisors (IAIS), international compliance with which is strongly encouraged by the Financial Stability Board's Framework for Strengthening Adherence to

International Standards. FSA staff have thus made significant contributions to a more harmonised global insurance supervisory environment, which has benefited UK insurers which, like Lloyd's, have an international focus.

(b) *The differences between the insurance and banking sectors*

9. The Government's consultation paper proposals focus on lessons to be learnt from the banking crisis and on banking supervision. This is understandable given that the previous Government felt obliged to part-nationalise two of the largest banks in the world at a cost to the tax payer of hundreds of millions of pounds.

10. However, any consideration of reforms to the structure and substance of financial services supervision as a whole must take account of the fact that the financial services sector has different constituent parts. Although the insurance and banking industries form part of the broader financial services sector, there are very significant differences between them in terms of their business models, key activities and risk profiles.

11. It is also the case that the two industries performed very differently during the financial crisis.

12. The insurance sector, certainly on the non-life side, has navigated the global financial crisis fairly well to date. Indeed the Lloyd's market has traded very profitably during recent years and, notwithstanding the banking crisis, its financial strength has continued to grow.

13. Research has also demonstrated that there are differences in the extent to which the activities of the two industries present potential risk to the global financial system. A recent report by the Geneva Association on "*Systemic Risk and Insurance*"[18] found that the core activities of insurers and reinsurers are not a cause of systemic risk and do not represent a threat to the global financial system. This view has been broadly endorsed by the International Association of Insurance Supervisors (IAIS). In a June 2010 Position Paper on *"Key Financial Stability Issues"*,[19] the IAIS commented that:

> *"The insurance sector is susceptible to systemic risks generated in other parts of the financial sector. For most classes of insurance, however, there is little evidence of insurance either generating or amplifying systemic risk within the financial system itself or in the real economy."*

14. It is therefore vital that the specificities of the insurance sector are taken into proper account in the design of the new regulatory architecture. The consultation paper focuses almost entirely on the supervision and regulation of banks. The result is that it lacks detail as to how exactly supervision of the insurance sector is to be undertaken by the authorities and how an appropriate separation of banking, insurance and other financial services oversight responsibilities will be achieved.

15. We believe that ensuring the right level of separation between insurance and banking supervision will require the Prudential Regulatory Authority's (PRA) internal structure to include a separate insurance division, headed by a senior and respected individual at the same level of seniority as the head of banking supervision.

16. We also submit that it is vital that the PRA includes a sufficient number of qualified staff with experience of insurance risk. Implementation of the EU's Solvency II regime, due to enter into force in late 2012, is the most fundamental reform of prudential insurance supervision undertaken by the EU in the last 30 years. It represents a formidable challenge for UK regulators and the industry to meet its demands. It is important that the PRA has the resources and appropriate skills and expertise for these challenges and that it is able to discharge its new duties in an efficient and effective manner.

(c) *Proper co-ordination between the separate regulatory authorities*

17. The new regime will involve separation of regulatory responsibilities across several regulatory authorities, including the PRA, the Consumer Protection and Markets Authority (CPMA) and the Economic Crime Agency. This separation carries an obvious but serious risk that there may be either duplication of regulatory oversight or possible failure of the authorities to co-ordinate their activities in an appropriate and effective fashion. It is therefore pleasing that the consultation paper acknowledges the importance of effective co-ordination between the authorities and makes various proposals for achieving this, including suggesting that the authorities should have regard to the objectives of the other authorities in their work which should "be supplemented with mechanisms for operational co-ordination and, where appropriate, formal consultation". It is very important that measures and protocols are put in place to ensure such proper co-ordination is achieved between the authorities. The Government should explain in more detail how it will achieve such co-ordination learning the lessons from the perceived failure of coordination within the tri-partite arrangement.

18. We would make one practical suggestion in this regard. It is highly undesirable that an authorised firm or individual should be required to seek approval from two different supervisory organisations. This will mean an increased administrative burden, with the potential for delay, duplicated work and an absence of coordination that could even see a person or firm approved by one body and rejected by the other. We suggest that the PRA and the CPMA take full responsibility for all the authorisations that the firms they

[18] Geneva Association: "*Systemic Risk in Insurance—an analysis of insurance and financial stability*" March 2010. The Geneva Association is a leading international insurance "think tank".
[19] IAIS Position paper on key financial stability issues 4 June 2010.

regulate require, as well as the authorisations of the firm's staff. This is just one example of the ways that the proposed structure will give rise to additional administration, unless careful thought is given to supervisory coordination and cooperation.

(d) *Observance of better regulatory principles*

19. One of the strengths of the existing UK regulatory system has been its attention to principles of good regulation. The overhaul of a regulatory system provides an opportunity to further embed and improve this strength,

20. It is pleasing that the paper suggests that the regulatory authorities should have regard to principles of good regulation and to act proportionately. More assurance is, however, necessary. The Government should affirm that the PRA will retain the full range of statutory safeguards under FSMA (eg proper consultation on rule-making, a complaints process, rights of appeal).

21. Indeed, we would go further and urge the Government to legislate that all the new authorities will be guided in their actions and behaviour by core principles of regulatory best practice, such as these under consideration by TheCityUK[20] covering the following areas:

— Transparency: regulation should be transparent and accessible, delivering consistent outcomes;

— Proportionality: regulation should balance necessary controls with scope for innovation. It should be proportionate, both as to regulatory solutions and as to the varying scales and types of business, as well as targeted and technologically neutral;

— Accountability: responsibility should be clearly defined, including to whom and for what;

— Facilitation: regulation should facilitate and reinforce the role of financial services as a key enabler of social and economic development, both domestically and internationally;

— Impact Assessment: robust regulatory impact assessments should become standard and should include assessments of the cumulative impact of regulatory requirements;

— Scope and compliance: before introducing new regulation, authorities should ensure existing regulation is being used to its fullest extent;

— Convergence: regulation at regional and national levels should reinforce global convergence, not impede it and should provide a firm base for businesses from any jurisdiction to operate globally; and

— Competition: market structures should promote competition and openness to international participants. Regulation should facilitate progress towards easier market access and growth in international trade.

(e) *Efficient use of resources by the authorities*

22. The new authorities should have regard to the need to use their resources in the most efficient and economic way and should not seek to impose disproportionate and inappropriate levels of regulation on the industry. The insurance industry has been subject to very significant increases in recent years in financing the costs of regulation imposed by the FSA (the costs for the Society of Lloyd's have risen from £1.3 million in 2008–09 to £2.2 million in 2010–11). We would hope that the new architecture would not lead to yet further significant increases in fees payable by the insurance sector.

(f) *Interaction with the European authorities*

23. The vast bulk of insurance regulatory rules applicable in the UK derive from EU legislation. It is vital that the UK is effectively represented in the various deliberative and decision making bodies in the EU which determine the detail of legally binding financial services regulation. Much greater consideration must be given to how the proposed new structure and multiple agencies will interact with the EU to ensure that the UK has a strong and effective voice in the development of financial services regulation within the new European Supervisory Authorities, supervisory colleges and the other European initiatives.

24. The new EU financial supervisory structure, to be introduced in January 2011, makes it even more important that UK supervisory bodies engage constructively with their EU counterparts. The EU's supervisory authorities, including the European Insurance and Occupational Pensions Authority (EIOPA) will have enhanced rule-making and intervention powers, but will continue to rely on the contributions of national supervisors for the informed development of regulatory initiatives. EIOPA's remit will cover both prudential and business conduct issues. The UK authorities will need to decide between themselves which would be the appropriate body to represent UK interests at EIOPA meetings most effectively. We would also expect the importance of prudential regulation to be recognised through the PRA's participation on EIOPA's Board of Supervisors.

[20] A body for the promotion of the UK-based financial and professional services industry.

(g) *Competitiveness of the UK insurance industry*

25. Last but certainly not least, we would stress that the UK insurance industry is a very significant source of income, tax and employment for the UK Economy. The proposed changes in financial supervision in the UK should have regard to the desirability of maintaining the competitive position of the UK. This is not a plea for light touch regulation: the two new supervisory bodies will have their primary objectives and maintaining the UK's competitive position need not deflect them from achieving those objectives. The consultation paper states:

> *"there is a strong argument that one of the reasons for regulatory failure leading up to the crisis was excessive concern for competitiveness leading to a generalised acceptance of a light touch orthodoxy".*

26. We believe that this "argument" is itself open to challenge. The Turner Review, in its detailed assessment of regulatory developments preceding the financial crisis, makes no reference to this. Certainly it has no validity in relation to the supervision of non-life insurance, which has been subject to an increasingly intrusive supervisory approach, both on the solvency side, through the introduction of ICAS, and on conduct of business, through the "Treating Customers Fairly" initiative. We stress that we believe that the industry gains significant benefit on the international stage from being subject to high quality supervision.

27. The UK is the world's third largest insurance market, receiving total premiums of $309 billion in 2009.[21] Although it is smaller than the insurance markets of the US and Japan, a much greater proportion is made up of international business, dependent on the industry's global competitiveness. The London market remains the world's leading wholesale insurance centre and the only place where, in addition to the Lloyd's market, the world's 20 largest international insurance and reinsurance companies are active. Its premium income in 2008 was conservatively estimated as £24.7 billion.[22] The London insurance market is also a major employer. Insurers and pension funds employed 325,000 people in June 2009, including 50,000 in the London Market. Insurers' activities also give rise to significant employment in supporting services.

28. There is nothing inevitable about London's current financial success. London market insurers such as Lloyd's, operate in global markets and compete with firms from other jurisdictions that benefit from more benign tax regimes. It faces significant competitive challenge from international markets in jurisdictions such as Bermuda and Switzerland. Solvency II's implementation is costing insurers significant amounts. It is important that the proposals for UK financial supervisory restructuring do not impose a further heavy burden of cost and administration.

29. The Government should therefore recognise the particular position of the London insurance market and ensure that any moves it makes on financial supervision strengthen rather than undermine its competitive position.

Specific Comments

(a) *Financial Policy Committee*

30. The FPC has a broad remit which includes powers to give directions to the individual regulatory authorities, such as the PRA and the CPMA. That being the case, it is vital, that the FPC's expertise is broad, comprising not just persons knowledgeable about banking issues but about insurance and reinsurance also.

(b) *Supervision of the Lloyd's Market*

31. The consultation document contains very little information about the proposed approach to regulation of the Lloyd's market and its constituent parts. Indeed only one paragraph addresses this subject.

32. The paper seems to suggest that prudential supervision of the Lloyd's market would be undertaken by the PRA and supervision of the market's conduct of business activities undertaken by the CPMA.

33. It seems clear that the Government is resolved to introduce this proposed separation of responsibilities but we believe that responsibility and expertise for prudential supervision of different entities engaged in the Lloyd's market should be focused in one team in the PRA rather than dispersed across different agencies. We would therefore anticipate that the PRA will take over regulation of the Society of Lloyd's (otherwise known as the Corporation of Lloyd's) and relevant subsidiaries as well as the Lloyd's managing agents currently authorised by the FSA.

Executive Summary

34. In summary, Lloyd's:

- supports the establishment of the FPC but believes it must include persons knowledgeable about insurance issues;
- stresses the significant differences between the banking and insurance sectors, and proposes that the PRA's internal structure should include a separate insurance division, headed by a senior and respected individual at the same level as the head of the banking division;

[21] Swiss Re Sigma *World Insurance in 2009* February 2010.

[22] IFSL Research *International Financial Markets in the UK* May 2010.

- requests that measures and a protocol be put in place to require proper and effective co-operation between the authorities so as to avoid risks of duplication of oversight or inadequate interaction;
- underlines the importance of the authorities observing principles of good regulation;
- seeks assurance that the regulatory authorities, and in particular the PRA, will be subject to the full range of statutory safeguards that exist under FSMA to ensure that they are properly accountable including in areas such as consultation, a complaints process, and rights of appeal;
- asks that due regard continues to be paid to the competitiveness of the UK industry in the further design of the new regulatory system; and
- proposes that responsibility and expertise for prudential supervision of the Society of Lloyd's, relevant subsidiaries and managing agents, lie with a dedicated insurance team within the PRA.

22 September 2010

Written evidence submitted by the London Stock Exchange

Introduction

We welcome the opportunity to respond to the Treasury Select Committee's inquiry into financial regulation. The regulatory framework is vitally important to our ability to finance the real economy in the UK, in maintaining investor confidence and attracting international business to the UK.

The London Stock Exchange is home to over 2,000 UK companies that have a combined value of over £1,750 billion. The Exchange is an essential provider 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. £161 billion has been raised by UK businesses, both large and small, through the Exchange since the run on Northern Rock which compares to the £200 billion pumped into the economy through the Bank of England's Quantitative Easing scheme.

The London Stock Exchange also plays a key role in attracting international companies to the UK. Currently over 600 international companies from 70 countries with a combined market capitalisation of £1,825 billion[23] are listed on our markets underlining the international scale and global importance of London's financial markets.

Executive Summary

In response to the inquiry our key points are:

- We support a true "twin peaks" regulatory model. The London Stock Exchange Group (LSEG) supports the creation of a twin peaks regulatory structure in which the regulation of conduct of business and macro-prudential activity are separated into two separate bodies. However, it is essential for continued financial stability that a strong markets division is created within the CPMA in order to ensure the proper and orderly regulation of the UK's capital markets.
- The CPMA retail and wholesale responsibilities must be operationally distinct and run by separate CEO's who report into an overarching Chairman. This will ensure appropriate regulation for each division of the CPMA and that each is run by a specialist champion. A strong and cohesive markets division within the CPMA will need to maintain a strong link between the primary market (where companies raise capital) and subsequently where shares in companies are traded (in the secondary market). This is necessary to maintain investor protection, ensure effective real time market supervision, tackle market abuse and execute enforcement activities.
- To ensure effective regulation, the UKLA must be part of the CPMA markets division. Our strong view is that CPMA markets division, as the main UK securities regulator, would be the appropriate place for the UK Listing Authority (UKLA). The proposed merger of the UKLA and Financial Reporting Council (FRC) offers little by way of synergies and would serve to fragment the regulation and supervision of primary and secondary markets, to the detriment of investors and issuers. The regulation of the UK's capital markets requires experience on a global scale and sophisticated real-time monitoring and response capabilities to ensure preservation of the market quality for issuers and investors. Only the CPMA markets division can provide this.
- Aligning the UK regulatory structure with the EU regulatory supervisors is vital to the UK maintaining a strong and credible voice in Europe. We welcome the consultation document statement that the CPMA markets division will have the UK seat at the new European Securities and Markets Authority (ESMA). This body will have rule making powers and be able to direct national regulators. It is therefore vital that the UK vote at ESMA speaks with authority and fights the UK's corner effectively. The removal of the UKLA from the CPMA markets division means that the UK will only be directly represented at European level on secondary markets issues.

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[23] London Stock Exchange Group data, August 2010. These are companies that either listed on the LSEG's International Main Market or admitted to AIM.

Primary market regulation has historically been a source of competitive advantage to the UK and we would not want to see this eroded in the name of European harmonisation. The UK market accounts for 60 to 80% of EU securities trading, yet we only have 8% of the vote at ESMA. Therefore it is vital that we are represented by technical experts with a detailed understanding of the UK's capital markets.

— It is important that UK financial regulators have regard to the international competitiveness of UK financial services. It is clear that the UK's capital markets were not a cause of the financial crisis, but were a key economic stabiliser. London's ability to attract international companies is also a key factor in its status as a global financial centre. In the wider context, the importance of the financial services sector to the Exchequer cannot be underestimated, this is a broader sector than only banking related activities. PwC have estimated that in financial year 2009, financial services companies contributed in excess of 10% of Treasury tax revenues.[24] It is therefore critical that the ability of financial services to fund the real economy and attract international business to the UK is a consideration of the UK regulators.

— Exchanges must maintain their current regulatory regime as market infrastructure providers: The consultation asks whether exchanges should be regulated like Authorised firms eg investment banks. There are significant differences between exchanges and authorised firms which must be appreciated and justify a different regulatory treatment under the Recognised Body (RBs) regime. The reputational impact of removing this status will seriously undermine the RB's ability to market London as a key destination for global capital.

1. Ensuring a "True" Twin Peaks Model which Includes the UKLA

1.1 We agree with HMT that the tripartite system contained a number of inherent weaknesses and contradictions that led to no one body possessing the responsibility, authority or powers to monitor the system as a whole.[25] We therefore support the move to a "twin-peaks" model of regulation, whereby macro-prudential regulation is carried out by the Bank of England and conduct of business regulation by the CPMA. It is critical however that this is a true twin peaks model whereby the CPMA and the PRA possess full powers and authority to conduct regulatory activities for the areas under their remit. Therefore we do not support a model which would split the UKLA from the CPMA because it would separate the regulation of primary and secondary markets in the UK and:

— It is inconsistent with current Government aims. Placing the UKLA, the UK's primary market regulator, outside the CPMA markets division (which will be the UK's main securities regulator) would be inconsistent with the Government's drive for a true "twin peaks" model to avoid the problems that arose within the current tripartite system.

— Need for focus on enforcement and implementation. The majority of the UKLA's functions involve real-time monitoring and response, and implementation and enforcement which are critical to market quality but are not the primary functions of the policy development focused Financial Reporting Council (FRC). Of the 20,000 securities admitted to the Official List, only 6% represent equity securities issued by UK companies, 74% are UK and international corporate bonds and sovereign debt (gilts). The remainder includes structured products, debentures (which can also be counted as debt), warrants and preference shares.

The FRC is not a real time regulator: it reviews accounts of issuers once listed, so after the event. Furthermore, its focus is on the companies themselves as corporate bodies, rather than the broader range of securities that can be issued.

Overlap with CPMA market supervision functions. There is significant overlap with CPMA wholesale market supervision functions which will deliver real synergies and more effective application of regulation and enforcement in the interests of market participants.

— The need for a commercially-orientated UKLA. To ensure we preserve the attractiveness of London as a capital raising centre and to facilitate capital raising by companies, it is critical to have a quick and efficient listing and capital raising process in the UK. £161 billion was raised by UK companies, large and small, through our markets during the crisis as investors supported businesses during the downturn. This requires a commercially-oriented UKLA, which is up to speed on the latest market practices, developments and integrated into the wider regulation of markets.

— The need for a strong voice in Brussels. The UK will only have one voting member at ESMA, which will be the CPMA markets division. Given the extensive impact the EU regulatory agenda is having on the UK's financial services sector, the need for a strong voice in Brussels has become imperative. It is vital that the CPMA markets division has the authority and weight to represent the interests of London's capital markets in total including primary and secondary markets policy. It is our view

[24] "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, para 3.2).

[25] Para 1.5 of the HMT consultation "A new approach to financial regulation".

that removing responsibility for primary market policy (with the UK listing function being the regulatory function that implements primary markets policy) from CPMA will fundamentally undermine the strength of our voice in this area. Some 60–80% of Europe's trading occurs in the UK, yet we only have 8% of the vote at ESMA; the CPMA must speak with authority and technical expertise. Historically this has been the key to the FSA's ability to fight the UK's corner in Europe—our representatives have understood the full technical detail from both the secondary and primary markets perspective of the policies under discussion.

— Maintaining London's ability to compete internationally. Our ability to strengthen and improve the standards for listing in London, as set by the European Directives for Prospectus, Transparency and Market Abuse, is key to London's ability to compete internationally. For example, London's premium listing standard is vital to attracting international issuers such as the recent ESSAR Energy listing from India. It is important that this standard is preserved and that London's ability to preserve its unique listing rules is maintained at ESMA, and not eroded in the name of European harmonisation.

2. Working Together—The PRA and CPMA

2.1 The PRA and the CPMA must be two distinct bodies; the PRA should not be the lead authority over the CPMA.

2.2 Within the CPMA equal emphasis must be placed on Markets and Consumer Protection; recognising the importance of regulation of wholesale capital markets to the UK economy and the key input of EU regulation in both conduct and market regulation.

2.3 The boards of both the PRA and the CPMA should have a strong and independent voice, composed of Non-Executive Directors who have a clear understanding and extensive experience of wholesale markets, conduct of business and macro-prudential factors.

2.4 It is essential that the PRA and CPMA are sufficiently cohesive and flexible and therefore capable of reacting rapidly and decisively to developments in the markets and the wider economy. This will be important for continued financial stability and ensuring that equity markets remain open as sources of capital in times of extreme market stress.

2.5 There should be clear accountability for the FPC, PRA and the CPMA.

(a) There needs to be clear Parliamentary oversight.

(b) LSEG welcomes the notion of regular TSC hearings on FPC meetings.[26]

(c) The PRA and the CPMA should be subject to similar levels of oversight, as suggested in paragraphs 3.40 and 4.39.

3. Aligning the UK Regulatory Structure with European Regulatory Supervisors

3.1 Both the PRA and the CPMA will represent the UK's interests in Europe. Particularly, the CPMA will represent the UK at ESMA, which will be based in Paris and the PRA on the EBA.

3.2 The UK represents 60–80% of EU securities trading, but only has 8% of the vote at ESMA. It is therefore essential that the CPMA speaks with authority and technical expertise. Our representative must understand the full detail and impact of policy proposals to find London's corner effectively—the devil is always in the detail. To achieve this, a strong and cohesive Market Division within the CPMA will be essential.

(i) This is because the laws under which companies raise money and operate on UK markets are set by the EU. It is only by influencing the process of the rules being made now, at ESMA, that you can achieve the right outcome for UK companies and investors

(ii) For example, UK market rules are set by EU Directives and regulation such as the Markets in Financial Instruments Directive (MiFID), European Markets Infrastructure Rules, Prospectus, Transparency and Markets Abuse Directives

(iii) Therefore, all future developments will be set at EU level and the UK has to have a strong and fully informed markets voice in Brussels to influence these rules

(iv) This necessitates a clear joined up approach to primary and secondary market regulation, with the UKLA remaining within the CPMA. This will ensure that the CPMA retains the experience, technical knowledge and proximity to markets that are essential to wield influence in Paris and Brussels. It is these factors which, in our opinion, have acted as an enabler for the FSA to be a knowledge leader in Europe.

[26] Para 2.60.

4. Maintaining the Competitiveness of the Financial Services Sector for Issuers and Investors

4.1 The committee and HMT consultation questions whether the PRA and CPMA should have regard to the international competitiveness of UK financial services. It is clear that the UK's capital markets were not a cause of the financial crisis, but were a key economic stabiliser. London's ability to attract international companies is also a key factor in our status as a global financial centre. It is therefore critical that the ability of financial services to fund the real economy and attract international business to the UK is a consideration of the UK regulators, to ensure that we do not have a UK example of the American Sarbanes Oxley law that drove business away from the US.

4.2 The London Stock Exchange is home to over 2,000 UK companies that have a combined value of over £1.75 trillion. The Exchange is an essential provider of non-bank finance to UK companies.

- During the crisis, the London Stock Exchange remained a robust and stable source of finance for UK companies, both large and small as bank lending channels all but dried up, and the off-exchange derivatives markets proved hugely illiquid, devastating companies' balance sheets.
- £161 billion has been raised by UK companies since the run on Northern Rock, which compares to the £200 billion pumped into the economy through the Bank of England's Quantitative Easing scheme.

4.3 We are very proud of our role in financing UK SMEs, and believe that innovative, high technology smaller companies will deliver the long term economic growth required for a sustainable recovery.

- Our stock market for smaller companies (AIM) has raised £70 billion for high growth companies since its 1995 launch. UK based companies on the market employ in excess of 250,000 people. A further 320,000 jobs are supported indirectly by these entities. Around £12 billion is contributed to GDP, with a further £9.4 billion supplied through Gross Value Added (GVA). The importance of AIM to the exchequer can not be underestimated; in 2009 AIM companies contributed £1.8 billion in tax revenues.[27]
- AIM is a regionally diverse, UK wide market, with 57% of UK AIM companies based outside of London.

4.4 The world's capital market.

- In 2009, London accounted for 16% of global further issues by money raised and around a fifth of global foreign equity trading.[28] There are currently 600 international companies from 70 countries with a combined market capitalisation of £1,825 billion[29] underlining the international scale and importance of London's financial markets.
- A successful primary market is critical to ensuring London remains a central destination to international.
- 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).[30]

4.5 The regulatory framework is vitally important to our ability to carry out successfully the above functions, generating finance to support the real economy. It is therefore essential that our regulators have regard to the impact of their actions on this role and on maintaining investor confidence and attracting international business to the UK.

5. Recognising the Special Functions of Regulated Bodies ie Exchanges

5.1 The HMT consultation asks whether the different regulatory regimes under which banks and recognised bodies such as stock exchanges operate should be combined into a single regime. We believe this is not appropriate for the following reasons:

- Exchange's fulfil important regulatory responsibilities as neutral market operators delivering major benefits to the real economy—stock exchanges provide critical access to capital for issuers from the UK and abroad. In doing so they play a key role in attracting international issuers and investors to the UK. There are currently 600 international companies on our markets from 70 countries with a total value of £1,861 billion;
- Creating a single regime will reduce regulatory standards to the lowest common denominator—London's reputation for high standards of regulation has been critical in attracting issuers and investors. The threat to these standards posed by a single regime will severely undermine London's competitive advantage;

[27] "Economic Impact of AIM and the Role of Fiscal Incentives" (Grant Thornton and London Stock Exchange).
[28] International Financial Markets in the UK—May 2010 (http://www.thecityuk.com/media/154873/ifm%20in%20the%20uk%2005%202010.pdf).
[29] London Stock Exchange Group data, August 2010. These are companies that either listed on the LSEG's International Main Market or admitted to AIM.
[30] Ipreo, June 2010.

- The reputational impact of removing exchange status will severely damage the Exchange's ability to market London and the UK as a major destination for global capital—this will have severe consequences for London as a financial centre: we estimate that every £1 of IPO fees collected by the Exchange is worth close to £1,000 in revenue to the wider financial sector. The financial sector supports over 300,000 jobs in the City alone and is estimated to contribute in excess of 10% of total tax revenues to the Exchequer;
- The separate regimes for RB's and banks are specifically designed to reflect the different risk profiles and functions of these bodie—the majority of authorised firms ie banks take balance sheet risk through dealing either for themselves or on behalf of customers. In contrast, the primary risk associated with infrastructure providers such as exchanges is IT failure;
- Combining the two regimes would not remove the need for a special regime—it would not achieve any meaningful "reduction" in regulations since any regulations would still need to deal with the particular functions carried out only by RB's (including SME funding, default management, market surveillance and intervention and disciplinary action).

22 September 2010

Written evidence submitted by the Investment Management Association

1. The IMA represents the investment management industry in the UK. At the end of 2009, its members managed some £3.4 trillion of assets on behalf of a diverse range of clients including pension funds, life insurance companies, holders of retail investment products, sovereign wealth funds and others. We welcome the opportunity to contribute to the Committee's deliberations on this matter and would be pleased to supplement this note with oral evidence should that be of assistance to the Committee.

2. There is no absolute and definitively correct structure for financial regulation. All models have their pros and cons. We think however that there are merits to the model now proposed by the Government, in particular:

- the separation of prudential and conduct of business regulation, which may sometimes be in conflict; and
- bringing oversight of financial stability into closer proximity with the prudential regulation of individual banks.

Ultimately, however, how well the structure performs will depend on the talents and experience of the individuals charged with managing it. Getting this right will be the single most important challenge facing the Government in introducing these changes.

3. We welcome and support the proposal that the prudential regulation of investment management firms should rest with the CPMA. This recognises that the business model of an investment management business is radically different from that of a bank or an insurance company, in that it is agency-based rather than a principal model. Custody of client funds is completely separate from the manager, unlike banks and insurers where they are held on balance sheet. For this reason, prudential or solvency regulation of the sort required for banks and insurers is not necessary for investment managers.

4. We also agree strongly that the CPMA should have oversight of all conduct of business regulation, both retail and wholesale. The focus of prudential regulators is on the structure and solvency of the business itself. Prudential regulation does not as a matter of course concern itself with the detailed rules around the institution's dealings with its customers. A major problem in the conduct area can of course impact a firm's prudential situation—Equitable Life being a case in point—so that the prudential regulator will need to keep itself informed. But that is very different from carrying out the supervision itself. It is significant that for many years banks were not subject to statutory regulation in respect of their dealings with customers, and it was only in recent years that the FSA began to take this on.

5. Keeping retail conduct regulation under one roof will also help to ensure that comparable rules are applied to different products which effectively compete with each other—for example funds, life insurance investment products and banking products. At the present time all are subject to different rules, although a forthcoming EU initiative will seek to address this. So long as this remains the case, there is a risk of consumer detriment.

6. Investment managers have a major interest in the integrity of capital markets. In aggregate, rewards for capital market intermediaries are at the expense of investors, most of whom are ultimately small retail clients, whether through pensions, ISAs or other channels. It is therefore essential that we have strong and effective regulation of capital markets to ensure that they operate openly and transparently and in the interests of issuers of capital and of end investors.

7. One necessary condition for an effective regulator is that it can see the whole picture. We do not therefore support the suggestion that the UK Listing Authority be removed from the CPMA and combined with the Financial Reporting Council. We do not believe it is sensible to separate primary from secondary regulation of the equity markets in this way. The continuing disclosures under the Listing Rules are an

essential ingredient of a well functioning market, and to separate responsibility for them from responsibility for investigating market abuse would risk opening unwelcome gaps in regulation which could ultimately work to the disadvantage of investors.

8. Moreover, the FRC is not equipped to act as a market regulator. Its primary functions now are for standard setting and for oversight of professions. We do not think there is a logical fit between these and the duties of UKLA.

9. We attach responses to the questions listed in the Committee's call for evidence.

IMA Responses to Questions posed in Committee's call for Evidence

OVERALL

1. *Will the Government's financial regulation proposals improve the framework for financial stability in the UK? Will they work in a crisis?*

2. *Do the Government's proposals get the balance right between tackling the problems of the last crisis and preparing the UK financial system for the next one?*

Simply reassigning responsibilities will not of itself improve financial stability in the UK. What will be crucial going forward will be the quality of the individuals charged with responsibility for managing these institutions and the effectiveness with which they co-operate.

To the extent that the regulation of banking is brought closer to financial policy, that may help to ensure effective communication during and planning for crisis. But at the root of the credit crisis was a widespread failure by market participants, regulators and policymakers to appreciate the risks that the system was running and its vulnerability to any loss of confidence. That is not and cannot be addressed simply by institutional change such as these.

3. *How do the Government's proposals dovetail with initiatives currently being undertaken at European and the global level?*

The Financial Policy Committee's responsibilities will to an extent map across to those of the new European Systemic Risk Board. The structure of supervision will however be different. There will be three authorities dealing with prudential regulation, not just the CPMA and PRA as proposed in the UK. More significantly perhaps, in the UK conduct of business regulation will all be carried out by the CPMA, whereas each of the three EU supervisory authorities will have responsibility in their sector.

The UK model is undoubtedly to be preferred, since it should in principle ensure a more consistent outcome as between banking, insurance and investment products. This will in turn be likely to secure better outcomes for consumers since there will be less scope for regulatory arbitrage between products and it will be easier for them to compare different types of product. But it will present challenges for the CPMA in that, while its primary relationship will be with the European Securities and Markets Authority, it will also have to deal with the banking and insurance authorities. It may need to seek the aid of the PRA in developing and maintaining those relationships.

4. *What costs will the regulatory structure place on consumers?*

We can see no reason why the costs of this structure need be greater than those of the FSA. There should therefore be no extra costs for which there might be a risk of being passed to consumers. In particular, these changes imply no need for major changes to existing supervisory rules. As already indicated the "horizontal" conduct supervision under the CPMA can be expected to work in the interests of consumers. See also our response to question 15 below.

POWER, ROLES AND RESPONSIBILITIES

5. *Do the Government's proposals appropriately assign roles and responsibilities between the different regulatory institutions?*

6. *Will there be unintended consequences of the Government's proposals for regulation on the prospects for non–bank financial institutions?*

Whilst we consider the broad architecture to be a matter for the Government; the positioning of asset managers with the CPMA for all purposes is welcome. We would trust that the FPC will not communicate solely with the PRA and would trust that buy side and savers' views will be captured in its considerations. There is a technical issue over many asset managers having an investment-only captured insurance company as a subsidiary for wrapping some products in an insurance contract. In theory these would have to be regulated by PRA on the current proposals, which would seem unnecessary duplication, and a de minimis approach would be appropriate.

We consider that responsibility for primary market supervision is intimately connected with that for secondary markets. The UK listing rules require listed companies to make a wide range of disclosures which are designed to ensure the functioning of an orderly market. We think it would be unwise to separate these responsibilities from those for policing market abuse. The proposals already put one aspect of market

regulation (clearing and settlement) with the Bank of England. Splitting the UK Listing Authority from the CPMA would spread market regulation across three different authorities. That would risk a less joined-up approach to market supervision, and a greater danger of market abuse. We would not therefore support the option canvassed in the Treasury consultation paper of combining UKLA with the FRC under a new companies regulator.

The Financial Policy Committee (FPC)

7. *Should the FPC have a statutory remit? If so, what should that remit be?*

8. *How should the success of the FPC, both in and out of crisis, be measured?*

9. *Given the international regulatory framework, what macro–prudential tools should be granted to the FPC?*

10. *Has enough been done to mitigate the risk of conflict between the FPC and the Monetary Policy Committee (MPC)? Is the FPC appropriately structured in terms of:*

(a) *The balance between internal and external members?*

(b) *The size of the Committee?*

11. *What characteristics, experience and qualities should the Government look for when appointing external members of the FPC?*

See our comments above in response to question 6.

The Prudential Regulation Authority (PRA)

12. *Should the PRA be the lead authority over the Consumer Protection and Markets Authority (CPMA)?*

We do not consider that the PRA should be seen as the lead authority over the CPMA. The high level proposals from HM Treasury do suggest a hierarchy, especially on the need to consult or inform about decisions: the CPMA is required to communicate with the PRA, whereas there is little or no obligation the other way round. In practice the concerns would be:

— different supervisory approaches or interpretations of identical EU-derived obligations;

— a suggestion that some consumer redress or protection might be compromised or postponed so as not to cause or exacerbate a prudential issue. This might include proper disclosures by banks or issuers as well as more common consumer redress issues. In our view the CPMA should be able to make its judgements unfettered by prudential concerns;

— Prudential approaches becoming dominated by the PRA (when its responsibility will not encompass by number the majority of prudentially supervised firms and when the CPMA-supervised firms should rightly be subject to prudential rules appropriate to their business models);

— the maintenance of extra resource at the PRA so as to shadow and comment upon CPMA consultations in the arena; and

— internationally an appearance that a second level regulator was dealing with key issues such as in markets and a variety of Directive proposals such as for Packaged Retail Investment Products.

13. *Is it appropriate for the PRA (and CPMA) to adopt a judgements-based approach to financial regulation and supervision?*

In principle, we believe this would be appropriate, both for the PRA and the CPMA. The credit crisis in part arose because of a too ready acceptance by regulators globally of business models that turned out to be unsustainable and destabilising. Equally, the IMA supports the FSA's recent statement about its more intrusive "upstream" approach to retail conduct—products have been sold to consumers in recent years which should never have come to market.

But great caution needs to be applied to such an approach. It must not turn into systematic second-guessing of decisions taken by regulated firms, which in turn becomes an inhibitor of legitimate innovation. They key to this will be to ensure that only staff with the highest levels of skills, training and experience—including experience in the industry—are entrusted with such judgements.

The Financial Services Practitioner Panel and Small Business Practitioner Panel have proven a valuable source of advice and counsel to the FSA. The Government propose that these should continue in existence for the CPMA but not for the PRA. We do not understand the reasons for this proposal, and consider that the PRA could benefit from practitioner input in the same way that the FSA has.

THE CONSUMER PROTECTION AND MARKETS AUTHORITY (CPMA)

14. *Do the reforms provide adequate protection for the consumer?*

Ensuring the objectives of the CPMA are rightly described is important; but an early appointment of the senior management team will be critical in setting the right culture for the CPMA.

Of necessity, the objectives will always be drawn at a high and wide level to avoid any lacuna in powers. Beyond descriptions of the CPMA as a consumer champion, the consultation does not address whether the CPMA will need (as FSA does) to have regard to the principle that a consumer should take responsibility for his own decisions, in considering what degree of protection may be appropriate. This issue, of consumer responsibility, has remained intractable despite the previous FSA chairman's struggle. In ensuring consumers are championed, we suggest that this should be seen as ensuring they have a better deal, and not simply, better protection. Disclosure, suitability and fairness must all be considered by the CPMA but the context must not be that consumers have no responsibility for their decisions—that would perpetuate a moral hazard in our system. We do support the continued existence of FOS and the FSCS.

15. *To what extent will the regulatory and administrative burden increase for those firms who now have to deal with two regulators?*

We consider that the benefits, particularly for consumers, of "horizontal" regulation of conduct of business by the CPMA will outweigh any costs arising from some firms having to face two regulators. In contrast if the conduct supervision of banks and insurers were undertaken by the PRA, there would be significant fissure in consumer protection matters. In general prudential supervisors are not equipped to carry on conduct or investor protection supervision.

OTHER ISSUES

16. *Should any of the proposed bodies be given responsibility for promoting competition in the banking and financial services sector?*

17. *Should any of the proposed bodies have a role in promoting the City of London?*

It is not the role of regulators to take on a promotional function. It is important that the new bodies should have a duty to have regard to international competitiveness in carrying out their duties, as the FSA does today. But that is very different from a role of positively promoting the UK financial services sector. That is properly a matter for Government to ensure a legal and regulatory environment which is conducive to the growth of a healthy sector, and for the sector itself, though bodies such as TheCityUK.

22 September 2010

Written evidence submitted by the Association for Financial Markets in Europe

1. INTRODUCTION AND EXECUTIVE SUMMARY

1.1 The Association for Financial Markets in Europe (AFME)[31] welcomes the Treasury Committee's (the Committee's) inquiry into Financial Regulation, which will consider the Government's proposals to reform the UK system of financial regulation, as articulated in the HM Treasury consultation document: *A new approach to financial regulation: judgement, focus and stability.*

1.2 AFME believes—at least in principle—that a "twin peaks" model can deliver effective regulation for both consumers and markets and we welcome, in particular, the emphasis on a more judgement-led style of regulation. However, in moving from a single regulatory authority to multiple authorities and in freeing regulators to make individual judgments, the precise design of the framework will be crucial to its success and the challenges of achieving a successful outcome must not be understated. Hence, given the fundamental nature of the reforms proposed by the HM Treasury consultation—which must be viewed within the context of the wider reforms at both an EU and international level—AFME is reviewing the proposals with particular focus on their potential impact on firms, markets and wholesale financial services business in London. We hope that summarising the issues upon which our Members have asked us to concentrate will assist the Committee.

2. AFME'S APPROACH

2.1 In preparing its response to the HM Treasury, AFME is conscious of the fact that much of the detail surrounding the proposed framework will be provided in subsequent consultations. Although further clarity is needed to understand fully the proposals, we stand ready "not only to answer the questions that remain but also to question the answers that we have put forward" and help "ensure we get the detailed design

[31] AFME represents a broad array of European and global participants in the wholesale financial markets, and its 197 members comprise all pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME was formed on 1 November 2009 by the merger of the London Investment Banking Association and the European operations of the Securities Industry and Financial Markets Association. See: www.afme.eu

right."[32] We are embarking on a major restructuring of financial regulation in the UK and hence, while AFME recognises the reasons and momentum for reform, we believe that the process needs to be conducted thoughtfully, collaboratively and openly.

2.2 In view of the ongoing nature of our work on the proposals and the fact that we are at the beginning of a long process, AFME believes that it would be most appropriate, at this stage, to set out the areas in respect of which we have open questions and issues (rather than respond to all of the specific questions to which the Committee may have regard during its inquiry). We trust that this approach will prove helpful to the Committee.

3. Areas of Focus

3.1 Regulation of markets in London (including the Market Authority): it is crucial that the current, robust regulation of markets and the expertise of the FSA's Markets Division are not diluted in the new framework.

3.2 In particular, we strongly oppose the proposed removal of the UK Listing Authority (UKLA) from the Consumer Protection and Markets Authority (CPMA), which would dislocate primary and secondary market regulation. We also believe that the implications of the proposal to regulate clearing in the Bank—which would divide the regulation of exchanges from the regulation of their clearing and settlement operations—will need careful consideration, particularly given market developments such as the "verticalisation" of exchanges (ie adding integrated clearing capabilities) and the moves to create pan-EU clearing solutions. Given the wider changes, eg at the EU level, it is vital that the new UK authorities have the maximum heft—expertise, authority, resources, and breadth of competence—to enable them to exert the necessary influence.

3.3 More generally, we would note that the customer protection element of the CPMA does not capture the breadth of the CPMA's role, which would include the conduct of business regulation of wholesale market firms and complex groups. We are also concerned that a "strong consumer champion" and a financial markets regulator do not naturally sit comfortably within one authority. We, therefore, suggest that the final name (and organisational structure) of this authority (the CPMA being a "working title") encapsulates its broader, conduct of business regulatory role.

3.4 Finally, we await with interest the forthcoming consultation on the proposed new Economic Crime Agency (ECA); AFME will, in particular, be responding on the question of whether responsibility for prosecuting criminal offences involving insider dealing, other forms of market abuse and other criminal law breaches which the FSA currently prosecutes should be transferred to the ECA.

3.5 *Accountabilities*: given the considerable powers that will be vested in the Bank of England (the Bank), we believe that the proposed accountabilities to HM Treasury and Parliament, particularly for the Financial Policy Committee (FPC), should be strengthened.

3.6 *Independence*: we have questions (and possibly concerns) around, for example, the multiple roles of the Governor and—although we recognise that this is intended to strengthen co-operation—the executive cross-membership of the FPC, MPC, Prudential Regulatory Authority (PRA) and CPMA Boards by a limited number of key individuals. We believe there is a serious risk that this arrangement will lead to a significant concentration of decision making powers in the hands of a few, over whom there is limited oversight. As discussed in 3.5 above, we believe the arrangements for oversight and scrutiny of these bodies should be strengthened. We also have questions around the degree to which there will be information barriers within the Bank to protect the confidentiality of firm-specific information.

3.7 We also believe that independent, non-executive directors should have an active role in all the work of their Boards, including decisions appertaining to specific firms (cf the FSA Board) and that the process for selecting non-executives with the appropriate skills, knowledge and experience, should be effective, robust and transparent. We also question whether independent non-executive directors should be in the minority on the Board of the FPC.

3.8 *Objectives*: we believe that the FPC, PRA and CPMA should have clear objectives—where possible auditable and accountable to Parliament—that reflect fully the multifaceted nature of their roles, even if the inter-relationships are complex.

3.9 As growth in the financial markets will aid economic recovery and offer better choice and availability to consumers, we believe strongly that the new authorities (but at the very least both the FPC and the CPMA), should have, as one of their high-level objectives, due regard to the UK's competitiveness as an international financial centre and how it may be enhanced by effective regulation.

3.10 As discussed at 3.24 below in relation to the PRA and CPMA, in order to achieve consistency, we also believe that the authorities' objectives should be cross-referenced.

[32] Speech by The Financial Secretary to the Treasury, Mark Hoban MP, at the London Stock Exchange, 26 July 2010.

3.11 *The Principles of Good Regulation*: we see no reason why any committee or authority (eg the PRA) should be able to operate without regard for the Principles of Good Regulation. We strongly believe that the PRA and the CPMA should be subject to the Principles of Good Regulation, including consultation and cost benefit analysis (subject to emergency over-ride as found in the Financial Services and Markets Act).

3.12 *Powers and functions*: the powers of the FPC, PRA and CPMA will be limited by EU regulation and constrained by the new EU supervisory architecture. It is important that the impact of such constraints is recognised fully, given the likely impact on the extent to which, for example, judgements can be made or unilateral action taken.

3.13 We support a more judgement-led approach to regulation, which we agree should be facilitated through the legislative framework. However, the success of more judgement-led regulation will ultimately rest on the quality and competence of the staff that take individual, firm-specific decisions. To ensure consistency and fairness, the authorities will need to have streamlined and clearly articulated procedures, which are transparent, provide reasons for a decision and give firms wishing to challenge a decision a fair hearing.

3.14 *EU and International relationships*: it is crucial that the UK maintains a strong, credible and coherent voice in the EU and internationally and continues to help shape regulatory developments. For example, by ensuring that experts are trained for placement in the new ESAs through a revival (including in the current FSA) of a process akin to the European Fast Stream programme that operated in Whitehall for many years and through the provision of high-quality thought-leadership (while not "front-running" policy initiatives requiring EU and international accord).

3.15 Given the importance of the UK's financial markets, the PRA and, in particular, the CPMA could have a target for preparing high quality, senior candidates to work in the ESAs. In addition, as discussed in 3.2 above, it is vital that the new UK authorities are staffed with individuals who have the expertise, experience and authority to negotiate effectively with EU and international bodies.

3.16 The reform process needs to focus on how the proposed UK structure will fit into, and work with, EU and international bodies. In particular, the structure and relationships between the proposed authorities must take into account fully the new EU supervisory structure; eg how the multiple UK authorities will align with the new European Supervisory Authorities (ESAs); and how the UK representatives on the ESAs will ensure there is co-ordination between UK stakeholders. For example, under the proposals both the Bank and the CPMA will have responsibility for regulating market infrastructure but only the CPMA will have a seat on the European Securities Markets Authority. The design of the PRA and CPMA must aim to eliminate these gaps, or risk a serious loss of heft and influence at the EU table

3.17 The process also needs to consider how incoming EEA firms, that establish branches in, or provide services into, the UK under a single market directive, will fall within the new framework, particularly as fundamental questions regarding Home and Host State still remain open at an EU level.

3.18 It will also be important, particularly for internationally active UK authorised firms, to ensure that the territorial application of the CPMA's conduct of business rules to firms' business activities outside of the EEA is appropriate and respects "local" regulations.

3.19 *Macro-prudential regulation*: while AFME welcomes the proposal to enshrine macro-prudential regulation, we have questions around how the FPC will operate given the global nature of markets and the need for strong linkages to the new European System Risk Board (ESRB), third country regulators such as the Federal Reserve and the US Financial Oversight Council and international bodies such as the International Monetary Fund and the Financial Stability Board.

3.20 The proposals—as set out currently—also appear to take a narrow view of financial/macro-economic stability; we are uncertain how they would address fully the potential impacts of other policy areas, notably monetary and fiscal policies. To be effective, a consistent and coordinated approach across all policy areas will need to be pursued. However, as the mechanisms for achieving consistency and co-ordination in the new framework appear to be limited to executive cross-membership of the FPC and MPC and sequencing of meetings, we believe that they should be developed further. AFME will also be considering issues such how the FPC's powers of direction over the PRA will link macro-prudential regulation to the micro-supervision of individual firms (ie through a "Pillar 2" process) and the more general use of macro-prudential tools.

3.21 *The scope of the PRA and the CPMA*: we note that the PRA will be responsible for "all firms who are subject to significant prudential regulation." However, we believe that the current proposal, under which the PRA would be responsible for the "authorisation, regulation and day-to-day supervision" of specific regulated activities—namely, "taking deposits", dealing in investments as principal and effecting and carrying our contracts of insurance—would result in significant, unintended consequences, including:

— increasing the number (and types) of firms to be regulated by the PRA (eg by bringing within scope any firm with a Part IV permission that includes dealing in investments as principal, regardless of whether the firm undertakes that activity or, if they do so, the scale of the business);

— dividing the authorisation and regulation of wholesale firms' trading activities between different regulatory authorities;[33] and,

— adding unnecessary complexity to the vital gate keeping, authorisation and approvals (approved persons) processes.

3.22 Whilst references to specific regulated activities could form the starting point from which to define the PRA's scope (ie to help determine which firms are, in principle, subject to prudential regulation) we believe strongly that the CPMA should still be responsible for the conduct of business regulation of these regulated activities. Since it is proposed that the CPMA regulate "all conduct" we assume—despite a degree of ambiguity in the consultation document—that this will be the case.

3.23 If it is considered necessary to give the PRA responsibility for authorisation of the specific regulated activities that are within its scope, we believe strongly that a single organisation should undertake authorisations, approvals (of approved persons) and other regulatory processes on behalf of the authorities or other authority (also on this see 3.26 *et seq* below).

3.24 *Co-ordination between the PRA and CPMA*: given the significant overlaps between the scope of the PRA and CPMA (some of which, as noted in 3.21 *et seq*, could be resolved by redefining the scope of the PRA), the authorities must have clear objectives. We also believe that each authority's decisions should be required to not be incompatible with the terms of reference of the other authority, unless to do so would conflict with its own terms of reference.

3.25 A procedure will need to be in place to ensure that individual regulatory decisions (whether concerning rule interpretations, a specific firm etc) taken by the authorities are compatible (for example, a CPMA enforcement penalty may impact on the solvency of a PRA regulated firm). A process should also be established to resolve differences between the authorities.

3.26 *Regulatory processes and shared services*: in respect of regulatory processes (ie authorisation and approval, supervision and enforcement), the new framework will need to deliver, amongst other things:

— efficient, shared, processes for authorisation, approval and other regulatory processes;

— co-ordinated and consistent supervision;

— co-ordinated reporting and data requirements (including an over-arching data integrity and standards programme and data warehousing that facilitates supervisory analysis without placing disproportionate burdens on firms); and

— clarity with respect to respective enforcement functions (and no risk of double jeopardy).

The increased costs and uncertainties for firms, when dealing with multiple UK regulatory authorities (in addition to exchanges and other regulators which may regulate group entities), must also be recognised.

3.27 Given the need for deep consistency and communality and to reduce administrative costs and undue bureaucracy, we believe that there should be a shared services organisation that performs regulatory processes and provides a common "back office" for both the PRA and CPMA.

3.28 *Transitional issues*: the transitional period (from now until 2012, in the event that the ambitious timetable can be met), will present a number of significant challenges. To maintain confidence and reduce uncertainty, these challenges will need to be managed carefully and effectively. Matter of concern include:

— the appointment of a high calibre CEO to lead the move to the CPMA;

— the retention of key FSA policy experts and senior supervisors (who are essential for more judgement-led regulation);

— the abilities of the new authorities (particularly the CPMA which may be seen as the junior partner) to recruit the calibre of staff needed for judgement-led regulation; and

— maintaining focus on and influencing key EU and international regulatory developments.

3.29 Retention of "talent" (in particular, wholesale market expertise) will be key throughout the whole process and FSA initiatives designed to enhance the training and competence of supervisory staff must be continued during the transitional period.

3.30 The new ESAs will also be established while there is uncertainty in the FSA. By the time the UK landscape is settled and the new UK authorities are fully operational, the ESAs may already be fully staffed and many policy issues and their strategic direction already resolved: hence the need for the UK to maintain focus, influence and involvement.

3.31 *FSA "shadow structure"*: we note that the FSA is developing a "shadow structure" for Q1 2011. While we recognise the operational challenges this process is likely to entail, it is important that the reorganisation does not foreclose on aspects of the current consultation or pre-judge future (more detailed) consultations.

[33] Example: The capacity in which a firm trades may depend on a number of factors including the market conventions. Where a firm deals in investments as principle, the activity would, under the proposal, be regulated by the PRA. However, where the firm—possibly even the same dealing desk—deals in investments as agent, the activity would be regulated by the CPMA. We believe that this would create lines of weakness in the regulation of trading activities.

4. Conclusion

4.1 Although our ongoing discussions with Members may raise additional issues, we hope that this summary will inform the Committee by flagging some of the open questions, issues and concerns which AFME Members believe are of importance at this stage of the process. We would be pleased, of course, to provide further information about any of the matters which our Members have raised if that would be helpful.

22 September 2010

Written evidence submitted by the Association of British Insurers

Introduction

1. The ABI is the voice of the insurance and investment industry. Its members constitute over 90% of the insurance market in the UK and 20% across the EU. They control assets equivalent to a quarter of the UK's capital. They are the risk managers of the UK's economy and society. Through the ABI their voice is heard in Government and in public debate on insurance, savings, and investment matters.

2. The ABI welcomes the opportunity to provide its views on the Government's proposals to reform financial regulation to the Treasury Select Committee.

3. The ABI believes in high quality regulation—but not in excessive regulatory burdens. We understand the drivers for regulatory change and are committed to making the Government's proposed reforms work. However, regulatory reform should not endanger the UK's, and in particular the City's, place as a leading international financial centre. The major outcomes we would hope to see from a revised regulatory structure are:

(a) consumers' needs being put at the centre the new regulatory structure;

(b) a regulatory system that does not stand in the way of continued, positive innovation in the financial system and that maintains high standards of consultation and open working with the industries it regulates;

(c) that the move to a "twin peaks" system does not result in two sets of conflicting regulatory requirements in place of the current unified system; and

(d) in relation to insurance specific points:

   (i) regulatory changes should not disrupt the UK's competitive insurance market—which ensures that consumers receive choice and good value from insurers; and

   (ii) effective regulation needs to reflect the risks and business models of different activities and therefore insurance regulation needs to be properly resourced and given equal status with banking, particularly within the PRA.

4. The ABI supports the Government's intention to create a Financial Policy Committee in the Bank of England to be responsible for financial stability and macro-prudential regulation. We also believe that the Government's proposed "twin peaks" model with separate prudential and conduct regulators, which has already been adopted in a number of countries, can be made to work efficiently. However, we have significant concerns about the detail of the proposals and also about the potential costs and the danger of such radical reform distracting the authorities from important current tasks which we recommend that the Committee consider as part of its inquiry.

5. Our detailed comments on the proposals are set out below.

Overall

6. These comments relate to our overall concerns about the proposals.

7. *Inefficient Regulatory Structures*—We believe that there is a potential for numerous inefficiencies, additional costs and overlapping jurisdictions to arise between the various bodies as a result of the complex mechanisms proposed to ensure co-ordination. We recognise that these arrangements are intended to ensure that the weaknesses identified in the Tripartite arrangements do not occur under the proposed new regime. However, as they stand we have a number of concerns with these proposals:

(a) They set up bureaucratic solutions to avoid overlap (joint membership of Boards and formal liaison arrangements) while tolerating overlap at operational level (for example proposing that PRA and CPMA will operate separate regimes for authorisations and permissions). In practice efficient joint working will require the PRA and CPMA to work together at all levels, not just at that of the most senior management, so that the two regulators can take an integrated approach to supervision of firms. Without it, insurance companies could easily receive two conflicting or contradictory sets of instructions from the respective regulators.

(b) They appear to operate largely in a top-down manner with the FPC having an ability to direct the PRA and CPMA to undertake certain actions (and a requirement on CPMA to consult with PRA

in certain situations) but little provision for FPC to take account of the views of the other bodies (or for the consumer implications of PRA decisions to be taken into account). We suggest that the Committee considers whether the objectives of each of the bodies should have regard for the work of the others. Otherwise we run the danger of institutionalising an isolated way of working, when the stated aim of the reforms is to tackle some of the disconnections that arose from the Tripartite regime.

We believe that a possible way to alleviate some of these concerns would be for certain functions including authorisations and approvals to be carried out jointly. We suggest that the Committee might want to consider whether an appropriate model for undertaking such joint work might be for a joint "service organisation" to undertake these roles which would report equally to both PRA and CPMA. Such a "service organisation" could also undertake other joint administrative roles such as the fee collection and administration.

8. *Role of the EU*—The proposals do not appear to sufficiently recognise the influence of EU developments on UK regulatory rules and practice—in effect almost all the relevant requirements for both prudential and conduct of business regulation are now set at EU level. This will increase further given that the new EU authorities will set binding technical standards. In practice this will severely limit the discretion of the UK authorities and, in particular, is likely to limit the extent to which the PRA can operate its proposed "judgement" based approach to regulation. We are also concerned that the proposals will result in a fragmentation of UK representation in Europe—the PRA will represent the UK in the European Banking Authority (EBA) and the European Insurance and Occupational Pensions Authority (EIOPA), and CPMA will have this role for the European Securities and Markets Authority (ESMA). While this in principle makes sense we would urge that consideration is given to practical engagement on how, for example, conduct of business matters in EIOPA will be dealt with. There will be a need for close liaison between the authorities to ensure that the correct UK representatives are involved in the work of the EU bodies—this is perhaps an area where HM Treasury can take the lead.

9. *Timing*—The consultation paper proposes that the new regulatory structures will be in place by 2012. We understand the Government's desire to make these changes quickly but it is a very challenging timetable and there must be considerable risks and difficulties in meeting it—revising the current Financial Services and Markets Act, especially the large amount of supporting secondary legislation, will be a considerable task. We suggest that the Committee might want to consider pressing the Government to explain its proposed timetable in more detail.

10. *Shadow organisations*—We understand that the FSA and the Bank of England are already in the process of reorganising their internal structures to shadow the proposed new organisations. There are clearly benefits in the FSA and Bank seeking to move to the new structures in order to ensure a smooth transition to the new regime. However, such reorganisations could pre-empt the Parliamentary legislative process in such a way that it would be difficult and expensive to undertake further changes in the event that Parliamentary scrutiny results in significant changes to the proposals. We suggest that the Committee might recommend that while the FSA and the Bank might begin planning for the new structures that they hold off substantive reorganisations at least until after the Government's legislation has received a second reading in the House of Commons.

11. *Distraction from ongoing work*—There are currently a substantial number of major regulatory developments underway (such as Solvency II and implementation of the Retail Distribution Review) and we are concerned that undertaking a major reorganisation of the regulatory structure at the same time will distract the authorities from focusing on implementation of these developments. In particular we are concerned that the Treasury and FSA may not ensure that the best outcome is achieved for the UK in the negotiations on how to implement Solvency II. The Committee may wish to explore this issue further with the FSA and the Government and might want to suggest that specialist teams are set up to ensure that the new structures can be implemented without distracting from ongoing work. At the very least, there should be a clear process to monitor the implementation of the most sensitive projects being inherited from the FSA.

Financial Stability

12. We welcome the proposal to set up a Financial Policy Committee to undertake responsibility for financial stability and macro-prudential regulation. The FPC may have to take decisions, such as limiting the amount of credit available, which could have significant political and societal implications. We are concerned that the proposed structure has insufficient political oversight (with the Treasury being limited to an observer role) and that it may be have insufficient non-banking expertise (as it will be dominated by Bank of England executives).

PRA

13. We are extremely concerned that the Government is considering removing the safeguards, such as requirements to consult and mechanisms to appeal regulatory decisions, currently within FSMA and we believe that these should be retained for the PRA. The consultation paper provides no justification or explanation as to why the Government believes that such safeguards might not be required—particularly given that it is intended to maintain the safeguards in respect of the CPMA. These safeguards are needed to

ensure that the regulatory authorities have undertaken due process in setting rules and making regulatory decisions and to ensure that the industry and other stakeholders (including consumers) are able to contribute to this process. There is also a need for a formal process through a complaints mechanism and the Upper Tribunal for firms to complain about failures in the way the regulator has acted or to appeal regulatory decisions which they believe are incorrect. We suggest that this is an issue on which the Committee seeks substantive explanations from the Government about its proposals. The move to a new regulatory structure should not be a move backwards from the relatively open and consultative approach of the FSA.

14. The Government's consultation paper proposes that the PRA will not have a duty to take account of the competitiveness of the industry in setting its rules. We do not agree with this and strongly support the retention of the need for the PRA to take account of the competitiveness of the industry in undertaking its regulatory responsibilities. The UK financial services industry and the City of London in particular, is a world leader and this provides substantial benefits to the wider economy through creating many skilled jobs, its impact on the balance of payments and on tax receipts. A strong regulatory environment is a competitive advantage for UK firms but it is essential that regulation does not become so burdensome as to damage the UK's attraction as a centre for financial services.

15. The emphasis in the consultation paper is, understandably, on the close links between the PRA and the senior management of the Bank of England but while this will clearly be beneficial to the supervision of banks it is unclear that this will provide commensurate benefits for insurance regulation. We believe that to ensure high quality insurance supervision it is essential for this to have equal status within the PRA as banking supervision. This might best be done by having a head of insurance supervision on a par with the head of banking supervision, ensuring that a number of the non-executive directors of PRA are chosen for their insurance expertise and sufficient training for insurance supervisors to maintain and improve their professional skills and provide a career path for specialist insurance supervisors. In addition the PRA must ensure that it employs a sufficient number of actuaries and experts on insurance risk in its policy teams.

CPMA

16. The Government proposes that the CPMA should act as a "consumer champion". We agree the CMPA should have a clear primary objective which focuses on promoting and protecting the interests of consumers. However, it is entirely inappropriate for an independent regulator to act as a "champion". It should instead take an evidence based approach to policy-making and supervision taking account of the views of all stakeholders. We believe that this is an issue which the Committee should consider further as part of its investigation.

17. Currently the Government proposes that the CPMA will not have a duty to take account of the competitiveness of the industry or of the desirability of facilitating innovation and competition in setting its rules. Although CPMA will need to identify and address any competition weaknesses in financial services markets, it should understand the benefits that competition can deliver to consumers and seek where possible to facilitate effective competition. We note that other key consumer regulators in the UK—such as Ofgem and the Legal Services Board—have objectives to promote and protect the interests of consumers where appropriate through promoting effective competition. This makes sense—competition helps ensure prices are low and products are of a good quality. So we propose that CPMA should be subject to a similar primary objective. The CPMA should also be required to have regard to the benefits of UK competitiveness and innovation.

18. The Government has indicated it will examine how consumer protection is enshrined in FSMA and update or strengthen the regime. We would welcome an open debate on the purpose and objectives of conduct regulation to ensure the CPMA is clear about the outcomes it will be measured against. It is important to recognise that consumers have an interest in not only being "protected" from sub-optimal products but also in accessing products that meet their financial needs. For example, we propose CPMA should be required to take account of broader Government objectives such as promotion of saving and preventing excessive household debt and suggest that this is an issue to which the Committee should give further consideration.

The forthcoming changes to the legislative framework offer a timely opportunity to review the role of the Financial Ombudsman Service (FOS). We support the core function of FOS—to provide an independent, informal and accessible service for resolving for individual customer complaints. However, problems have often arisen where FOS decisions have much wider implications for the industry because they impact upon large volumes of similar cases. Such cases require consultation with all the key stakeholders and analysis of the costs and benefits of a particular approach to all complaints of that type. This form of quasi-regulatory analysis cannot be satisfactorily conducted by FOS as a non-regulator. We propose the CPMA would be better placed to conduct such an assessment and to give binding guidance to the FOS on its approach to similar cases.

Market Regulation

19. We welcome the Government's recognition in the consultation of the economic and strategic significance of the wholesale financial markets to the UK. Unfortunately the Government's proposals for regulatory structure divide responsibility for the financial markets unworkably between the Bank, PRA, CPMA and FRC. This division of responsibility creates a significant risk of regulatory fragmentation and incoherence, representing a serious threat to the competitiveness of the UK's wholesale financial market, and to the ability of the financial markets to finance the economic recovery.

20. To make the best of the structure under consideration, two things need to be done:

(i) If the financial markets are to be properly regulated, then the CPMA needs to have the full authority to do so, with control over as many of the issues affecting the financial markets as possible and must recognise the significance of the wholesale financial markets to the prosperity of the UK. The body should be responsible for wholesale market conduct and the Committee should give serious consideration to the arguments in favour of giving this body responsibility for the following areas:

— the market regulation of financial institutions dealing in investments as principal;

— the regulation of settlement systems and central counterparties bodies;

— the UK Listing Authority; and

— integral supervision of fund managers.

(ii) The statutory objectives and senior management structure of the CPMA must reflect the significance to the UK economy of wholesale market regulation:

— there are significant risks in brigading together regulation of the wholesale markets with retail regulation. The White Paper rightly recognises the different nature of wholesale markets. However, contrary to the White Paper's assertion, the underlying regulatory issues are also very different. Wholesale markets are complex, involving several professional parties, very different from the straightforward consumer/supplier relationship usually found in the retail market. Market efficiency is the key issue, rather than protection of particular parties in the markets; and

— there is a risk that the CPMA will develop a culture which is dominated by consumer protection issues, and that this will affect the markets division where the issues are very different. An operationally distinct division within CPMA is not enough. The different approach to the wholesale markets needs to be reflected robustly in the statutory objectives of the CPMA, and in the management structure of the CPMA—which we would suggest should reflect these differences by, for example, having separate management structures for the two activities including in areas such as enforcement.

22 September 2010

Written evidence submitted by the Building Societies Association

This document provides written evidence from the BSA to the Treasury Select Committee on its inquiry into financial regulation and the Government proposals for regulatory reform set out in A New Approach to Financial Regulation: Judgment, Focus and Stability.

Summary

The BSA regards the following four points as the most important. The rest of this submission replies individually to the questions asked by the Treasury Select Committee.

The need to build in diversity

In the BSA's view, the Government was absolutely right (in the Coalition's programme for Government published in May) to recognise the importance to financial stability of diversity in financial services. Financial stability must be the Financial Policy Committee's (FPC's) overriding objective and diversity is integral to achieving this objective.

Diversity also forms an important aspect of a competitive financial services industry (which the Coalition programme pledges to enhance still further). Accordingly, the BSA welcomes the suggestion in paragraph 4.12 that the need to maintain diversity is suitable as a "have regard" for the Consumer Protection and Markets Authority (CPMA).

It is worth noting that, because of one member-one vote, Board members of building societies, including executive directors are directly elected by consumers—in contrast to many other business forms.

The BSA believes that the FPC, the Prudential Regulation Authority (PRA) and the CPMA should each have a specific statutory remit consistent with, and in discharge of, the Government's policy of encouraging financial diversity. There should be a senior member of staff, in both the PRA and CPMA, with a specific remit of ensuring that diversity, including the particular position of mutuals, is fully taken into account. (See reply below to the following question—will there be unintended consequences of the Government's proposals for regulation on the prospects for non-bank financial institutions?).

The potential complexity and cost of the new arrangements

While the BSA recognises the underlying reasons why the Government has proposed the new regulatory framework, there are (as recognised in the HM Treasury Paper) risks of duplication, overlap, confusion and lack of co-ordination in what is planned. Therefore, it is essential that the practical arrangements are focused in such a way as to avert these potential problems.

It is also possible that, with a number regulators in place of one, regulatory costs will spiral at what is a very bad time for business and the economy. Any increased regulatory burden is likely to be particularly difficult for smaller firms, unless dealt with in a sensible, proportionate manner.

The BSA believes that certain fundamental principles should be established at the outset; namely:

- an overall limit on the overheads and budgets of the new regulators, benchmarked against the existing overheads and budget of the FSA (from which the new regulators will inherit their new functions);
- the sharing by the new regulators of "back office" facilities and services so far as practicable;
- the use by the new regulators of a common gateway for firms and others to the new regulators eg for regulatory returns, permissions and approvals etc;
- careful planning be undertaken to ensure that the new regulatory burdens do not disproportionately affect smaller firms;
- no overlaps between the PRA and CPMA eg on material in discussions and consultations, thematic work, enforcement etc and there should be a senior Treasury official charged with ensuring that, while the regulators must of course actively co-ordinate, they do not allow any drift into a position where their functions overlap;
- no substantial changes to the FSA Handbook of Rules and Guidance purely because of the creation of the new regulatory bodies (for the time being, only necessary modifications to accommodate the new regulatory regime, and any sensible simplifications that can be achieved with minimal further disruption); and
- an early resolution of the CPMA's regulatory approach—will principles-based regulation (PBR) still have a place in the regulator's approach to conduct of business or will this be swept away by the more intrusive and pre-emptive consumer protection strategy being developed by the FSA?

Beneath their own primary objectives, the FPC, PRA and CPMA should be subject to the same (or as near as possible, the same) range of statutory factors to which they must have regard, including each other's primary objectives, the importance of diversity in the financial system etc. Such a uniform position would be very much in the interests of consistency.

The CPMA's role as a consumer champion

It is inappropriate for a conduct of business regulator to be a "consumer champion"—yet this is what the Government proposes. Accordingly, while we fully recognise that the CPMA must, of course, have a fundamental consumer protection objective, we believe that the proposed primary objective for the CPMA should be extended by the addition of the italicised words, as follows:

> *"ensuring confidence in financial services and markets, with particular focus on protecting consumers and market integrity while acting in a fair, impartial and objective manner towards all interested parties and sectors."*

(See reply below to the following question—do the Government's proposals appropriately assign roles and responsibilities between the different regulatory institutions?)

Bank of England and FPC accountability

Taking a broad view of the proposed arrangements, there is a risk of the emergence of an excessively powerful Bank of England unless very robust accountability and transparency provisions are put in place. We welcome the Government's recognition of the need for strong accountability, but believe that the proposed arrangements could go further, without diminishing (but, indeed, reinforcing) the overriding importance of financial stability. (See reply below to the following question—has enough been done to mitigate the risk of conflict between the FPC and the Monetary Policy Committee (MPC)?)

Introduction

1. The Building Societies Association (BSA) represents mutual lenders and deposit takers in the UK including all 49 UK building societies. Mutual lenders and deposit takers have total assets of over £365 billion and, together with their subsidiaries, hold residential mortgages of almost £235 billion, 19% of the total outstanding in the UK. They hold more than £245 billion of retail deposits, accounting for 21% of all such deposits in the UK. Mutual deposit takers account for about 36% of cash ISA balances. They employ approximately 50,000 full and part-time staff and operate through approximately 2,000 branches.

Will the Government's financial regulation proposals improve the framework for financial stability in the UK? Will they work in a crisis?

2. We believe that they have the potential to deliver improvement and to work in a crisis.

3. If the framework operates as planned, each body would be clear in its fundamental role. Potentially there would be clarity of objectives and a reduced risk of considerable activity in respect of one function (say, conduct of business regulation) camouflaging inadequacies in another (say, prudential regulation of firms). However, along with potential benefits, the new arrangements also carry certain risks (such as increased costs, complexity, overlap, conflict etc). And the contrasting objectives of the PRA and CPMA will externalise conflicts that under the FSA have been managed within a single body. This will give rise to further challenges that will need careful management.

Do the Government's proposals get the balance right between tackling the problems of the last crisis and preparing the UK financial system for the next one?

4. The key strength of the proposed arrangements—as noted above—is that each body would have a clear primary responsibility or objective. If accompanied by proper co-ordination and decisive early action, the new framework has the potential of averting future crises.

5. But the keys to preventing further serious problems are (i) sound business plans properly carried forward and (ii) effective regulation in practice (the two elements absent, for example, from the Northern Rock crisis and from other business and regulatory failures)—nearly everything else is damage limitation. However many safeguarding procedures are put in place, there is unlikely to be a serious regulatory bulwark against financial instability unless the relevant authorities are fully committed in practice to carrying out their functions effectively.

6. Of course, no-one knows the nature of the next crisis, so it is difficult to be certain whether the new framework will be adequate in responding to the nature of that crisis.

How do the Government's proposals dovetail with initiatives currently being undertaken at European and the global level?

7. We welcome the Government's recognition (in paragraph 1.12 and elsewhere in the HM Treasury Paper) of the European-wide, and—indeed—international, nature of the financial stability work, and the fact that the FPC, PRA and CPMA will work closely and in co-ordination with their European and international partners.

What costs will the regulatory structure place on consumers?

8. Any increased costs of the new regulatory framework would ultimately be passed on to consumers in pricing, but the impact assessment in the HM Treasury Paper is optimistic. Costs are not only direct financial costs, but also, possibly more importantly, the increased costs—in terms of management and board time—of dealing with two or more regulators in terms of their demands for information, the potential introduction of new regulation, lack of understanding of particular business models that require explanation, and a whole host of other firm/regulator interactions.

9. In view of the fact that the supervisory enhancement programme led to a very significant increase in FSA staff numbers, especially on the supervisory side, and taking into account current economic conditions and strictures on both public sector and private sector budgets, the BSA believes that the combined overheads and budgets of the new regulators should be subject to a ceiling for the time being of, say, 90% of the current equivalent FSA measures.

10. In the summary (above) we make a series of practical suggestions to help control the cost of the new regulatory structure without jeopardising—but, rather, enhancing—its effectiveness.

11. If the new regulatory structure significantly inhibits diversity, innovation and competition, consumers could potentially pay a heavy price. As with many of the issues discussed within this overall agenda there are trade-offs to be made, and the precise costs and benefits of those trade-offs will become apparent only over time.

Power, Roles and Responsibilities

Do the Government's proposals appropriately assign roles and responsibilities between the different regulatory institutions?

12. Broadly, yes—this is their main strength. However, we consider it important to ensure that, beneath their own primary objectives, the FPC, PRA and CPMA are subject to the same (or as near as possible, the same) range of statutory factors to which they must have regard, including each other's primary objectives, the importance of diversity in the financial system etc. Such a uniform position would be very much in the interests of consistency. As noted above, the new structure gives rise to potential conflict between the PRA and CPMA. Ultimately, financial stability is the main prize and that points to the PRA prevailing in any difference between the two regulators.

13. The one serious concern we have about the assignment of roles and responsibilities is the CPMA's proposed role as "consumer champion". The fundamental point is that a rule-making and rule-enforcing body cannot have the impartiality essential for the task, while at the same time being a "champion" of one half of the interested parties. It is rather like a judge being told to apply the law in a case objectively, while at the same time being a "champion" for one of two litigants. Therefore, as noted above, we believe that the proposed primary objective for the CPMA should be extended to make explicit a requirement of fairness, impartiality and objectivity.

14. This is not to say that we don't see a role for consumer champions. Many independent bodies fulfill this role, and it is an important role for the media. However, we question whether the consumer champion role is appropriate for a body that also has regulatory responsibilities. Moreover, directors of mutual firms are elected by consumers, and there is often a clear joint interest between building societies and consumers in meeting the same objectives. Indeed the BSA's research clearly shows a much better record in meeting consumer needs on the part of mutuals than plcs in the UK.

Will there be unintended consequences of the Government's proposals for regulation on the prospects for non-bank financial institutions?

15. There is a risk that the new arrangements will favour the plc business model and have insufficient regard to alternative business models, such as financial mutuals, despite the fact that that financial mutuals tend to be subject to a more restrictive powers regime than plcs, thus making them inherently safer (but not, of course, entirely safe).

16. A mixed, diverse financial services sector is more likely to be financially stable than one that is dominated by a single type of business organisation. There is much evidence supporting the proposition; see for example, the speech by Andrew Haldane, Executive Director, Financial Stability, at the Bank of England Rethinking the Financial Network www.bankofengland.co.uk/publications/speeches/2009/speech386.pdf and the very recent research report by the Oxford Centre for Mutual and Employee-Owned Business, Kellog College, Oxford, which set out a detailed and extensive case for promoting corporate diversity in the financial services sector www.mutuo.co.uk/latest-releases/oxford-university-report-mutuals-deliver-economic-stability/.

17. Diversity also forms an important aspect of a competitive financial services industry (which the Coalition programme pledges to enhance still further). Accordingly, as noted above, the BSA welcomes the suggestion in paragraph 4.12 of the HM Treasury paper that the need to maintain diversity is suitable as a "have regard" for the CPMA.

18. The Government also needs to be alert to the risk that the overall package of the new regulatory structure and tighter prudential requirements leads to displacement or disintermediation—pushing business outside the regulated financial sector on any scale does not necessarily contribute to financial stability.

The Financial Policy Committee (FPC)

Should the FPC have a statutory remit? If so, what should that remit be?

19. In the light of the events of the last three years, the inescapable conclusion is that financial stability must be the fundamental objective of the FPC—this should be a statutory requirement, although the difficulties of defining stability are acknowledged. However, the HM Treasury Paper accepts in principle that the FPC should take into account other factors when pursuing its primary objective, such as the impact of certain macro-prudential tools on levels of lending and UK competitiveness, and the objectives of other regulatory authorities (paragraph 2.26). The BSA concurs with this view.

How should the success of the FPC, both in and out of crisis, be measured?

20. Clearly, the averting of future crises is the key measure. Out of crisis, a measured and proportionate approach, allowing the PRA and CPMA to carry out their activities on a day-to-day basis unhindered is important, but accompanied by proper oversight, appropriate management information, and a determination to take action when necessary. Also important is the delivery of a competitive diverse market, especially in the retail sector, where firms of different sizes and corporate forms can meet customers' needs.

Given the international regulatory framework, what macro-prudential tools should be granted to the FPC?

21. The HM Treasury Paper sets out a range of tools (Box 2.C). We believe that the FPC's use of these tools should (i) be subject to consultation; and (ii) accompanied by an FSA-type compatibility statement—explaining with reasoning why the proposed use of the tool is the most appropriate way of meeting its stability objectives.

22. To the list of macro-prudential tools must be added the proposed funding mechanism for deposit protection envisaged in the European Commission's proposals for an amended deposit guarantee schemes directive (DGSD). Building up a deposit protection pre-fund at the speed and scale envisaged by the Commission would have a major impact on profitability in building societies (and banks) over the next decade. This would compromise the UK authorities' ability to deploy other macro-prudential tools. Accordingly, oversight of deposit protection and the FSCS must be the responsibility of the FPC/PRA and not the CPMA as suggested in the HM Treasury Paper.

23. It should be remembered that a great deal of work on relevant mechanisms (the special resolution regime, the FSA's supervisory enhancement exercise, recent changes under the Financial Services Act 2010 etc) has already been carried out.

Has enough been done to mitigate the risk of conflict between the FPC and the Monetary Policy Committee (MPC)? Is the FPC appropriately structured in terms of:

- *the balance between internal and external members? and*
- *the size of the Committee?*

24. The BSA acknowledges the examination given of the accountability of the FPC, beyond the statutory "have regard to" provisions, set out in paragraphs 2.52—2.67 of the HM Treasury paper, and supports the measures proposed. It is very important to ensure that the accountability provisions work in practice.

25. As explained below, the BSA believes that the PRA and the CPMA should be subject, essentially, to the same statutory accountability provisions as the FSA. We recognise that the position of the FPC, as a body with high-level responsibility for financial stability is substantially different from the PRA and the CPMA, whose primary responsibilities are the regulation of individual businesses.

26. Nevertheless, in view of the fact that the FPC will be taking over an aspect of the work that was previously, to some extent, within the FSA's remit, it would be sensible to consider each of the FSA's accountability provisions and examine whether or not there is a case for applying them to the FPC. Such an examination would be in line with the IMF's statement to the effect that a central bank, if given a stronger role in financial stability, should be subject to "robust mechanisms that ensure transparency and a high degree of accountability" (see paragraph 2.66 of the HM Treasury Paper).

27. We recognise that some of the FSA's accountability provisions may be inappropriate for a broad financial stability regulator that might need to act quickly in the public interest. The BSA would not want to see any inappropriate restraints placed on the FPC.

28. The new arrangements are likely to focus attention on corporate governance at the Bank. Therefore, it would be appropriate to examine whether the FPC, like the FSA currently, should be required to have regard to good corporate governance in managing its affairs. Arguably, it should also be required to have regard to the views of the statutory panels. Another possibility is for the Treasury Committee to interview the Board members of the new regulators.

What characteristics, experience and qualities should the Government look for when appointing external members of the FPC?

29. A range of experience and expertise but, above all, independent-minded and measured individuals, capable of acting decisively when necessary.

The Prudential Regulation Authority (PRA)

Should the PRA be the lead authority over the Consumer Protection and Markets Authority (CPMA)?

30. The PRA should be the lead authority. The separation of roles is a positive move, but will not remove the potential tensions between financial stability and conduct of business. To take an entirely simplistic example, but one that illustrates the point, the imposition of a 1% mortgage rate and a 5% savings rate would be good for consumers, but not for financial stability. Externalising of tensions previously managed within a single regulator does not, by itself, abolish them.

Is it appropriate for the PRA (and CPMA) to adopt a judgements-based approach to financial regulation and supervision?

31. In principle, especially in times of impending crisis, it is better to rely on judgments than on systems. Having said that, regulated businesses are entitled to a reasonable degree of certainty and the judgements must be objective, impartial and based on facts. The ability of the PRA to deliver this will depend on the quality of staff it is able to recruit.

32. And the PRA's demands for information (eg to run stress tests) should be balanced against the costs to firms of providing this information, accepting that not every possibility can be continually evaluated. If mandatory intervention below certain capital thresholds, as mentioned in paragraph 6.17 of HM Treasury's Paper, are introduced, this would limit the discretion available to the PRA, so any such regime would need to be carefully designed and articulated.

The Consumer Protection and Markets Authority (CPMA)

Do the reforms provide adequate protection for the consumer?

33. Yes—the establishment of the CPMA, focused on a single conduct of business role, could potentially provide a strong safeguard for consumers, as long as it does not conflict with the requirement for firms to operate in a prudentially sound manner. (We have noted above the need for the CPMA to be required to act fairly and impartially, which is in the interests of all concerned). However, the main protection for consumers is the choice that they are offered from a diverse range of businesses of different sizes and corporate forms.

To what extent will the regulatory and administrative burden increase for those firms who now have to deal with two regulators?

34. The impact assessment is optimistic in this respect, but still indicates that between 1,500 and 2,000 firms would be subject to regulation by both the PRA and the CPMA. There are clearly risks of spiralling regulatory burdens, especially for smaller firms. Appendix B of the Treasury paper explicitly recognises this. This is why the BSA has proposed a series of practical measures to reduce the risk—see the second point in the summary above.

Other Issues

Should any of the proposed bodies be given responsibility for promoting competition in the banking and financial services sector?

35. It should be borne in mind that the principles of good regulation comprise a number of very important concepts, as set out in paragraph 4.10 of the Treasury Paper, including the relevant authority's need to use its resources efficiently, the responsibilities of those who manage the affairs of authorised persons, proportionality of burdens and benefits, the UK's competitive position, competition aspects etc. These should not be brushed lightly aside.

36. The BSA believes that, in exercising its functions, the PRA and CPMA should not place overriding importance on competition, competitiveness and innovation, but it should take these matters fully into account because they are integral to the businesses being regulated.

Should any of the proposed bodies have a role in promoting the City of London?

37. This is mainly a matter for the institutions that operate in the City, but in the interests of the UK economy, the issue is one to which the FPC should have regard. It should be remembered that much financial service activity takes place outside the City of London—for example, the services provided by building societies and other institutions throughout the rest of the UK.

22 September 2010

Written evidence submitted by the Finance & Leasing Association

Introduction

1. As part of its consultation on a new regulatory architecture for financial services, the new Government has asked whether the regulation of consumer credit should be transferred from the Office of Fair Trading (OFT) to the new Consumer Protection and Markets Authority (CPMA).

2. This paper sets out the Finance and Leasing Association's (FLA) views on this aspect of the Government's proposals and also deals briefly with the question of the prudential regulation of non-banks.

3. The FLA represents a wide range of lending companies, including banks, building societies and non-banks of several kinds. Between them they provide 30% of UK consumer credit (around £52 billion last year), including credit and store cards, high-street credit, secured and unsecured loans and direct lending of many kinds. Our members also fund over half of all new car sales in the UK (£16.5 billion) via hire purchase. We are therefore in a unique position in being able to comment on the impact of regulatory reform from across the credit market.

4. The Government has made clear its intention to consider the evidence carefully before coming to a view on the future of consumer credit regulation. The FLA welcomes this cautious approach.

THE CURRENT REGIME

5. The Government first needs to identify any obvious gaps in the existing consumer protection regime. For 36 years the UK has had comprehensive protection for consumer credit customers in the form of the Consumer Credit Act 1974, administered by the OFT. Moreover, in the past five years the pace of change in UK consumer credit regulation has been rapid. The Consumer Credit Act (CCA) 2006 introduced a new OFT licensing regime, new and clearer consumer information, and new guidance for customers in financial difficulties. The OFT maintains a Consumer Credit Register of licensed companies, inclusion in which requires market participants to comply with a series of strict fitness tests.

6. The new EU Consumer Credit Directive (CCD) (now being implemented) will require standardised information to be given to consumers when they apply for credit, give consumers the right to withdraw from a credit agreement within the first 14 days, and create a new right to repay loans early, either in part or in full.

7. In addition, the OFT has just introduced a new rulebook on irresponsible lending. Further regulatory change is also currently under consideration in Brussels.

THE STATE OF THE MARKET

8. While well-intentioned, the sheer volume of this new regulation has contributed to the shrinkage of the UK consumer credit market, which is increasingly expensive and difficult for lenders. Owners of mobile capital are already exploring more attractive overseas markets. Gross unsecured lending in the UK was down by 11% in 2009. And in the first half of first half of 2010, FLA consumer finance members wrote 12% less business than for the same period last year, itself down on the previous year. There is now a serious risk of creating a market in which lower or even medium-income customers are prevented from accessing affordable credit. The social consequences need to be considered very carefully before further regulatory change is contemplated.

THE CASE FOR CHANGE

9. We therefore agree with the Government's view that any change must deliver "real and justifiable benefits" for consumers. Rigorous cost-benefit analysis will be crucial, and it is important to be realistic.

10. The creation of a new statutory regime for consumer credit would be a mammoth task, involving the repeal and replacement of a body of primary and secondary legislation which has evolved and been updated over many decades, and is closely inter-linked and cross-referenced with other legislation (eg on the sale of goods). Any new regime would also, of course, require significant system changes and staff re-training in the 100,000 or so companies currently regulated by the OFT for the provision of credit. While these considerable costs might be outweighed by potential benefits, they would need to be substantial for both consumers and lenders.

11. Some FLA members (including the larger banks) are currently subject to the OFT's regime for consumer credit and to the FSA's for other forms of financial service provision. Similarly, companies providing credit services and insurance are answerable to the two regulators. There would in principle be efficiency savings to be gained for these companies from unifying the regimes. A single regulator would arguably be able to take a broad overview of a firm's business and avoid the "silo-effect" which can arise when there are several regulators dealing with different parts of a business. But the differences between the FSA and OFT have begun to diminish in recent years. While the FSA in theory takes a principles-based approach to regulation and the OFT is bound by the highly-prescriptive Consumer Credit Act, in practice both regimes rely on extensive rulebooks and supervisory practice has been converging. The primary remaining difference is that, relatively speaking, the OFT regime remains low-cost.

12. One concern about the current FSA regime is that the theory of principles-based regulation allows the regulator scope for retrospective changes to the rules which can make compliance planning very difficult. Any new regime would need to ensure clarity and predictability. A new regime would also require supervisory staff teams with a very good knowledge of the regulated markets. The current FSA does not have this expertise in the consumer credit markets and there would therefore need to be considerable training and recruitment in setting up a new regime.

13. It is also important to understand that the Government has relatively little scope to make substantial changes to actual rules governing the sale of consumer credit in the UK, because these are largely determined by EU Directives, including the maximum-harmonisation CCD (see above).

14. It would therefore be important that any new unified regime was likely (a) to provide further benefits for consumers and (b) do so in a cost effective way. Neither point is currently clear and the case still needs to be made for the proposed move of consumer credit regulation to the CPMA.

Prudential Regulation and Non-banks

15. Turning briefly to prudential regulation, it is important to recognise when comparing credit and saving/current account provision that the risks facing the customer and provider are fundamentally different. In the credit markets, the main risk lies with the provider (ie that the customer may not be able to repay the loan). The opposite is true of other financial services, where the customer runs the risk that the provider may become insolvent. This is why a regime of prudential regulation and deposit protection exists in the saving and banking markets.

16. We continue to believe that this fundamental distinction remains valid. The new prudential regime should not attempt to apply a regime designed to protect the customers of deposit-taking institutions to the consumer credit markets. This would be likely to produce serious distortions, drive companies from the market, and give no benefit to customers.

17. We would be happy to provide the committee with further detail on the issues raised in this paper, as well as oral evidence.

September 2010

Written evidence submitted by the Financial Services Authority (FSA)

1. We are submitting this memorandum as part of the Committee's inquiry into the Government's proposals to change the system of UK financial regulation and in advance of our evidence session on 23 November. In line with our practice of not publicly commenting on Government consultation documents to which we have contributed to, we do not propose to comment on the proposals as a whole. This memorandum, however, highlights how the FSA is preparing to implement the proposals and sets out our assessment of the principal implementation risks and our proposed mitigations, along with the key risks and opportunities arising from the new structure.

2. The following sections cover:

— the high level process we have put in place in response to the Government's proposals;

— the principal risks arising from the transition to the new structure; and

— the regulatory risks and opportunities associated with the long term regime.

Process

3. We have established a regulatory reform programme, led by the FSA Executive Committee, which is working with the Bank of England and HM Treasury to design the regulatory and operating model for the new authorities and manage the transition to the new structure. The expectation is that the cutover will occur in mid-2012. However, in order to minimise the risk of staff losses, we plan to move in early 2011 to a shadow split (reflecting the mandates of the "Prudential Regulation Authority" and "Consumer Protection and Markets Authority") within the FSA for our current risk and supervisory functions in early 2011. This will also allow us to modify the operational aspects of the new approach before its formal launch in 2012. The FSA will be responsible for operating the shadow split but in designing the interim structure is consulting with Bank of England to ensure maximum continuity. The final design of the PRA will be a joint decision with the Bank of England.

Risks Associated with Transitioning to the New Structure

4. Executing the de-merger of the FSA is a complex and resource-intensive exercise with a significant execution risk. At the high level, the principal challenges to successful execution are:

— *People retention risk*: the uncertainty created by moving to the new structure for individuals is undoubtedly posing retention and recruitment problems.

— *De-merger process*: in addition to the people retention risk it should be recognised that the actual activity of identifying and matching approximately 4,000 staff to new roles for the new agencies is complex and potentially disruptive.

— *Personnel stretch and its impact on ability of the FSA to discharge its Financial Services and Markets Act (FSMA) obligations*: the requirement to manage the transition places considerable pressures which self evidently reduces management and staff time available for discharging the statutory obligations of the FSA.

— *Continuity of the regulatory interface with firms*: the de-merger carries the risk of a break of continuity of experience and dialogue with the firms.

— *Requirement for new supervisory processes*: the new regulatory structure requires a complete redesign of the underlying processes which support our supervisory activities. For example:

(a) ARROW (the FSA's supervisory risk framework) is fully integrated and will need to be sub-divided for the two new agencies.

(b) A particular challenge in the design process is identifying and defining mechanisms to deal with those issues which clearly span both prudential and conduct regulation, for example with-profits issues in insurance.

(c) The authorisation process, which is currently a unified one, will be split to allow each individual agency to take responsibility for its own authorisation decisions.

5. We highlight below the mitigating measures we are taking in relation to each of these issues.

6. *People retention risk*: risks in relation to staff retention, recruitment and stretch often arise during any major organisational change. Our overall turnover was 7.6% at end August this year,[34] which although low by financial services standards, is the highest turnover at the FSA since January 2009. The FSA is also facing retention pressures in key skills areas, for example, some areas within the Risk Business Unit currently have turnover levels at 16%. This is a function both of a recovery in demand for specialist skills in the market place as a whole, along with the impact of increased staff uncertainty arising from the reorganisation. Our key mitigation in response to increased turnover focuses on increased recruitment activity and re-allocating staff where possible; we will also look to increase our use of external contractors if necessary. In appropriate cases, we are considering retention payments and/or salary increases, based on competitive benchmarking, to ensure we are able to retain critical skills needed to achieve our business goals and/or to ensure we can replace vacated roles.

7. *De-merger process*: we are seeking to mitigate the de-merger execution risks by our two stage process of moving to the shadow structure before the actual transfer of staff. In executing this approach we are working with external consultants to seek to identify the best possible method for balancing the requirements of fairness to staff, continuity for staff but also ensuring skills are best matched to the new roles. To further minimise the disruption risk we are seeking to "lift and shift" those FSA divisions which clearly relate exclusively to either PRA or CPMA functions without significant change. However, given that we currently operate an integrated model of supervision this will not be possible in many cases: our supervisory teams combine prudential and conduct of business activities, with individual supervisors included in both.

8. *Personnel stretch and its impact on ability of the FSA to discharge its FSMA obligations*: as we move further in to the design and transition arrangements, there is an increased need for management time and focus to shape and implement the shadow structure, in particular spending more time with the staff. These additional demands on management time will mean that the FSA will be at risk of not delivering the same level of supervisory work as it currently does. We believe, however, that through a structured re-prioritisation process we can minimise the impact of this risk, but inevitably the amount of time spent on pre-emptive routine supervision will decline over the transition period. Additionally, the pressure on senior management time will reduce our ability to influence developments at the European level.

9. *Continuity of the regulatory interface with firms*: the transition to the new structure will necessarily involve a change in the manner of our dealing with firms and potentially also in the composition of the supervision teams. This in turn carries the risk of a break in continuity of experience, dialogue and knowledge, and therefore a reduction in the effectiveness of the engagement with the firms until the level of relationship and regulatory knowledge can be rebuilt. The earlier move to a shadow structure within the FSA provides a mechanism for mitigating this risk since we will still have common knowledge and the ability to support each other.

10. *Requirement for new supervisory processes*: we have set up a separate design team staffed by experienced individuals from the FSA and the Bank of England to design the new operating model. We have also studied best practice in other comparable overseas regulators. Critically, however, wherever possible we will seek to build on our intensive and intrusive supervisory model that has been introduced in the last few years for both conduct and prudential supervision. The two phase approach will also allow us to modify the process in light of the experience gained from the gradual introduction for the new regime. The new regulatory model will require a number of changes to the current FSMA model and we are engaging with HM Treasury to ensure these issues are fully considered.

11. We will seek to mitigate all these risks by carrying out phase one of an interim structure as quickly as possible, thus minimising the time period where management resources are thinly stretched and staff anxiety at its highest. Furthermore, we will use external consultants in some cases rather than internal management resources and as far as possible allocate dedicated staff to manage the change, allowing other staff to concentrate on their supervisory role. We have also significantly increased our level of communication and engagement with staff to help manage the uncertainty that any change generates, and to communicate the opportunities that the new structure provides for them.

[34] Rolling 12 months.

Opportunities Created by the New Regime

12. We consider there to be both opportunities and risks arising from the long term regime for financial regulation. As we have previously discussed in earlier FSA publications, the principal benefit from the proposals is the creation of a comprehensive and clear framework, led by the Bank of England, for addressing macro-prudential issues. The new structure of a Financial Policy Committee (with responsibility for macro-prudential analysis and policy and the necessary authority over the micro-prudential authority to ensure effective implementation of that policy), will undoubtedly address the previously identified gap in the UK regulatory architecture. The UK will also benefit from the fact that this structure will allow the central bank and the micro-prudential supervisor to speak in a fully coordinated manner in international and European prudential fora.

13. We can also envisage that separate objectives for the PRA and CPMA will create a narrower specialised focus and fewer internal resourcing conflicts.

14. The Government's plans additionally, and importantly, provide the opportunity to build on the far-reaching improvements that the FSA has been making to its approach to conduct and prudential supervision and carry these into CPMA and PRA. There is a particular opportunity to further advance the consumer protection agenda through the creation of a focused agency which would certainly benefit from having a wider scope, encompassing in particular regulation of unsecured consumer credit. The fact that new legislation is required also creates an opportunity to improve the regulatory framework particularly with regard to consumer protection, and the FSA is working closely with HM Treasury to take advantage of this opportunity.

Risks Associated with New Regime

(a) *Interaction between PRA and CPMA*

15. The changes will, as is the case with any restructure, give rise to regulatory risks which will need to be addressed over the long term. In moving from an integrated supervision model to one of "twin peaks", there will be a loss of the integrated view of a firm and groups whose supervision is split across PRA and CPMA. The issue is that prudential and conduct risks are not completely separable since nearly all conduct risks can potentially generate prudential risks and certainly in all cases carry information that is relevant to the assessment of prudential risk. Mis-selling for example can be an indicator of a poor risk culture and over time can affect the quality of a firm's asset base. This can be managed by effective co-ordination between the PRA and CPMA, including through domestic colleges where appropriate. Information sharing between the two organisations and cross-representation at Board level, both envisaged in the Government's consultation, will be key.

16. It is possible that regulatory arbitrage may arise as firms try to exploit differences in approaches between the PRA and CPMA. We think that the scope for this will be limited, given clarity of the boundary between PRA and CPMA. However, it will be important to keep the boundary under review.

17. We can envisage there being some difficulty in attracting/retaining specialist prudential expertise in the CPMA which will continue to have some prudential responsibilities, for example with regard to asset managers, given the organisation's conduct focus. This could be mitigated through people strategies that include initiatives such as secondments between the PRA and CPMA.

18. As time passes, there is a risk of different requirements emerging (eg for governance, high level systems and controls) for firms and individuals that are regulated/authorised by both the PRA and CPMA. Mitigation will be through close involvement in respective policy-making functions as well as the cross-representation at Board level.

(b) *European/International*

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

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

(c) *Markets Oversight*

21. In relation to markets oversight, it is the FSA's view that there are two key design criteria for any regulatory structure. One is the need to have a clear integrated oversight of the marketplace; origination, trading, clearing and settlement. The second is ensuring that the UK's representation in European and international fora is as clear, coherent and strong as possible. This is particularly important in relation to wholesale markets issues since, as noted above, the new European Supervisory Markets Authority (ESMA) will have significantly increased powers over UK-based activities. The UK only has one seat in ESMA and, as the Government's proposals note, this will need to be filled by the Markets component of CPMA. The Markets component of CPMA must therefore have the greatest possible credibility and influence both domestically and internationally, and have the capacity to attract high quality staff. The comments in the Government's consultation document about achieving this are most welcome.

22. However, one version of the structure proposed in the consultation document would if implemented divide the responsibilities further, potentially creating a new "tripartite" for markets regulation consisting of the Financial Reporting Council (primary markets regulation), the CPMA (secondary markets regulation), and the Bank of England (post trade regulation).

23. This division of responsibilities within the UK would create a highly fragmented representation in European and international fora. This risk could be mitigated through a set of coordinating mechanisms defined through MoUs, but any multi-agency structure carries greater coordination risk than a unitary one.

24. A separate risk in this proposed new structure would be the separation of primary markets regulation (UK Listings Authority (UKLA)) from secondary markets regulation (CMPA). No other major EU countries separate primary and secondary markets regulation because coherence between the two is essential for an effective running marketplace. The coordinating mechanisms required between the CPMA and FRC would need to reflect that the UKLA is not simply a companies information regulator but a securities markets regulator for all securities (only 6% of securities relate to UK companies equity). The UKLA is one key component in the chain of real-time markets surveillance—consisting of: monitoring the conduct of issuing firms (and the sponsoring investment banks); supervising the infrastructure on which trading takes place; and taking enforcement action under the market abuse regime. Effective market regulation requires oversight of the entire transaction chain.

(d) *Enforcement*

25. The Government consultation document recognises that the CPMA will be responsible for the enforcement of its conduct rules in relation both to consumer protection and market integrity. It also makes reference to a subsequent consultation on the creation of an Economic Crime Agency and the question of whether responsibility for prosecuting certain offences should be transferred to a new agency. We believe it is critical that the CPMA maintains a strong and effective enforcement function with broad powers, including criminal prosecution to deal with insider dealing and market abuse. The FSA currently operates a fully integrated model and the success of the credible deterrence strategy over the last three years demonstrates that this has been highly successful. Any move away from this approach would thus carry the risk of undermining the CPMA's ability to achieve its goals and the progress made to date. Furthermore, the lack of clarity on this issue adds further uncertainty which affects both our planning process and staff retention and recruitment.

Conclusion

26. This paper has set out for the Committee a summary of the implementation risks for the FSA and the mitigating measures we are taking, along with an overview of the principal opportunities and risks which we believe the new structure operates. Our senior management team are fully focused on doing their upmost to minimise the implementation risks and take advantage of the opportunities presented to improve regulation in the UK and thus improve outcomes for consumers and market users.

27 September 2010

Written evidence submitted by Financial Services Consumer Panel

Introduction

1. The Financial Services Consumer Panel welcomes the opportunity to contribute to the Treasury Committee's inquiry into financial regulation.

2. As with our previous submissions to the Treasury Committee, this submission focuses on specific areas where the Panel has the most expertise and therefore concentrates predominantly on the proposed Consumer Protection and Markets Authority (CPMA). We have also commented on the overall approach to consumer protection in the HMT consultation and some other issues which are essential to ensure that the new regulatory architecture affords consumer protection the priority it deserves.

3. To be beneficial to consumers, the new Consumer Protection and Markets Authority will need a clearer remit and stronger powers than the FSA:

— a mandate to act as a strong consumer champion—the CPMA needs clarity of purpose and focus to act in the consumer interest. This requires strong leadership backed up by greater powers to crack down on dubious practices and if necessary to ban products;

— a duty to promote competition—the primary objective of the CPMA should be to ensure that consumers have access to markets which are fair, transparent and competitive. The regulatory philosophy underpinning this should equate to 'competition where possible, regulation where necessary' consistent with the general approach adopted in the UK to industry-specific regulation;

— a duty to ensure consumers are treated fairly in their dealings with firms—the CPMA should ensure costs are proportional and that there is straightforward access to remedy and redress. The CPMA should continue and extend the FSA's analysis of business models, and should retain, and use, the FSA's powers to regulate charges if competition is ineffective;

— a presumption in favour of transparency—the CPMA should have a duty to publish as much information as possible on the performance of regulated firms so that transparency becomes a regulatory tool empowering consumers to take well-informed decisions, choosing well-run businesses and creating a market pressure in favour of compliance;

— access to the Chancellor and the Secretary of State for Business to increase the representation of consumer financial issues at Cabinet level—the CPMA should not only report to HM Treasury but also report directly to the Chancellor on retail risks and have a relationship with the Secretary of State for Business;

— adequate focus on consumer protection—the CPMA must not get distracted with its markets brief and when assessing matters of consumer protection, should not over prioritise market stability or international competitiveness where this would risk fettering its discretion as a consumer champion; and

— apropriate information sharing between CPMA and PRA supervisors to ensure that there is a joined-up approach to regulation and sufficient consumer representation at a senior level throughout the new regulatory structures.

Overview

4. Given our unique position as a statutory adviser to the FSA, the Consumer Panel has been well placed to assess the past performance of the FSA in protecting consumers. While there have been considerable strengths and we have been impressed by the FSA's progress in recent years, there have historically been very serious weaknesses:

— the FSA has done too little, too late and it has been too weak and too invisible to protect consumers from harm;

— it has not insisted upon effective compliance in cases such as with profits, payment protection insurance, split capital funds, endowment mortgages, sub-prime mortgages, bank charges and precipice bonds. FSA investigations were not completed in a timely fashion with successive ineffectual investigations resulting in escalating consumer detriment and an overburdened Financial Ombudsman Service picking up the pieces;

— this shortfall has been made manifest by the emergence of major mis-selling scandals. However, a lack of transparency by the FSA arising from constraints in the original FSMA 2000 Act and a consequential failure to disclose information has left consumers in the dark, oblivious to the unacceptable treatment experienced by others. Large firms were under little pressure to improve compliance since enforcement was an uncommon occurrence, with modest fines;

— the FSA has not had a duty to promote competition amongst providers and has not therefore pursued this approach to improving outcomes for consumers. In part, this is because of the potential conflict between promoting competition and ensuring prudential standards;

— the FSA has carried out little economic and market analysis that would illuminate the underlying sources of consumer detriment;

— the FSA's concentration on sales processes rather than business models and product development detracted from an, effective focus on earlier intervention; and

— the wider implications, risks and lessons from past business reviews were not being picked up in many cases and consequently industry behaviour did not improve.

5. The weaknesses outlined above are associated with the "light touch" regulatory approach that characterised the FSA from its inception until the beginning of the current financial crisis. More recently, there have been welcome steps by the FSA towards a more vigorous stance on consumer protection, with earlier, more extensive enforcement and intensive supervision.

Overall Questions

What costs will the regulatory structure place on consumers?

6. Indirectly all costs will inevitably be borne by consumers. Consequently the Panel is very concerned that the new structure will lead to a duplication of staff and structures. In as far as it is possible, new bodies should share resources in the form of data, supervision staff, IT systems and Independent Panels. The move to the new "twin peaks" structure presents a significant risk that the joined-up approach to the supervision of conduct and prudential risk may unwind with a deleterious effect on consumer protection.

7. The Consumer Panel is of the view that the PRA needs effective consumer input and that ideally this should be undertaken by a Consumer Panel within the PRA. However, failing this, the existing Financial Services Consumer Panel should have a nexus with the PRA and the FPC to ensure that consumer interests are adequately represented. The FPC and the PRA should have a duty to consult the Independent Panels to ensure that there is proper scrutiny of decisions and the Panels should have the power to raise issues with the CPMA, PRA and FPC. Alternatively, if there is to be a user group body in the PRA and FPC this should have adequate consumer representation.

8. Given that the financial services industry will pay for the CPMA and other bodies, the Consumer Panel is concerned that there is insufficient clarity as to how the bodies which are also funded by the levy, such as Financial Ombudsman Service (FOS) and the Consumer Financial Education Body (CFEB), are resourced. We are concerned that the proposals as they stand give insufficient certainty to the issue of funding and consequently risk the independence and sustainability bodies dependent on the industry levy.

Power, Roles and Responsibilities

Do the Government's proposals appropriately assign roles and responsibilities between the different regulatory institutions?

9. The CPMA, PRA and FPC should be required to have regard to each others' objectives in carrying out their work. With the concentration of power in the new system in the Bank of England it is particularly important that consideration is given to the impact on consumers.

10. The Panel is concerned that the new bodies not only work closely with each other, but also have appropriate relationships with CFEB and FOS, to ensure that information and best practice are shared. Consideration needs to be given to appropriate use of memorandums of understanding between the new bodies to facilitate good communication and the sharing of information.

11. The main concern of the Consumer Panel regarding board members of the new bodies is to ensure that there is a sufficient consumer perspective and not an overly strong industry bias. One of the problems with the FSA at its outset was the over-representation of the industry amongst its non-executive directors and therefore a reluctance to take the strong measures which were necessary to protect consumers.

12. An issue for the Consumer Panel with regard to the FPC is whether, as it seems possible from our initial reading of the HMT consultation, the CPMA is effectively at the bottom of the hierarchy and liable to be overruled by the two other bodies. This could lead to consumer issues being neglected and potentially that conduct risk itself may be downgraded as the balance of seniority is tilted to the bodies charged with prudential and macro-prudential regulation.

The Prudential Regulation Authority (PRA)

Should the PRA be the lead authority over the Consumer Protection and Markets Authority (CPMA)?

13. The Consumer Panel would be very concerned if the PRA were to be seen as senior to the CPMA. This would mean that consumer protection and market stability are not accorded the importance they deserve. Each of the new bodies should have equal ranking and should pay due regard to each others' objectives, at least in their secondary objectives.

Is it appropriate for the PRA (and CPMA) to adopt a judgements–based approach to financial regulation and supervision?

14. The Panel agrees with a balanced approached to regulation based on principles and rules. The regulator must be active in ensuring compliance with these rules and this can only be achieved if it is reasonably clear what those rules are. It is important that the FSA's experience of a balanced regulatory approach is appropriately instilled in the new bodies.

15. With the rapid evolution of global business and regulation the Panel does not consider that there is a place for the old-fashioned approach of the "Governor raising his eyebrows" as it is sometimes put. Consumers and businesses need clarity to act and understand their rights and obligations.

THE CONSUMER PROTECTION AND MARKETS AUTHORITY (CPMA)

Do the reforms provide adequate protection for the consumer?

16. The reforms as presently proposed do not provide adequate protection for consumers. Notwithstanding the failings the FSA had exhibited over the last decade, lessons have been learnt and the present FSA is carrying out its role more effectively. History must not be allowed to repeat itself by resetting the regulatory clock.

17. Aside from the duty to promote competition, which is dealt with more fully below, the CPMA needs to have regard to fairness and proportionality of the measures it introduces. Earlier in 2010, the Consumer Panel published its 10 point plan[35] setting out our view of the six most important issues for the industry to tackle to achieve better outcomes for consumers and the four priorities for regulators. These included a focus on intelligent regulation, making firms adhere to the rules, ensuring effective redress and offering timely and appropriate compensation.

18. Intelligent regulation is where regulators make balanced, proportionate judgements on firm business models based on prudential and conduct information, rules and principles. This can be differentiated from more primitive forms of box-ticking regulation; in that supervisors use their judgement and experience based on a holistic view of the entirety of the information available. This should result in clear, joined-up, enforceable rules which offer one-stop regulation, proactive market and firm monitoring for early risk identification and effective product scrutiny. Consequently, The Panel is concerned that splitting prudential and conduct supervision between the CPMA and PRA introduces a new risk in that regulators may no longer have the perspective of the entire regulatory landscape resulting in disjointed regulation.

19. Making firms adhere to the rules involves using credible deterrence so that firms fear the reputational and financial risk of non-compliance. This requires a regulator like the CPMA to have the correct leadership so that it can take strong action, clarity in terms of its remit and greater transparency in the regulatory process. There also need to be confident enforcement staff who know they have the powers to act and make firms comply. Additionally, staff should have new powers to suspend and even ban financial products subject to the principles of proportionality and effectiveness and with the safeguard that affected firms could seek judicial review of such decisions.

20. Greater transparency will allow consumers more of the right sort of information on which to make informed choices about the investments they make and the companies with which they do business. This would involve the CPMA in faming, naming and shaming; giving examples of best and worst practice. Thus giving consumers the power to make informed choices and if necessary take their business elsewhere. We would also like to see clear powers to publish complaints data and the publication of Own Initiative Variation of Permissions (OIVOPs).

21. The Consumer Panel has undertaken considerable research into transparency over the last few years and in our more recent report Transparency as a Regulatory Tool[36] we have found that the FSA, although comparing well to other international comparisons, could go further. We would like to see the CPMA become a global leader in transparency on firm complaints, enforcement proceedings, financial promotions and corporate Governance. There should be a presumption in favour of transparency to allow consumers to make sensible choices and for responsible businesses to prosper.

22. To allow for greater transparency, the Panel has argued for changes to sections 349 and 391 of FSMA 2000. Section 349 should be amended to allow information which the FSA finds in the course of its work, such as complaints data, to be disclosed in pursuit of its consumer protection objective with the usual safeguards of proportionality, cost effectiveness and subject to judicial review. Our section 391 amendment would allow the publication of warning notices, the FSA's equivalent of a formal charge, in line with standard practice in other areas of law enforcement. Enforcement action can take years to complete, during which time consumers can continue to suffer major detriment oblivious to the serious allegations which are being investigated. Consumers should therefore have the right to know at the earliest opportunity so that they can take action to protect themselves. Firms will consequently be incentivised to resolve problems quickly.

23. This view on transparency was endorsed by the Conservative White Paper[37] "effective competition relies on consumers being able to make informed choices", which was based on the approach of the Obama administration in the United States.

24. A logical adjunct to this is per-brand authorisation of banks so that firms can no-longer hide behind a myriad of brands and that consumers are aware as to precisely the level of protection they have in terms of deposit guarantees.

25. Effective redress can only be accomplished if firms understand their regulatory obligations to handle complaints fairly. They must learn that it will be cheaper for firms and consumers to resolve problems earlier. Likewise, timely and appropriate compensation will only occur if the regulator is both empowered and motivated to get tough with firms. This requires strong leadership and a remit to protect consumers along with effective enforcement.

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[35] http://www.fs-cp.org.uk/publications/pdf/10point_plan.pdf

[36] Transparency as a Regulatory Tool, John Leston.

[37] From Crisis to Confidence: Plan for Sound Banking, Policy White Paper July 2009.

26. The Panel is not satisfied that the new structure will have sufficient consumer input at board level. It is essential that there are board members with an adequate mix of abilities and experience of consumer issues on the boards of each of the three new bodies. It is also vital that the CPMA is held accountable by the Consumer and Practitioner Panels for its actions in delivering its objectives. The independent scrutiny provided by the Panels should be strengthened with greater resourcing and a duty to consult as there will be two bodies taking over from the FSA and consequently a substantial increase in the complexity of the regulatory landscape, with the FPC in particular having a very high level focus.

27. Given the departure of Hector Sants to the PRA and his appointment as a Deputy Governor of the Bank it is essential for the success of the CPMA that an energetic CEO is appointed at the earliest opportunity.

28. In our 10 point plan the Panel called for industry to take stronger action towards treating customers fairly. The CPMA should enforce this through analysis of business models and regulation where competition is ineffective. Senior management needs to be held to account for the activities of staff and there needs to be effective redress for consumers ensuring firms handle complaints fairly.

29. To ensure that the CPMA is effective in meeting its objectives and that consumer financial issues are sufficiently represented at Cabinet level, the CPMA should have direct access to the Chancellor of the Exchequer and report on consumer issues in the same way as the PRA reports on prudential matters. Moreover, we want to establish the principle that the CPMA, as a body funded by industry, also has a relationship with the Secretary of State for Business.

30. Although it is important that the new elements of the regulatory structure pay regard to each others' objectives, if the CPMA is to be an effective consumer champion, it must prioritise consumer protection ahead of overarching concepts such as financial stability. Misbehaving firms should not be able to escape censure by arguing that the fine or redress might impact on firm stability.

31. By extension, when dealing with consumer protection the CPMA should prioritise this over having regard to "the international character of financial services and markets and the desirability of maintaining the competitive position of the UK".

32. The CPMA should take on the consumer credit powers of the OFT. This would give greater clarity in the regulation of consumer financial products. We also take the view that the CPMA should take on the regulation of claims management companies where they are involved in financial services and that this should apply throughout the United Kingdom.

33. The Panel is concerned about the possible creation of the new Economic and Financial Crime Agency and the risks this may pose for effective enforcement. The new agency would fragment enforcement creating a two tier enforcement structure, with lower-level criminal activity dealt with at the CPMA. Furthermore, the CPMA would be denuded of many experienced staff members who may leave to join the new agency. Moreover, the Treasury document is silent on the continuation of the Regulatory Decisions Committee of the FSA which provides a vital proportional and independent check and balance on the enforcement process. This structure is crucial as it allows for due process and thus enables the greater transparency in disclosing enforcement information which would empower consumers.

34. Related to this is our concern about the interaction between supervisory teams and that there is a possibility that if PRA supervisors lead teams from both the PRA and CPMA then information relevant to the CPMA may not be collated. This could leave the CPMA ill informed about consumer protection and market stability issues. Aligned audit processes in the CPMA and PRA are essential to police the delivery of efficient and effective supervision.

Other Issues

Should any of the proposed bodies be given responsibility for promoting competition in the banking and financial services sector?

35. Financial services regulation should proceed on the principle of competition where possible, regulation where necessary.[38] The principles of the Cruickshank[39] report also have a bearing, principally on the CPMA. Cruikshank proposed that a primary competition objective would serve to minimise the anti-competitive effect of regulatory activity. A competition objective for the FPC or the PRA would not be beneficial as it would conflict with the prudential role of these bodies.

36. The CPMA's primary objective should therefore be to champion consumers of financial services and to ensure wholesale market integrity, promoting effective competition in retail and wholesale markets wherever possible and ensuring good consumer outcomes. The Panel supports the formulation devised by the Which?'s Future of Banking Commission which called for a competition mandate and for the necessary powers to achieve this.

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[38] Regulatory Reform in Britain Author(s): John Kay, John Vickers, Colin Mayer, David Ulph, Economic Policy, Vol 3, No 7 (October 1988), pp 285–351.

[39] Competition and Regulation in Financial Services: Striking the Right Balance, Cruickshank July 1999, http://archive.treasury.gov.uk/press/2000/p98_00.html

37. Consumers are also concerned about the efficiency and competitiveness of wholesale markets as this is where their savings and pension funds are invested. The proportionality of costs is important as higher transaction costs in these markets mean higher charges for consumers which have an adverse impact, especially when compounded over a lifetime of savings.

September 2010

Written evidence submitted by the Financial Services Practitioner Panel

Executive Summary

1. This submission is from the Practitioner Panel, a body set up under FSMA 2000 as an independent Panel to represent the interests of practitioners to the FSA. Details of the role and remit of the Practitioner Panel are at Appendix 1.

2. This submission answers to the questions as set out by the Committee. The key points which we would draw out from our answers are:

(a) Overall we do see clear benefit in the establishment of an FPC to address macro-prudential risks, but we believe that this could have been achieved as an addition to the current regulatory structure.

(b) The move from a single integrated regulator to a "twin peaks" model risks losing some of the good work done by the FSA since the crisis and has an inherent risk of lack of communication and coordination between the various regulatory bodies (in this case the CPMA, PRA and FPC) and potential cost, duplication, overlap or underlap.

(c) The proposals recognise the need to minimise the risks of splitting the regulator, but with insufficient detail to be assured of their effectiveness. There must be a system of coordination at every level, as changes in the conduct and prudential areas within firms are inextricably linked.

(d) There is a significant risk of increased costs, not only in the transition, but also in the structure of the separate regulatory bodies and the inevitable introduction of additional requirements such as for macro prudential regulation.

(e) None of the proposed bodies map directly onto the relevant EU bodies, on which the UK has only one vote. The scope for dilution of the UK's voice in Europe is therefore very significant.

(f) There is much power vested in the Bank of England via the FPC and PRA, and potentially with fewer checks and balances than the present regulatory regime. All the regulators must be transparent and accountable, with the appropriate consultative mechanisms. As part of this, we are advocating an increased role for the independent panels across the regulatory structure.

(g) The new regulators must all retain an objective to take account of the impact of their actions on the competitiveness and innovation in the financial services industry. We are opposed to the CPMA being positioned as a "consumer champion", as this is too emotive and ill defined as a role for a regulator.

(h) Although we do not object to a "judgement led" approach for the PRA, the Treasury Consultation does not indicate the principles on which such judgements will be based. Judgement led regulation is only acceptable on the basis of clear and transparent principles which are applied on an equal basis.

(i) The proposed tripartite approach to markets regulation, with the separation of primary markets, secondary markets and post-trading is unlike the approach in any other jurisdiction. We are not convinced that the CPMA is the best location for markets regulation. We recognise the difficulties of this decision, but believe that Markets regulation, including the UKLA, should be a standalone function, or with the PRA.

(j) We await the specific proposals on enforcement, which has been an important component of the existing regime.

Treasury Committee Questions

3. *Will the Government's financial regulation proposals improve the framework for financial stability in the UK? Will they work in a crisis? Do the Government's proposals get the balance right between tackling the problems of the last crisis and preparing the UK financial system for the next one?*

4. We think that the creation of the FPC has the potential to improve the effectiveness of financial services regulation in the UK. However, the FSA has progressed far since the last crisis, and other aspects of the changes introduce additional complexities which create the need for additional safeguards and coordination. This therefore may reduce the effectiveness of the regulatory framework in preventing or tackling a crisis.

5. The transition process itself creates a risk of the erosion of the effectiveness of the regulator, at a time when there is a need for the regulator to be focused on other issues. We believe the implementation risks are very significant, especially at the current time:

(a) We have already seen a significant loss of senior FSA personnel.

(b) Whilst the crisis may have lessened in intensity, the FSA is dealing with major regulatory change and supervisory issues. To overlay a protracted period of fundamental organisational upheaval raises a material risk of management distraction.

(c) We perceive there to be a considerable risk of dilution of focus on the international agenda at a time when such focus is imperative.

6. The potential problem of coordination is clearly recognised in the Treasury Consultation, but there is little detail on the effective mechanisms for ensuring coordination throughout the regulatory system. The prudential and conduct aspects of a firm's business are inextricably linked, and so it is difficult to see how the regulators will act independently of each other.

7. *How do the Government's proposals dovetail with initiatives currently being undertaken at European and the global level?*

8. There is recognition in the Treasury Consultation of the need to link in to initiatives at European and global level. We want the UK to be in a strong position to negotiate, both at Government level and at regulatory level. We do not want the fragmentation of the UK regulator to dilute the UK's voice. We have urged the FSA to take a high profile role, and would not like the FSA's initiative in appointing a Director dedicated to European and International issues to be lost.

9. The new UK structure does not dovetail into European structures any better than the current system, and risks fragmentation and dilution of the UK's messages with the split of regulatory responsibilities. This is particularly pronounced in the proposed division of markets regulation which does not tally with ESMA.

10. The reference to the PRA using its "judgement" in many parts of the consultation could conflict with European and global initiatives unless the judgement is against clear standards. International firms operating in the UK cannot be expected to conform to judgement decisions which are not based on clear policy statements and procedures, and UK firms should not be disadvantaged by any arbitrary application of judgement.

11. *What costs will the regulatory structure place on consumers?*

12. Consumers, through increases in fees and charges, ultimately pay for all the costs of the regulatory structure. There are potentially significant costs in the transition to the new system as a one-off cost. The new system itself is likely to cost more in regulatory fees and in the resources of firms in dealing with two regulators.

13. There may be further consumer costs if the CPMA's role as consumer champion is interpreted too narrowly. If it restricts firms from developing new products and working the market effectively, there may be less choice available, with consumers paying more for products which are less suited to their requirements. One example of this is the Retail Distribution Review, which may improve standards, but it will also reduce the availability of advice for consumers.

14. *Do the Government's proposals appropriately assign roles and responsibilities between the different regulatory institutions?*

15. The roles and responsibilities of the different regulatory institutions seem generally to be appropriately assigned. We have a number of specific considerations, as follows.

16. *Location of markets*. We have found it difficult to identify what the government is trying to achieve with the changes proposed for markets. It seems it would be better to have Markets in a stand alone regulator, or as part of the PRA, rather than the CPMA.

17. Confidence in the markets is fundamental to the strength of London and those institutions that trade there: a failure in the markets would have an immediate effect on the UK's financial stability. We note that within the FSA, the regulation of markets does not take place within the Supervision Directorate of the FSA, but is located in the Risk Division, indicating its strategic importance to overall risk in the financial system. In many other European countries, markets are regulated by a separate authority. If the current FSA Markets Division, with all its responsibilities, was transferred to a separate markets regulator, the firms affected would only be supervised by the new regulator, so it would not cause further fragmentation for practitioners.

18. Whilst we appreciate that there are pros and cons, we also believe that the UK Listing Authority (UKLA) should stay with the rest of Markets regulation and not be moved to the FRC as suggested in the Treasury Consultation. If the UKLA moved to FRC, it would be too far away from financial services regulation, and so insufficiently aware of the competitiveness and wider pressures of the financial markets. Splitting the UKLA off from the rest of Markets would also weaken our voice in Europe.

19. *Governance*. We are concerned about the accountability mechanisms for effective challenge and consultation in the regulatory system. Overall, there is much power vested in the Bank of England, with little external accountability, whilst its actions will have an increased impact on how firms operate and the UK economy as a whole.

20. The FPC is extremely powerful and yet does not seem to have enough external checks and balances. One option is that the FPC has a majority of independent members so that the industry and consumer viewpoint is fully taken into account, although we recognise this might not be practical. An alternative might be for an advisory and consultative body similar to the previous Bank of England Board of Banking Supervision, which gave industry input before FSMA replaced the Banking Act. Another alternative would be to establish a Practitioner Panel for the PRA, perhaps with additional powers for the Practitioner Panel, or a sub group of it, to interact with the FPC.

21. *Independent Panels*. The current system of the Independent Panels (Financial Services Practitioner Panel, Smaller Businesses Practitioner Panel, Financial Services Consumer Panel) providing guidance and checks and balances in the development of policy is important. It should be maintained, not only in the structure of the CPMA, but in the PRA as well, with possible input into the FPC.

22. These changes also present an opportunity to strengthen the powers of all the Panels. Currently the only onus on the FSA is to explain why they are not responding to challenges from the Panels. We would welcome more formality in the responsibility of the regulator to consider our views, with less discretion to ignore representations without evidence that the opinions have been fully taken into account. We would like all the Panels to have the right to raise major concerns about the impact of regulation on financial stability with the FPC.

23. *Decision making and crisis management*. We do not believe that there is enough clarity of ultimate authority and escalation of conflicts in the current proposals. For instance, if the PRA cleared a change of ownership of a major UK financial institution to a company based in a country with whom the UK had a difficult political or economic relationship, would the FPC be able to step in on financial stability grounds to stop such a takeover?

24. *Costs and benefits of regulation*. There is not enough reference in the Treasury consultation to the need for any new developments in regulation to be challenged on the basis of costs versus benefits. This is an area where we have criticised the FSA for not paying enough attention to cost benefit analysis (CBA), or not always undertaking a rigorous CBA when changing procedures. We will urge that all parts of the new regulatory system must adhere to strict cost benefit analysis for implementation of new regulatory requirements.

25. *Structure of regulators*. At this stage, we do not have the details of the proposed structures of the PRA and CPMA, but they must have a breadth of sector representation which will be critical for ensuring appropriate resources are employed. There must be equal standing between the CPMA and the PRA, and a chief executive should be appointed to lead the CPMA as soon as possible. We are also concerned about the lack of clarity on the future of parts of the enforcement function. This is a key part of the regulatory system, and must be strong, but with appropriate appeals mechanisms.

26. *Consumer champion role for CPMA*. We do not believe that the CPMA's main role should be as a consumer champion and have indicated the cost implications in paragraph 13. We are particularly concerned about such an emotive and ill-defined description which may allow undue bias into the role of regulator.

27. *Will there be unintended consequences of the Government's proposals for regulation on the prospects for non–bank financial institutions*

28. We note that paragraph 3.34 of the Treasury Consultation refers to the PRA benefitting from the expertise, experience and credibility of the central bank, but it is unclear that this will help the regulation of companies in insurance and other sectors. It is essential that senior staff with non-banking expertise are appointed at the PRA. There should also be a consideration of specifying certain independent members of the FPC are from non-banking backgrounds to counter-balance the banking members.

29. In addition the FSA in response to the banking crisis has tended towards a read-across of policy proposals from different sectors with a seeming preference for "one-size-fits all" approach. Once the PRA is part of the Bank of England there is a danger that this will increase with banking driven interests taking over the agenda.

30. *Should the FPC have a statutory remit? If so, what should that remit be?*

31. We would welcome a statutory remit for the FPC which would give it clear accountability. We advocate that the remit should be to maintain financial stability, with due regard to maintaining the competitiveness of the financial services industry in the UK.

32. We also believe that there should be some statutory challenge to the FPC's opinions on behalf of industry practitioners. There must be practitioner membership within the independent members and an external monitoring/advisory role for part of the Practitioner Panel or another independent practitioner dominated grouping.

33. *How should the success of the FPC, both in and out of crisis, be measured?*

34. The measure of financial stability which will guide the FPC needs to be defined. With that in place, the transparency of decisions and six monthly reports as recommended in the consultation paper should allow the success of the FPC to be measured.

35. However, the MPC is dealing with more measurable objectives and a narrower range of clearly defined tools than the FPC will have. Therefore the FPC will need to base its views on judgements and so will need a greater level of transparency, scrutiny and challenge, with publication of measures taken to avoid any crisis after an appropriate interval.

36. We would argue that the FPC should be measured on the basis of regulatory stability in addition to maintaining financial stability. It is important for the industry and for consumers that the regulatory agenda does not lurch between policy priorities, and provides a consistent and certain regulatory environment.

37. *Given the international regulatory framework, what macro–prudential tools should be granted to the FPC?*

38. The detail of macro-prudential tools is not within our expertise, but we would urge that any implementation of macro-prudential requirements from the FPC which impact on firms should still be subject to full consultation through the PRA and CPMA.

39. *Has enough been done to mitigate the risk of conflict between the FPC and the Monetary Policy Committee (MPC)?*

40. The MPC has a clear inflation target, whereas the FPC's more general objective of financial stability is less easy to measure. We would not support any proposals where the MPC's views could over-ride that of the FPC, with regulation of financial services firms potentially manipulated via the FPC to help achieve inflation targets.

41. *Is the FPC appropriately structured in terms of the balance between internal and external members and the size of the Committee?*

42. We are concerned about the balance of FPC membership. As well as six out of 11 members from the Bank of England, the chief executive of CPMA is counted as an external member. This means seven out of 11 are officials from the regulatory structure. This committee must be seen as independent, and also in tune with current industry practices. The FPC will have such an impact on the financial services industry, that one option would be to have a majority of independent members on the FPC or a specialist advisory body (see paragraph 20).

43. Independent membership of the FPC must be seen as a substantial role which requires time commitment between meetings. Members will need to be provided with resources and back up to ensure they operate with credibility and their opinions are not ignored.

44. *What characteristics, experience and qualities should the Government look for when appointing external members of the FPC?*

45. There must be people with detailed knowledge of the financial services industry as external members of the Committee. Most people currently working in a regulated firm will have conflicts of interest. Instead, independent members could work alongside the industry, or be only recently retired and be well regarded and of high standing in the financial services industry.

46. There should also be members of the Committee with wider experience than that of banking to ensure that the interests of the whole financial services industry, and particularly that of other firms regulated by the PRA, are taken into account.

47. *Should the PRA be the lead authority over the Consumer Protection and Markets Authority (CPMA)?*

48. Although we understand the need to resolve potential conflicts, it is essential that the CPMA is seen as being as important as the PRA. If the CPMA is seen as junior, it could harm how the CPMA is regarded by firms, and the CPMA's position in EU and international negotiations. It could also damage its ability to attract the highest quality staff. We would not want this to happen. There is already an imbalance in the appointment of Hector Sants as Chief Executive of the PRA, but no appointment to the head of the CPMA—who must be a credible person of similar standing to Hector Sants.

49. One could argue that the CPMA should be the lead regulator, as under the current arrangements, all firms will be regulated by the CPMA, but a smaller number of firms will be regulated by the PRA.

50. *Is it appropriate for the PRA (and CPMA) to adopt a judgements–based approach to financial regulation and supervision?*

51. Any judgements-based approach must be referenced against clear principles, with consistent application across sectors, groups and firms, and with reference to the requirements in other jurisdictions. It is unclear in the Treasury Consultation what transparency and accountabilities are proposed around the adoption of a judgement-based approach.

52. We disagree with paragraph 3.9 of the Treasury Consultation that excessive concern for competitiveness was the cause of regulatory failure leading up to the recent crisis. The regulator must take account of the need for financial services firms to operate successfully in the market place.

53. We believe that PRA rule-making must be subject to similar requirements to the current FSA consultation requirements.

54. *Do the reforms and the creation of the CPMA provide adequate protection for the consumer?*

55. The CPMA's proposed role as "consumer champion" is too emotive, too ill-defined, and fundamentally inappropriate for a regulator to hold. We advocate a role for the CPMA to ensure that the market works effectively for consumers. Consumers must take some responsibility for their own decisions and we welcome the reference to consumer responsibility in paragraph 4.25 of the Treasury Consultation.

56. The remit of the CPMA must also guard against any inadvertent extension of consumer protection measures into the wholesale market, where such restrictions would stifle the market.

57. At the moment the balance between product and sales regulation for the CPMA seems unclear. If greater product regulation is introduced, there should be a commensurate reduction in the regulation of sales practices.

58. *To what extent will the regulatory and administrative burden increase for those firms who now have to deal with two regulators?*

59. There are significant increases in the costs of the new model, both in direct regulatory fees and for firms who will have to deal with two rulebooks, two sets of requirements, and two teams of supervisors coming to visit. There may also be unnecessary duplication and potentially conflicting regulatory demands from the two bodies.

60. As overall support costs are likely to increase, with a corresponding pressure to contain costs, we would not like this to result in a reduced effectiveness of supervision.

61. *Should any of the proposed bodies be given responsibility for promoting competition in the banking and financial services sector?*

62. We believe it is vital that all the new proposed bodies should have to pay regard to the need to maintain competitiveness in the banking and financial services sector. It is not a regulator's role to promote competition.

63. *Should any of the proposed bodies have a role in promoting the City of London?*

64. We believe the regulator has a role to promote the effectiveness of the UK in its EU and international relations, but not in promoting London.

September 2010

APPENDIX 1

ROLE AND REMIT OF THE PRACTITIONER PANEL

1. The role of the Practitioner Panel is to advise the Financial Services Authority on its policies and practices from the point of view of the regulated community. It has statutory status under the Financial Services and Markets Act 2000 (FSMA). As such, the Practitioner Panel is given access to the FSA's plans for new regulatory policies, and so is able to provide an important sounding board for the FSA before the ideas have been made public.

2. Members of the Practitioner Panel are drawn from the most senior levels of the industry, with the appointment of the Chairman being formally approved by the Treasury, to ensure independence from the FSA. The members are chosen to represent the main sectors of the financial services industry as regulated by the FSA. The Panel currently has senior practitioners from the retail and investment banks, building societies, insurance companies, investment managers, financial services markets, custodians and administrators.

3. The Chairman of the FSA's Smaller Businesses Practitioner Panel (SBPP) sits *ex officio* on the Practitioner Panel to ensure co-ordination, but debate on issues specifically affecting smaller firms are covered by that Panel. The SBPP is submitting separate evidence to this Inquiry.

4. The names of the members of the Practitioner Panel as at 20 September 2010 are as follows.

Panel Member	*Position*
Iain Cornish (Chairman)	Chief Executive, Yorkshire Building Society
Richard Berliand	Head of Global Cash Equities and Prime Services, JP Morgan Securities Ltd
Simon Bolam	Principal, E H Ranson & Co (Chairman, SBPP)
Russell Collins	Head of Deloitte UK Financial Services Practice

Mark Hodges	Chief Executive, Aviva UK
Simon Hogan	Managing director, Institutional Equity Division, Morgan Stanley
Roger Liddell	Chief Executive, LCH.Clearnet Group Limited
Helena Morrissey	Chief Executive Officer, Newton Investment Management
Xavier Rolet	CEO, London Stock Exchange Group
Andrew Ross	Chief Executive, Cazenove Capital Management Limited
Malcolm Streatfield	Chief Executive, Lighthouse Group plc
Helen Weir	Group Executive Director Retail, Lloyds Banking Group plc

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Written evidence submitted by the Smaller Businesses Practitioner Panel

Executive Summary

1. The Smaller Businesses Practitioner Panel was set up by the Financial Services Authority in recognition of the need to have a specific Panel to represent the interests of smaller firms to work alongside the Practitioner Panel and Consumer Panel. We are pleased that the importance of our Panel's work is recognised in the Treasury Consultation, with its proposal to set our Panel on the same statutory footing as the other two independent Panels. More details of our role and membership are at Appendix 1.

2. The key points made in our submission are as follows:

(a) smaller firms represent around 90% of regulated businesses by number, and yet the Treasury Consultation does not refer to the impact on smaller firms;

(b) the Government's proposals will have a significant cost and burden impact on small firms. These firms are already dealing with regulatory changes such as the Retail Distribution Review, and wider trading pressures from the economic downturn; The disruption involved in regulatory change itself is disproportionate to the benefits;

(c) these changes are seeking to solve problems which have essentially been resolved through changes at the FSA and Tripartite system. The changes will be disruptive and costly and seem not to offer any commensurate benefit in regulation;

(d) a new weakness in regulation will be introduced in the divide between prudential and conduct, as the business models of small firms are not split in that way, so hazardous patterns could be missed by supervisors;

(e) we do not believe there is enough external accountability in the new system. Significantly more power is being given to the Bank of England, and the powerful new FPC has few checks and balances. The PRA only has tentative proposals for the current FSA level of accountability;

(f) we are against any type of "judgement-based" regulation which is not based on clear and transparent principles;

(g) the impact of the regulators' actions on the industry's competitiveness and firms' ability to do business must be a key consideration;

(h) a role of "consumer champion" is not an appropriate role for a regulator.

Introduction

3. It is vital to recognise that smaller firms represent around 90% of all regulated firms—some 15,000 businesses, providing financial advice and other services in towns and cities throughout the UK. Despite this importance, there is little reference in the Treasury Consultation to the likely consequences of the proposals on the smaller firms sector.

4. These proposals could have a seriously adverse impact on the viability of smaller firms. We are already preparing for regulatory changes resulting from the Retail Distribution Review and Mortgage Market Review, as well as initiatives from Europe such as Solvency II. On top of this, the Government's wider plans to reduce the deficit are expected to lead to a contraction of business, as likely increases in unemployment and cuts in public spending reduce consumer spending to immediate and essential purchases.

5. This added regulatory burden at a time when trading conditions will be difficult is unwelcome. Smaller firms might reasonably expect help and support from the Government to lessen the burden of bureaucracy during difficult economic times, rather than any suggestion that it might increase. We believe the Department for Business Innovation and Skills (BIS) should be asked to comment on the impact of this increase in regulatory requirements on smaller firms.

6. The Government's proposals, in so far as they relate to smaller businesses, are seen as trying to introduce solutions that have already been identified and resolved by the FSA within its existing "unified" structure. Indeed, the added regulatory burden with its associated costs, will be seen as a backward step.

TREASURY COMMITTEE QUESTIONS

7. *Will the Government's financial regulation proposals improve the framework for financial stability in the UK? Will they work in a crisis? Do the Government's proposals get the balance right between tackling the problems of the last crisis and preparing the UK financial system for the next one?*

8. The Government's proposals seem essentially focused on the last crisis, and so the proposals, although flexible, do not necessarily create a framework capable of responding to the future threats posed by all financial markets. The vast majority of the regulated community are smaller firms who played no part in the last crisis. Nevertheless, smaller firms are potentially set to pay a high price, both regulatory and financial, for the actions of a relatively small number of larger firms.

9. The formation of the FPC, to consider systemic or macro-economic risk should assist in obviating future crises at that level. However the change in regulatory structure will not, and may indeed prove to be an impediment. A weakness of the FSA before the crisis was that it did not interrogate firms' business models adequately. The FSA's approach tended to be reactive, responding to problems that had already arisen, and giving inadequate attention to the structure and business models of firms. However, this has been addressed by the FSA in its restructuring in response to the crisis, with the Risk Division now performing that function.

10. The Government's proposed regulatory divide introduces a new weakness into the regulatory analysis: business models are influenced both by prudential issues such as capital structure and liquidity, and also by the products sold. Having these two aspects in two different regulators makes an overall view of a firm more difficult, and may impede the regulators' ability to anticipate problems arising at firm level.

11. In addition, from a firm's point of view, there is not always a natural dividing line within a firm's culture between its moral duties relating to prudential risks and conduct risks. It will therefore be more difficult to hold conversations with regulators who want to see that split. Issues could fall down the cracks between regulators: actions taken in one area of any business will have an impact on other areas, and supervisors must be aware of this.

12. The micro prudential regulation of smaller institutions may become less effective and the macro consolidated impact of systemic prudential issues within sectors such as stockbroking (which controls highly material amounts of retail client assets) will be more likely to be missed. The prudential regulator will not be looking for them and the consumer regulator will not be geared up to identify or deal with them.

13. Under the current proposals, a significant proportion of smaller firms will be only regulated by CPMA although they have some prudential risks. There must be skills within the CPMA to ensure prudential safeguards are adequate within firms regulated solely by them.

14. Overall, we remain to be convinced that splitting up a single body into two or three will improve regulation, particularly in a crisis. A particular concern is the need for formal cooperation mechanisms which could easily slow down the system.

15. In addition, it seems there will be little change in staff from the FSA to the new regulators: it will therefore be the same staff doing similar jobs under a different title so unlikely to be a fundamental change in effectiveness.

16. We believe the disruption of regulatory change is totally disproportionate. The few problems in regulatory structure that arose within smaller firms have been identified and resolved.

17. *How do the Government's proposals dovetail with initiatives currently being undertaken at European and the global level?*

18. Apart from the top level European stability body, the new European bodies are sector specific, with more emphasis on understanding the various sectors of the market. This means the proposals for UK regulation do not mirror Europe, and yet it is crucial for the UK to have a strong voice in European negotiations.

19. *What costs will the regulatory structure place on consumers?*

20. The costs of all the changes will ultimately be borne by consumers. The Treasury Consultation acknowledges that it will be more expensive to run two smaller regulators than one larger one. There will be costs for the new regulators having to split back-office services such as IT and HR, as well as costs for firms in changing reporting methods to deal with different regulators and their methods of operating to adhere to any changes to the rules.

21. For those firms who are regulated by both the PRA and CPMA, there will be the cost of responding to more than one regulator. This will be in an increased burden of hosting visits from two regulators and providing information to more than one regulator. On top of this, there is the danger of the two regulators placing conflicting demands on the behaviour of firms.

22. An example of the increased burden of dual regulation is that on the credit union sector. Credit unions have prudential and conduct risks and so are likely to be regulated by both. This will increase the cost of borrowing to those more vulnerable in society, and reduce dividends to those being encouraged to save for the future with more meagre resources than the majority involved in the financial services sector.

23. Ultimately, these regulatory changes represent yet another cost which small firms have to bear. We already have hugely unpredictable costs in supporting the Financial Services Compensation Scheme. The levy on firms is decided on an annual basis, depending on how many firms have gone into default and the consequent compensation payments required to consumers. At the moment, with large payments expected, it is extremely difficult to predict the size of the likely costs, and yet firms have to devise a fee structure to cover this. It is likely that firms required to fund this will err on the side of charging too much rather than too little—in order to try to ensure their survival.

24. *Do the Government's proposals appropriately assign roles and responsibilities between the different regulatory institutions?*

25. If the split is to occur as outlined, the key divide between prudential and conduct seems sensible. However, we refer to our concerns as outlined in answer to the first questions, that this change is unnecessary and will neither improve the regulation of smaller firms, nor definitely prevent any future crises.

26. We believe that a regard to competitiveness and viability of the financial services industry should be a responsibility of all of the regulatory institutions, and not be reconsidered for the PRA as suggested in paragraph 3.9 of the Treasury Consultation. It is untenable that a regulator should have the power to act in ways which could undermine the stability of such an important sector of the UK economy without considering the consequences of their actions.

27. As there will be fewer smaller firms regulated by the PRA compared to the CPMA, we are concerned that the smaller firm voice may become lost within the PRA. We will urge that there is a specific facility created, similar to the FSA's Smaller Firms Division, in both the CPMA and the PRA, to protect and promote the interests of smaller firms.

28. It is inappropriate for the CPMA to be a "champion for consumers"', especially in relation to smaller firms. A better approach would be to ensure a reasonable and fair balance between the interests of consumers and the impact of those interests on firms seeking to provide quality services to consumers.

29. The FPC and Bank of England will be very powerful influencers of regulatory policies, and ultimately, the whole business environment in the UK. We are concerned at the low level of external accountability proposed in the new structure, with no input from practitioners specified. For the PRA, there is only a consideration of possible current accountability mechanisms of the FSA being transferred to the PRA (HMT Consultation, paragraph 3.38). We would advocate an increased role for all three of the FSA's current independent panels interacting with the CPMA, PRA, and FPC. From the smaller firms' point of view, it is crucial that the perspective of 90% of firms by number is taken into account at all levels of the regulatory structure.

30. *It is unclear how the future structure of enforcement will work. This is an important aspect of regulation, which we want to see working effectively, and with appropriate appeal mechanisms.*

31. *Will there be unintended consequences of the Government's proposals for regulation on the prospects for non-bank financial institutions*

32. The new prudential regulator must be flexible enough to recognise the differences between banks and non-bank institutions. It is a concern that paragraph 3.34 of the Treasury Consultation refers to the supervision of financial firms having the benefit of the expertise, experience and credibility of a central bank, without reference to the possible need to expand that expertise and experience to those sectors not previously covered by the Bank.

33. It is already predicted that a large number of small advisory firms will go out of business as a consequence of the implementation of the FSA's Retail Distribution Review in 2012. The regulatory changes proposed in the Treasury consultation will lead to yet more costs in changing systems for dealing with a new regulator. The consequence of this will be to encourage more small firms to give up, so denying consumers access to financial advice, and employees access to work.

34. For small firms overall, these regulatory changes represent an additional burden for which there seems to have been no cost benefit analysis. We believe, in the case of smaller firms, that the cost of the regulatory changes will be disproportionate as there are no perceived benefits.

35. *Should the FPC have a statutory remit? If so, what should that remit be?*

36. We believe the FPC should be democratically accountable through a statutory remit. As well as financial stability, the statutory remit should also direct the FPC to consider the impact of their decisions on the viability, competitiveness and multiplicity of the financial services community.

37. We recognise that the FPC will not focus its attention on the activities of small firms, nevertheless, it must not make decisions which will unnecessarily penalise them.

38. *How should the success of the FPC, both in and out of crisis, be measured?*

39. In a crisis, the success of the FPC will be if UK financial institutions remain secure and markets continue to function. Out of a crisis the success should be on the basis that UK financial institutions remain internationally competitive, that the UK remains an attractive place to do business and that markets are liquid and transparent.

40. *Has enough been done to mitigate the risk of conflict between the FPC and the Monetary Policy Committee (MPC)?*

41. There is the prospect of some conflict in terms of the different remits requiring conflicting policy responses, but this should be minimised and managed through the mutual members of the MPC and FPC.

42. *Is the FPC appropriately structured in terms of the balance between internal and external members and the size of the Committee? What characteristics, experience and qualities should the Government look for when appointing external members of the FPC?*

43. We believe that there must be independent members with experience and understanding of the management of financial services firms; including smaller businesses. These people must also have experience of other regulated sectors beyond banking, particularly insurance as it is such a major part of the system.

44. *Should the PRA be the lead authority over the Consumer Protection and Markets Authority (CPMA)?*

45. We do not believe it is appropriate to have the PRA as the lead authority. If prudential and conduct are to be split, the regulators should have independence and equal authority. The CPMA must not be seen as a junior partner, as it could adversely affect the way it is regarded by regulated firms and in any negotiations on behalf of the UK.

46. Indeed, we would advocate the CPMA as the lead authority over the PRA: all firms are due to be regulated by the CPMA, and only a smaller number by the PRA.

47. *Is it appropriate for the PRA (and CPMA) to adopt a judgements-based approach to financial regulation and supervision?*

48. The idea of judgement-based approach from the PRA (and possibly CPMA) without any agreed guidelines cannot be allowed to prevail when there are European legal structures which apply to the UK—much of it set through maximum harmonisation directives.

49. In today's global economy, the UK cannot have a subjective and uncertain regulatory regime which could unfairly disadvantage UK firms, but must work within clear and transparent guidelines.

50. *Do the reforms and the creation of the CPMA provide adequate protection for the consumer?*

51. It is unclear that consumer protection will increase under the proposed system. Indeed, consumer protection could reduce if there is not sufficient information sharing between the PRA and CPMA. As with any new system, there is a danger of gaps developing between the new bodies.

52. However, if the activities of the two regulating authorities dovetail and firms do not suffer too much disruption in the changeover, consumer protection should persist at least at the current level.

53. *To what extent will the regulatory and administrative burden increase for those firms who now have to deal with two regulators?*

54. The proposals indicate that the vast majority of smaller firms will only be regulated by the CPMA. Nevertheless, these firms are still likely to have additional burdens in revising systems to deal with a new regulator with possibly differing priorities.

55. For those firms having two sets of regulators, they will have two supervisors to whom they are accountable, with two sets of visits rather than one, and a need to notify two regulators of changes in the business. There may also be differing, possibly contrary requirements from two regulators which will cause frustration and delays.

56. For some small firms, for instance credit unions, the possibility of being regulated by two bodies will increase administrative and financial burdens on a sector which is, in the main, run by volunteers and with low financial resources.

57. We are also concerned that if the new regulators try to keep overall costs down to current levels, the quality of supervisors and supervision may deteriorate.

58. *Should any of the proposed bodies be given responsibility for promoting competition in the banking and financial services sector?*

59. Market forces should be allowed to create healthy competition, but as the regulator is intervening in that market, it must have regard to the impact of its actions on competitiveness. However, we do not believe that it is the role of the regulator to actively promote competition.

60. *Should any of the proposed bodies have a role in promoting the City of London?*

61. All the proposed bodies should have a role in promoting the UK's interests as a whole in EU and international relations.

September 2010

APPENDIX 1

ROLE AND REMIT OF THE SMALLER BUSINESSES PRACTITIONER PANEL

1. The Smaller Businesses Practitioner Panel (SBPP) was set up by the Financial Services Authority (FSA) to represent the views and interests of smaller regulated firms and to provide advice to the FSA on its policies and strategic development of financial services regulation.

2. Our members are drawn from smaller firms operating across the main sectors of regulated business.

3. We consider several factors when deciding on the definition of "smaller" businesses and take a flexible approach to the application of criteria. A firm may have—in relative terms—a minor market share or small number of employees in the context of its industry sector. In addition, the firm's financial position and whether the firm is owner-managed may be relevant.

4. We work to ensure that the interests of smaller financial services firms are taken into account and their importance to a healthy, successful and vibrant marketplace are properly reflected in the policies of the FSA.

5. The names of the members of the SBPP as at 22 September 2010 are as follows.

Panel Member	*Position*
Simon Bolam (Acting Chairman)	Principal, EH Ranson and Company
Guy Matthews (Appointed Chairman from 1.11.10)	Chief Executive, Sarasin Investment Funds
Clinton Askew	Director, Citywide Financial Partners
Ian Dickinson	Director, The Brunsdon Group
Paul Etheridge	Chairman, The Prestwood Group
Peter Evans	Chief Executive, Police Credit Union
Sally Laker	Managing Director, Mortgage Intelligence
Fiona McBain	Chief Executive, Scottish Friendly Assurance
Keith Morris	Chairman and Chief Executive, Sabre Insurance
Andy Smith	Special Projects Advisor, TD Waterhouse UK
Andrew Turberville Smith	Chief Operating Officer and Finance Director, Weatherbys Bank Ltd

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Written evidence submitted by the City of London Corporation

INTRODUCTION

1. The City Corporation welcomes the opportunity to contribute to the Committee's inquiry into financial regulation. The City of London Corporation aims to promote and reinforce the competitiveness of the UK-based financial services sector by tackling issues which may impact upon the open, efficient and competitive environment for doing business. The City is keen to ensure that the most effective possible regulatory structure for UK-based financial services is put in place, in order to safeguard the stability of the financial system, to help restore public confidence and to safeguard the competitiveness of the sector, regardless of the nationality of ownership of the companies concerned. A healthy and thriving financial services sector provides employment, generates export earnings and produces tax revenue in order both to address the deficit and to finance public service provision.

2. The Corporation's work on financial regulation matters is informed by its International Regulatory Strategy Group (comprising representatives from a variety of industry sectors including investment banking, asset management, insurance, legal and accountancy services, exchanges and market infrastructure), which replaced an earlier EU Advisory Group. Its role includes identifying strategic level issues where a cross sectoral position can add value to the existing industry views.

3. In the current economic climate it is clear that constructive collaboration is required between authorities and industry, but the City Corporation also believes that industry must be proactive in seeking to improve the situation before solutions are imposed. Confidence in the financial services sector's ability to generate growth has been dented and the business community is aware that maintaining the status quo in terms of banking supervision is not a realistic option. Some adjustment to the regulatory framework is therefore inevitable.

4. This memorandum addresses the specific questions posed in the request for evidence to which the City is in a position to respond. It acknowledges that there are widely differing views across business sectors and between companies and trade bodies. It does not seek to offer a consensus.

Roles and Responsibilities of the New Bodies

5. A particular concern in the new regulatory structure is that firms may be faced with being supervised by two separate regulators since it appears there will be much overlapping in both the authorisation of firms and individuals between the proposed Prudential Regulation Authority (PRA) and the Consumer Protection and Markets Authority (CPMA). It is essential therefore that expensive and long drawn out duplication of work between these regulatory authorities is avoided, with an integrated model used as far as possible. There is also a risk in the new structure of separate and distinct rulebooks evolving between the PRA and the CPMA, particularly in the area of prudential regulation, where the two regulators share responsibilities. A single and consistent rulebook is essential for all participants in the sector.

6. Authorisation should be dealt with by one authority, in order to ensure efficiency and consistency in regulatory decisions. Giving the CPMA responsibility for collecting fees from the firms reinforces the argument in favour of also giving it sole responsibility for authorisation of individuals and organisations, in order to avoid duplication and to create a direct link between the handling of applications and the granting of authorisation.

7. In addition, the new structure does create the possibility of duplication, not taken into account in the impact assessment attached to the consultation paper. This includes the proposals to separate out the FSA's existing authorisation, enforcement, and rule-making functions between both the PRA and the CPMA. There is a clear need to examine more closely the level of benefit gained against costs incurred. If the supervisory duplication within the new structures materialises, there is a risk that the costs of these proposals may exceed those set out in the assessment. The estimate in the impact assessment of transitional costs of £50 million spread over three years seems low in view of the scale of the reorganisation required.

8. Although it is appropriate to give the CPMA primary responsibility for the operational supervision of markets, there are concerns over the transfer of the listing authority responsibilities to the Financial Reporting Council, particularly since this would take place prior to any final decision being taken about a companies regulator. The UK Listing Authority has very different functions from the FRC and it is not clear how a merger of the two would deliver public benefit. It is important for the FRC to retain its independent status in order properly to carry out its role as the ultimate regulator of the accountancy profession through its operating bodies (the Accounting Standards Board, the Auditing Practices Board, the Board for Actuarial Standards, the Professional Oversight Board, the Financial Reporting Review Panel and the Accounting and Actuarial Discipline Board). It is not currently clear how these functions, for which independence is essential, could be brought together with those of a listing authority.

9. The Government consultation implies that the main dangers that the changes in regulatory structure are designed to address are bank or building society failures on the pattern of the events of 2007–08. There can, however, be occasional failures in the non-banking area of the financial services sector. Effective powers of intervention should be in place to resolve such crises, although in the event of the failure of a non-banking institution, the appropriate point of intervention will need to be identified at the time, rather than identifying a mandatory defined threshold.

Financial Policy Committee

10. The Financial Policy Committee (FPC) should be given the primary objective of setting capital ratios in a manner that would underpin financial stability, enabling it to use this instrument in a counter-cyclical manner. The FPC should also be able to apply secondary factors, since the use of capital ratios will not alone be sufficient to support financial stability. This could include the setting of liquidity ratios and leverage ratios appropriate to ensure financial stability.

11. These factors should be set as statutory objectives, but with the FPC having the discretion to determine the level at which capital, liquidity and leverage ratios should be set, keeping within the framework of Basel III. There will be a need for international co-ordination in determining the level at which all these new instruments are set in order to ensure that as far as possible that policy contradiction in different markets are avoided.

12. Both the PRA and CPMA should have regards to the primary objectives of the FPC, since it is the primary body charged with setting the parameters to achieve financial stability across the system.

Other Issues

13. The proposed changes in the UK's regulatory structure will of course take place as a new system of EU-wide supervisory institutions is put into place, with the banking supervisor based in London. It is essential that the new UK bodies, from the start, seek to influence the development of the EU-wide regulatory and supervisory structure, encourage secondments and develop a dialogue with equivalent bodies including those in the United States and the emerging financial centres of the Middle East and Asia.

14. The requirement for the CPMA (and other regulatory bodies) to have regard to the competitiveness of the UK financial service sector is strongly endorsed. Whilst proper and effective regulation is essential for financial stability and both domestic and international trust and confidence, it is important that the competitive position of the sector, as major contributor to employment, export earning and tax revenue, is not undermined by regulatory requirements and approaches which exceed in their severity those of partners and competitors.

Economic Crime

15. The City Corporation also notes the Government's announcement that it will seek to improve the nationwide arrangements for combating specialist crime. In 2007 with the support of the City Corporation, the City of London Police assumed National Lead Force (NLF) responsibilities for Fraud and Economic Crime. The City Corporation makes a substantial contribution to the operational costs of the City Police, not only in its role as NLF, but in support of its broader role as the territorial force for the "Square Mile". Benefits are clearly gained from this interdependency and the City would not wish to see progress made in this key area of policing compromised in establishing the new National Crime Agency (NCA) or Economic Crime Agency (ECA).

16. The City of London Police is very keen to share its expertise in this evolving landscape. Close collaboration can bring benefits to all parties involved, ensuring that these have ready access to the resources and technology employed, as well as the systems, processes and agreements which already in place in developing initiatives such as the National Fraud Investigation Bureau (NFIB) and Action Fraud. In addition, the City Corporation would continue to provide a strong and established system of accountability with local residents and businesses through the Police Committee.

17. There is a strong desire, certainly among the business community, that fraud remains a top priority. The City Police has built the trust of the financial services industry and this is fundamental in ensuring that intelligence continues to be shared to prevent crime and to disrupt serious and organised crime groups.

October 2010

Written evidence submitted by Which?

Financial Regulation

1. Whilst the major focus has understandably been on the failure of the tripartite system to deliver effective prudential regulation, there have also been serious flaws in the FSA's approach to conduct of business regulation. This has led to a failure to deliver sustained improvements for consumers and a number of major problems surrounding issues like Payment Protection Insurance (PPI), endowment mortgages and bank charges. These failures cost consumers and the industry billions of pounds and damaged consumer confidence.

2. Alongside to changes in structure we need fundamental changes to the approach taken in consumer protection, macro and micro prudential regulation. In summary, we believe that the measures we are proposing would lead to a more effective, efficient and accountable regulator

Consumer Protection and Markets Authority

3. The objective for the CPMA should be to ensure a fair, transparent and competitive market in financial services, with particular focus on protecting consumers and ensuring market integrity. It should have a duty to promote effective competition and when discharging its functions should "have regard" to factors including the price and value for money of financial products and services, the need to proactively disclose information and promoting public understanding of the financial system and financial inclusion. It should take a stronger approach to enforcement with higher financial penalties and action against individuals. It should also regulate products rather than simply examining the sales process. The Board should contain a number of individuals with experience and knowledge of consumer issues. Proper accountability can only come alongside improved transparency. Section 348 of FSMA should be removed and there should be a presumption in favour of disclosure of information.

Coordination between the CPMA, PRA and FPC

4. Splitting responsibility between three different regulators does not remove the conflicts which can exist between different functions, but merely externalises them. We do not believe that the PRA should be given primacy over the CPMA. To permit the PRA to prevent the CPMA taking a firm-specific conduct decision sends a dangerous message to the industry that only firms which are small enough to fail without causing damage to financial stability will be forced to bear the full consequences of mistreating consumers.

Prudential Regulatory Authority

5. The current supervisory approach to prudential regulation is not effective. The significant implicit subsidy received by the banking sector has eroded market discipline, distorted competition and encouraged banks to intertwine highly leveraged investment and wholesale banking activity with essential retail banking activities and the payments system. Responsibility for prudence must lie with the banking institution, its management, shareholders and debt providers and not be delegated to regulators. Stability is not created by trying to prevent failure, but by enabling firms to fail in a controlled way. The regulator must change its approach from attempting to prevent failure in all circumstances to ensuring that banks can fail, but without significant harm to their customers, vital banking services or the economy.

Macro-prudential Regulation (Financial Policy Committee)

6. We support the introduction of the Financial Policy Committee and note the implications of the use of macro-prudential tools such as changing Loan-To-Value limits and capital requirements on consumers. It is important that these issues are tackled prior to the start of the operation of the FPC.

Consumer Protection and Markets Authority

7. Which? believes that structural changes will not, on their own, address the root causes of poor regulation. Major changes in approach are needed to ensure financial services consumers receive adequate protection from the new Consumer Protection and Markets Authority.

8. The previous approach to regulation failed to deliver sustained improvements for consumers. It was an approach that was too reactive and failed to put in place the right incentives for firms, make competition work for consumers or ensure that there was a credible deterrent against poor practice. Instead of tackling the root causes of consumer detriment, the regulator sought to control the sales process. There was an emphasis on disclosure of information, rather than ensuring that consumers could understand and act on this information. This led to a number of major problems surrounding issues like Payment Protection Insurance (PPI), endowment mortgages and bank charges. These failures cost consumers and the industry billions of pounds and damaged consumer confidence.

9. The ultimate purpose of regulation is to ensure that markets work in the interests of consumers. The CPMA should work to ensure that market forces can work more effectively in the financial services market so that companies which treat their customers fairly and offer good value for money products gain business at the expense of firms which do not. Similarly, it must be made clear to firms, their management and shareholders that a failure to treat customers fairly will have a significant detrimental effect on the firm's reputation and bottom line.

10. Over the past year we have seen a number of welcome changes to the FSA's approach including a move from a purely reactive to a proactive approach and a greater willingness to tackle the root causes of consumer detriment. We are keen to ensure that this new approach is carried across to the new regime and that the CPMA is given the mandate, powers and tools to deliver improvements for consumers. In order to achieve this we believe the following issues must be addressed:

Mandate and Objectives

11. We believe that the objective for the CPMA should be to ensure a fair, transparent and competitive market in financial services, with particular focus on protecting consumers and ensuring market integrity. We have concerns about the unintended consequences that could result from the current proposed primary objective relating to "ensuring confidence"—for example, it could discourage the regulator from publicising bad practice or drawing attention to areas where markets are not working properly for consumers. As a result we believe the Government should reconsider the objective it has set out.

12. Whatever its primary objective, we believe the CPMA should have a duty to promote effective competition.[40] It should be given the necessary powers to regulate the sector to achieve this, including the ability to apply specific licence conditions to banks and exercise competition and consumer protection legislation. Its competition powers would be concurrent with the competition powers of the OFT and will enable the regulator to make market investigation references to the competition commission.[41]

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[40] Please see Annex 1 for an explanation of the shortcomings of Competition Regulation under the Financial Services and Markets Act 2000.

[41] For further information please see Chapter 3 of the Future of Banking Commission report, http://commission.bnbb.org/banking/sites/all/themes/whichfobtheme/pdf/commission_report.pdf

13. In order for the CPMA to act as a strong consumer champion, we support the inclusion of a number of "have regards" including:

— *The price and value for money of financial products and services*: The loss of the Supreme Court case on unauthorised overdraft charges has exposed significant gaps in the ability of regulators to tackle unfair charges so we believe the CPMA should be given the authority and powers to these. We outlined a possible approach in our submission to the European Consumer Rights Directive and also raised this issue in our response to the Treasury Committee's inquiry into Competition and Banking.[42]

— The need to proactively disclose information which might influence a consumer's decision to engage in a commercial relationship with a financial services company: there should be a presumption in favour of disclosure and information should only be withheld where its release would damage the interests of consumers.

— *Promoting public understanding of the financial system*: the regulator should ensure that consumers have, understand and can use the information they need to make decisions about financial products and services.

— *Promoting financial inclusion*: This should recognise that in the same way as utility services, access to basic financial services are essential for consumers to properly participate in society.

14. We support the removal of the need for the regulator to have regard to the international character of financial services and markets and the desirability of maintaining the competitive position of the UK and the desirability of facilitating innovation. We do not feel these are suitable objectives for a regulator tasked with consumer protection. The inclusion of "innovation" presupposes that innovation in financial services is always beneficial for consumers and markets. In actual fact, innovation of product design can frequently involve increasing complexity or products which benefit the industry not consumers. The need for regulators to have regard to "international competitiveness" creates a conflict of interest which tends to support the *status quo* and be insufficiently challenging to the industry.

Supervision and Enforcement

15. We welcome the intention that the CPMA will take a strong approach to enforcement to ensure credible deterrence. In order to achieve this we believe the following changes are necessary.

Financial penalties will need to be significantly higher than those imposed by the FSA

16. Examples of fines in Payment Protection Insurance (PPI) cases have shown the level of fines issued were minute in comparison to the revenues firms generated from mis-selling—in the case of the January 2008 fine for HFC Bank Limited it represented less than 0.4% of sales revenue.[43] Even after the FSA had decided to significantly increase the level of penalties it imposed for PPI mis-selling, the fine levied on Alliance and Leicester represented less than 3% of the revenue they gained from selling the product.[44] It is unsurprising that the FSA's regulatory activity in the market for Payment Protection Insurance has not had the desired outcome in ensuring that customers are treated fairly. We would suggest the CPMA looks at the example of other regulators who levy substantially higher fines for consumer abuses. Under the Competition Act 1998, the OFT has the power to levy a financial penalty of up to 10% of global turnover of the business involved. OFWAT and OFGEM have similar powers. British Airways was fined £121.5 million for collusion over fuel surcharges.[45] Argos and Littlewoods were fined a total of £22 million for fixing the price of toys and games.[46] OFWAT fined Severn Water £35.8 million for mis-reporting information and providing sub-standard service.[47] Shareholders will only be incentivised to put pressure on senior management to ensure customers are treated fairly when financial penalties represent a significant proportion of the revenue gained from selling a product.

Greater action should be taken against the senior individuals responsible

17. Senior management have to be clear that breaching regulations will result in serious consequences for themselves and for their firm's reputation and bottom line. The CPMA should send a clear signal that it will take action against individuals, including greater use of orders prohibiting the individuals from working in the financial services industry.

[42] http://www.which.co.uk/documents/pdf/consumer-rights-directive-allowing-contingent-or-ancillary-charges-to-be-assessed-for-fairness-bis---which---consultation-response-226521.pdf; http://www.publications.parliament.uk/pa/cm201011/cmselect/cmtreasy/memo/banking/m20.htm
[43] http://www.fsa.gov.uk/pubs/final/hfc_bank.pdf
[44] http://www.fsa.gov.uk/pubs/final/alliance_leicester.pdf
[45] http://www.oft.gov.uk/news/press/2007/113-07
[46] http://www.oft.gov.uk/news/press/2003/pn_18-03
[47] http://www.ofwat.gov.uk/regulating/enforcement/prs_pn2108_svtfne020708

Remuneration Systems

18. The CPMA should move from a purely reactive approach to one which seeks to tackle the root causes of consumer detriment. In our view, remuneration systems linked to sales targets create a conflict of interest between the consumer and the firm. They encourage banks to recommend courses of action which result in the sale of a product, rather than that which is most suitable for the customer. They also contribute to mis-selling. For example, advisers at Alliance and Leicester received six times as much bonus for selling a loan with PPI as they did for selling a loan without PPI.[48] The CPMA should prohibit remuneration and commission systems for both frontline staff and senior management which encourage mis-selling.

Effective Redress

19. In the past 10 years we have seen substantial detriment caused to consumers in a number of areas including mortgage endowments and Payment Protection Insurance. The impact of these problems on consumers has been compounded by the slow response of the industry and regulators. Excessively long timescales, poor complaints handling and inadequate redress have become all too common. The CPMA should adopt an effective redress system which improves the incentive for firms to treat customers fairly. Two approaches which should be adopted are:

Past case reviews

20. The CPMA must show greater willingness to utilise the s 404 powers to require firms to actively review past sales of a particular financial product where detriment has occurred. This would be a similar process to a "product recall".

Collective redress

21. The CPMA should introduce an improved method of collective redress which would allow a collective claim to be made on behalf of all those consumers who are adversely affected. This could have benefits for consumers in improving access to redress while reducing the administrative cost for firms and the regulator of dealing with individual cases. We believe that the Courts should have the power to ensure that claims could be done on an opt-out basis.

Conduct Risk

22. The CPMA should preserve the FSA's Conduct risk division which is aimed at the identification of emerging risks before they crystallise and cause major consumer detriment. We also recommend that the CPMA should make greater use of market testing and mystery shopping.

23. In addition, there should be a Committee introduced with members from the CPMA, OFT, FOS to share information about potential risks and the merits of dealing with the issue through a complaints-led approach or by regulatory action by the CPMA. This Committee would gather evidence from consumer and industry groups and set a timetable for investigation. This proposal would enhance the current "wider implications" process. At the same time, we would favour a move towards a more formal process (along the lines of a supercomplaint process) which allows consumer bodies to raise potential issues with the CPMA and for the CPMA to publicly report on action taken.

Product Regulation

24. We believe that the CPMA should embrace the role that product regulation can play in addressing conflicts of interest, disciplining markets and aligning the interests of producers with consumers. In many markets, competition provides an effective force in shaping the products on offer and ensuring they meet consumers' needs. However, effective competition relies on consumers being able to make informed choices, based on an ability to compare competing products with each other. This should cause firms which offer poor value and poor quality products to lose business at the expense of their competitors. However, this is frequently not the case in the financial services sector, where consumers' ability to make informed choices are hindered by a combination of their lack of financial capability, product complexity, incomplete or unclear contracts, the length of time between the purchase of a product and discovering whether it has worked and a lack of transparency in the design and marketing of financial products.

25. Product regulation could be used by the regulator to address three key issues:

- Ensure minimum standards for key products: There are certain products, such as current accounts and protection products, that consumers need access to. We believe the regulator should ensure that any such products meet minimum standards. We would draw a parallel with motor insurance where all products on sale must meet minimum legal requirements, and consumers then have the option to add on additional "bells and whistles".
- Minimise the toxic aspects of products and in some cases prohibiting a particular type of product or specific product (for example single premium PPI): Product regulation can play a valuable role in limiting the harm that certain products can cause.

[48] http://www.fsa.gov.uk/pubs/final/alliance_leicester.pdf

— Ensure the availability of "vanilla" products: Experience has shown that the financial services industry alone will not develop simple, good value for money products which meets consumers' needs. We believe the regulator should pursue the idea that providers and intermediaries should offer simple, straightforwardly priced "vanilla" products alongside their additional product offerings.

Governance and Accountability

26. Further steps need to be taken to ensure that the regulator is subject to greater accountability than is currently the case with the FSA.

27. We welcome the intention to make the CPMA subject to audit by the NAO. The regulator should also be accountable to the Parliamentary Ombudsman. We support the continuation of the Consumer Panel. The Consumer Panel must be properly funded and resourced. It is important to recognise the inherent imbalance in resources between those who lobby on behalf of the industry and those who lobby on behalf of consumers.

28. In addition to increased oversight by the Treasury Committee, we believe it would be beneficial if the regulator made itself more available to scrutiny. This could take the form of a monthly question time where senior figures and board members were required to take questions from key stakeholders.

Board Structure

29. In the past, the fact that 10 of the 12 members of the FSA board had been currently or previously employed by the industry raised the risk that only the prevailing mindset of the industry gained credence in Board deliberations. There was a clear preference to codify existing industry practice instead of asking searching questions about whether markets were working efficiently and in the interests of customers.

30. It is clear that alternative perspectives are needed and the Board of the CPMA needs to be more diverse, with an increase in consumer representation and Board members with experience and knowledge of consumer issues. It is important that all Board members are independent of the industry and should only be allowed to participate in decisions where they are free from conflicts of interest.

31. We would also like to see greater transparency around the agendas, forward plan and minutes of board meetings to provide full information about when the Board is taking key decisions—though we acknowledge that financial stability considerations may occasionally limit the amount of information which can be disclosed in advance. It would also be useful to hold at least one public board meeting a year—where individual board members would take questions from stakeholders.

Regulatory Transparency

32. Proper accountability can only come alongside improved transparency. We believe that regulatory transparency could have a powerful effect towards incentivising firms to improve their practices. It also helps the industry as it ensures that, if scandals do arise, offenders are identified and the entire industry is not tarred with the same brush.

33. The main roadblock to greater regulatory transparency is Section 348 of FSMA that prevents the FSA from disclosing information it receives in the discharge of its regulatory duties, except in certain defined circumstances. In addition to the problems involving its interpretation by the FSA, it also places substantial barriers to organisations making Freedom Of Information (FOI) requests to the regulator. It allows the regulator to reject FOI requests without being subject to a public interest test. Which? has submitted a number of FOI requests to the FSA asking for the names of mortgage lenders which had performed poorly in the FSA's thematic work. We believed that consumers had a right to know which lenders were treating customers unfairly and that this information should also be shared with the Court judges hearing repossession requests from these lenders. The FSA rejected our request and offered a number of excuses including that it would harm the lenders brand and reputation, would undermine firm's willingness to engage in a dialogue with the FSA and to provide the FSA with information and the restrictions imposed on it by Section 348 of FSMA.[49] The FSA has also refused to disclose the instructions which it had given to firms which had been fined for mis-selling PPI, stating that as the instructions it gave to the firms would invariably involve information received from the firm, they would also not be able to disclose it due to Section 348 of FSMA. A culture of secrecy harms accountability and only benefits those firms breaking the rules.

34. Section 348 should be removed and the text of the future legislation should reflect the minimum restrictions on disclosure required by EU directives. We believe this to only consist of a requirement for the FSA not to disclose confidential information it has received from other EU regulators.

[49] For further details pleas see Which? written evidence included in the Treasury Committee's Fifteenth Report of session 2008–09, *Mortgage arrears and access to mortgage finance*, (Ev 63).

35. The actual practice of the CPMA would be influenced by a clear mandate to disclose information where it might help the CPMA achieve its objective of a fair, transparent and competitive market in financial services or where it might influence a consumer's decision to engage in a commercial relationship with a financial services firm.

36. In addition to the legislative changes, we would like to see further transparency in seven key areas.

— *Thematic work*: We believe the regulator should disclose the firm-specific results of the thematic work it undertakes. The current failure to name those firms performing poorly means that consumers are kept in the dark and firms are able to get away with not treating their customers fairly without suffering any practical penalty.

— *Misleading financial promotions*: We would like the regulator to take a similar approach to the Advertising Standards Authority (ASA) and introduce a Financial Promotions Register which shows where the regulator has received complaints and where a firm has been required to withdraw or amend a misleading financial promotion. This would provide a powerful incentive for firms to improve standards, would help draw the attention of consumers who may have responded to the misleading promotion, and could motivate more consumers and consumer groups to report adverts they find misleading.

— *Price data*: We would like the regulator to require firms to provide the relevant price data on their products, and use this data to publish comparison tables. This will make it easier for consumers to shop around to get the best rate and spot when they are getting a bad deal, and for organisations like Which? to warn them about products to avoid.

— *Complaints data*: The FSA has moved to publish complaint numbers for individual firms which receive more than 500 complaints every six months. However, we believe that the FSA should go further and publish all of the complaints statistics it receives from all firms online. As these are already collected by the regulator electronically, there should be no additional costs for individual firms.

— *Own-Initiative-Variation-of-Permission*: This would ensure that in a situation where the FSA has concerns about a firm and varies its permission to undertake specific activities. This could include restrictions such as not allowing the firm to accept new business, but can also include actions such as requiring firms to contact customers who have replied to a misleading financial promotion.

— *Warning and enforcement notices*: The FSA should publish details of the firms which it has referred to enforcement.

— *Redress schemes*: The FSA should publish the names of the firms which are subject to the scheme, list what activity the firms are undertaking, the text of all letters used in customer contact exercises, the criteria the firms are using to calculate redress, the response rates to any customer contact exercise and the amount of redress paid.

The Financial Ombudsman Service

37. The existence of an effective consumer redress system is vital to ensuring confidence in the financial system and to facilitate the smooth running of the industry. Which? as an organisation has redress for consumers as a core principle. We support alternative dispute resolution systems as a cost-effective alternative for both consumers and firms. Which? believes that the FOS is effective at providing a method of dispute resolution which is fair to both consumers and firms. The FOS ensures a level playing field between firms and consumers and provides an effective alternative to the court system. It is important that the reforms to regulation do not downgrade the role of the FOS.

Interaction/Coordination between the CPMA, PRA and FPC

38. It was clear from our discussions with a consumer group from a country that already operates this model that splitting responsibility between different regulators does not remove the conflicts which can exist between different functions, but merely externalises them. There should be coordination arrangements but we do not believe that the PRA should be given primacy over the CPMA. If a firm-specific conduct decision would impact financial stability by leading to a failure of a bank then the PRA has clearly not been undertaking its remit effectively. In the current environment we also do not believe that a decision to prevent the CPMA from taking a firm-specific decision which would lead to the failure of the firm would or should ultimately lead to the continued existence of that firm. If a firm has broken the regulations and/or common law and consumers have suffered financial detriment then it will not be possible for the PRA to extinguish the legal liability of the firm. To permit the PRA to overrule the CPMA also sends a dangerous message to the industry that only firms which are small enough to fail without causing damage to financial stability will be forced to bear the full consequences of mistreating consumers. We believe that the Government should publish some scenarios showing the circumstances which it believes might lead to the PRA overruling the CPMA in a firm-specific conduct decision.

39. There will also need to be a coordinated approach between the CPMA and PRA for breaking up any banks which pose a systemic risk or harm competition. Under the new regime there would be two possible reasons for restructuring or breaking up a bank. For example, the competition authorities may have concerns about the dominant market share of one individual bank in the mortgage market. The prudential regulator could have similar concerns regarding the dominant position of that bank on the basis that it would make it impossible for the bank to fail without causing significant damage to the economy.

40. The CPMA will also need to provide input to the PRA on the preparation of "living wills" to ensure that these cover how customers will be treated and provide sufficient protection for customers' interests.

41. The PRA and CPMA will need to work closely together in making their respective decisions about the granting, amending or withdrawing permissions for particular activities. For example, permission to be active in the mortgage market could include activities which would be of interest to the PRA (mortgage lending) and the CPMA (advising and arranging mortgage contracts).

42. The supply chain for financial services is complex and it is possible for a firm designing a product to have no contact with consumers (by distributing the product through third parties). We would like clarification about where the regulation of the product design phase would be located if the firm was not regulated by the CPMA.

PRUDENTIAL REGULATORY AUTHORITY

Problems with the current approach to prudential regulation

43. Which? is concerned with the current approach to regulation of banks and the legacy of the Government's intervention during the financial crises. These have significant effects on the prospects for competition in retail (and likely SME) banking by creating:

- — distortionary subsidies, direct through state aid bailouts and indirect by reducing funding costs, to the largest market incumbents thereby strengthening their market power; and
- — no effective regime to enable market exit by failing banks (whether due to poor management or dissatisfied customers) while preserving financial stability of the economy as a whole.

44. These concerns relate to the public policy for regulation of banks and the role of UKFI in managing taxpayers' stake in those banks that relied upon state aid to avoid failure. Further reform should also be taken in the overall approach to regulating banks: too often regulators are held accountable for banks' decisions that create instability or put consumers at risk and those same banks remain in business regardless.

Regulation—implicit subsidy

45. Which? established a Commission into the Future of Banking early in 2010, and received evidence from key players amongst banks, regulators and government. Evidence to the Commission made it clear that the banking industry enjoys a significant public subsidy, in the form of tax payers' funds used to protect failing banks from insolvency. Lord Myners noted that "the banking industry, because it's been underwritten implicitly against failure, without paying a premium, has enjoyed a huge subsidy". This was evident in the approach to bank failure during the crises but also marked a long-standing trend, when dealing with risks to financial stability, of preserving the status-quo by state aid or by merger.

46. This subsidy arguably distorts decision making by banks, fostering riskier behaviour than would otherwise be acceptable, while enabling those banks to raise funds more cheaply. For those banks requiring taxpayer support, it has been necessary to support the whole bank, not just the assets and liabilities linked to essential banking activities such as the payment transmission system or securing customers' deposits. Mervyn King noted to the Future of Banking Commission: "Ultimately the heart of the problem does come down in my view to the inherent riskiness of the structure of banking that we've got, and the difficulty of making credible the threat not to bail out the system, which is what is underpinning the implicit subsidy and creating cheap funding for large banks taking risky decisions."

47. It has been argued that the value of this subsidy, which distorts the cost of capital for banks, has increased over the course of the financial crisis as the implicit subsidy became explicit support, and is greater for larger than smaller banks. For example, Andy Haldane of the Bank of England estimates that the subsidy for the biggest five banks in the UK amounted to £50 billion for the period 2007–09, representing about 90% of the total implicit subsidy available to the banking industry. In its submission to the Future of Banking Commission Virgin Money estimated private equity investors demanded a 10–13% higher cost of capital from new entrants than from the largest incumbents: effectively double the cost facing the largest banks.

48. This subsidy results in a significant moral hazard. It fundamentally erodes the ability of small or new entrant banks to become serious challengers to the large, established incumbents. As a result market discipline, the key mechanism of competitive markets, is made ineffectual: good banks are unable to drive out the bad, while big banks remain big. By encouraging high and excessive leverage, the implicit subsidy actually increases the likelihood of taxpayers being forced to step in and support the banking sector. It also encourages banks to intertwine highly leveraged investment and wholesale banking activities with essential retail banking activities and the payments system.

Is it appropriate for the PRA to adopt a "judgement-based" approach to financial regulation and supervision?

49. Whilst we accept the criticism of the previous regulatory approach to prudential regulation, expecting a move to a more judgement-focused approach with regulators exercising judgements about the safety and soundness of firms through greater supervision to lead to greater outcomes poses two particular problems. Firstly, because the increasing trend to put reliance on the regulator's supervision of compliance with international capital adequacy standards, such as those set by the Basel Committee on Banking Supervision, has created perverse incentives for banks to game the rules. Secondly, judgement-based supervisory regulation can all too easily turn into "shadow management" and there is a limit to how effective this approach can be to regulating individual firms. Supervisory regulators will always be outnumbered by market participants who retain an informational advantage.

50. In his evidence to the Future of Banking Commission, Mervyn King cited the example of Citibank, which still faced near collapse during the crisis despite high calibre management and very close supervision by "dozens" of regulators embedded within the firm. He noted that "I cannot believe that any regulator in the world could honestly pretend that they would do better than what happened (at Citibank), and I think we have to recognise that sometimes things happen which are almost impossible to anticipate, hard to calibrate in advance in terms of how much capital you need to put aside, or how much cash you need to bank, in order to be sure that you won't get into trouble . . . Having a system that's robust with respect to that seems to me of fundamental importance, and as I understand it, that is exactly what regulators in other industries supplying utilities would encourage us to do"

51. Which? agrees that the lessons of other regulated industries have not been applied to financial services. In other industries, regulators strive to establish the pre-conditions for effective competition. It has always been recognised that for effective competition to be possible, the regulator has to ensure there are specific arrangements in place which allow firms to fail while ensuring the continuity of essential services. For example, in the Water Industry when Enron acquired Wessex Water, OFWAT imposed conditions including requiring the Board to act as if it was an independent company and prohibited cross-default operations.[50] Their primary objective was not to protect Enron's shareholders, but to ensure that customers would continue to receive an essential service and that the creditors of Enron corporation should have no recourse to the assets of the Water company. The result was that when a combination of fraud and incompetence caused Enron to collapse, the ring-fencing provisions ensured that Wessex Water was able to continue to function and essential services were maintained.

52. The prudential regulator must change its approach from attempting to prevent failure to ensuring banks can fail, but without significant harm to vital banking services or the economy. Stability is not created by preventing failure, but by enabling firms to fail in a controlled way. The PRA would be the guardian of the "living wills" which banks would be required to produce.

53. Ensuring that banks face a realistic prospect of failure would help improve the accuracy of the pricing of equity and debt to individual banks and help ensure that these more accurately reflect the risks of a specific bank. Responsibility for prudence must lie with the banking institution, its management and debt providers and not be delegated to regulators.

54. The PRA would take pre-emptive steps to:

(i) protect ordinary depositors and retail customers;

(ii) ensure the continuity of all essential retail banking services; and

(iii) in the case of any institution that is too big or otherwise too significant to fail, intervene to restructure that institution such that its failure would no longer present a systemic risk.

55. The PRA should have a specific duty to promote competition. This would help support its focus on not preserving the status quo or existing institutions, but creating a market with the realistic prospect of failure. It would also ensure that the PRA does not impose excessive barriers on new entrants, by making them carry higher levels of capital or liquidity than existing banks. It should also have an objective to limit and remove the extent of the implicit subsidy received by the banking sector, which distorts competition and disadvantages new entrants.

56. The PRA should need to "have regard" to the objectives of the CPMA. It will need to work with the CPMA to ensure that "living wills" and the arrangements for the provision of essential banking services offers sufficient protection for customers' interests. The PRA should take responsibility for monitoring and setting down standards for remuneration practices which could work against its objectives for the stable and prudent operation of the firms it regulates.

57. We support the proposal that the PRA will not need to "have regard" to the competitiveness of the UK as a location or the need to promote innovation. This is for similar reasons to those explained in paragraph 14.

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[50] For details of the ring-fencing provisions imposed see OFWAT, The Proposed Acquisition of Wessex Water Limited by YTL Power International Berhad, April 2002.

Governance and Accountability of the PRA

58. The consumer panel established as part of the new regulatory function should also monitor, advise and challenge the PRA through its policy development to ensure that it takes into account the interests of consumers. The PRAs rule-making function should be subject to statutory processes which include consultation with the consumer panel. It is important that the PRA is not subject to excessive restrictions on its disclosure of information. Indeed, an approach which involves the active disclosure of supervisory information to the markets would be preferable. We welcome the fact that the PRA will be subject to audit by the National Audit Office.

Macro-Prudential Regulation

59. We support the introduction of the FPC to address systemic risk and to implement macro-prudential regulation. Consumers and small businesses have been damaged by a move from "feast to famine" in the availability of credit. The purpose of systemic risk regulation should be to oversee liquidity and capital standards at the macro level. It should be concerned with the inter-dependence of banks and their exposure to common economy wide shocks that may affect key sectors such as commercial and domestic property. Its role should be to act counter-cyclically, to smooth the credit cycle and to "take the punch bowl away" when credit growth led asset price bubbles grow unsustainably and threaten to lead to instability. This is not an easy task and the framework should ensure that the FPC has the credibility and expertise to challenge the prevailing consensus and to take appropriate action. We also believe that it would be advantageous for some of the external members of the FPC to have expertise and knowledge of consumer issues.

60. However, we express a note of scepticism about the potential effectiveness of macro-prudential regulation to prevent a financial crisis, not least because of the risks of regulators becoming victims of "flawed intellectual models" and the incentive for banks to find their way round any targets and rules. Increasing the role of macro-prudential regulation also raises questions about the fundamental purpose of banks and bankers. The *raison d'etre* of a banker should be to restrict credit to sectors of the economy (such as commercial property) which become over-valued.

61. Which? do not have the expertise to evaluate the effectiveness of the different macro-prudential tools proposed, so we have concentrated on their potential impact on consumers. This could fall into two different categories.

62. *Loan-to-Value limits for residential mortgages*: When these are changed they will inevitably lead to a number of consumers being stranded with their existing mortgage provider. For example, if a consumer has just taken out a 95% LTV mortgage and the FPC decides to limit the maximum LTV to 90% then that consumer will be unable to move to a different lender (and unless their mortgage is fully portable, to a different house). It is also likely that a reduction in the maximum LTV would lead to house price falls which would further exacerbate the position of that consumer. Unless mortgage contracts are tightly defined, banks will be able to exploit these captive customers by increasing their margins.

63. *Other capital requirement changes*: It is likely that banks will use any changes to capital requirements or risk weights to alter the price paid by existing customers. For example, many terms and conditions will allow banks to vary the contract in response to decisions by "regulators". How any changes to price will be applied and the discretion which firms may use to apply these changes are likely to be relatively opaque to consumers (unlike clear contractual terms which could exist for changes in interest rates to follow a clearly defined and transparent reference rate such as a product where the interest rate tracks the Bank of England base rate). We have concerns that firms may seek to apply these changes unfairly or to exercise unfair contract terms. There will also be conflicting messages for consumers if the MPC is lowering the base rate at the same time as the FPC is increasing capital requirements for particular types of consumer lending. The exact terms of contracts are likely to be issues for the CPMA, but how firms may exercise their discretion may also have systemic impacts if, for example, all banks are confident that they will be able to react to any changes in capital requirements by immediately passing on the costs to existing customers by increasing rates.

Annex 1

SHORTCOMINGS OF COMPETITION REGULATION UNDER THE FINANCIAL SERVICES AND MARKETS ACT 2000

Competition regulation under FSMA is, at best, wholly inadequate and, at worst, detrimental to the competitive landscape in the financial sector. The ambit of the FSA is currently centred on the maintenance of market confidence, raising public awareness, the protection of consumers and the reduction of financial crime. While the FSA also has, among its primary duties set out in FSMA, the requirement to have regard to "the desirability of facilitating competition between those who are subject to any form of regulation by the Authority", FSMA does not give the FSA concurrent competition powers with the OFT, which would allow it to either (a) directly apply competition law or (b) refer markets to the Competition Commission, as is the case for the regulators of other industries. It is clear that the FSA's approach is to avoid putting up further barriers against competition, rather than proactively seeking to improve the degree of effective competition in the industry. Indeed in some sectors of the market such as with-profits funds, the FSA

actually applies different rules to existing firms, compared to any recent or potential new entrants.[51] The inadequate focus on appreciating the benefits which competition can bring can also lead to codifying existing industry practice instead of driving improvements for consumers. For example, instead of improving the ability of customers to switch cash ISAs, the FSA simply required that the banks provide a "prompt and efficient service" and referenced existing industry guidance.

Indeed, in its composition, FSMA gives the impression to market participants in the financial sector that they have a degree of immunity from UK competition law since agreements or conduct by a dominant firm, which would usually breach competition rules, are not subject to enforcement if "encouraged by any of the Authority's regulating provisions". This provision of FSMA effectively puts the maintenance of effective competitive markets in the financial sector subordinate to FSA regulation, albeit that European competition law can be applied regardless of this exclusion. Competition law considerations were further disregarded when, in the course of the financial crises, the public interest test for merger regulations was widened to include "financial stability", allowing the Secretary of State to rule in the case of bank mergers, rather than the OFT or the Competition Commission.

The OFT has some specific responsibilities under FSMA 2000, necessary to compensate for the lack of competition objectives in the FSA's mandate. Section 160 of FSMA requires the OFT to keep the regulating provisions and practices of the FSA under review, and report any significantly adverse effects to the Competition Commission: a process known as "competition scrutiny". There have been no occasions under current legislation where the OFT has exercised this power. So, while the OFT may be suited to "repairing" or conducting investigations into previous competitive markets, it is not up to the proactive task of regulating vigilantly to make markets in the financial sector more competitive.

This special treatment of the financial services industry sends a clear message to both the regulator and industry that the "normal" rules of competition do not apply.

Annex 2

PAYMENT PROTECTION INSURANCE MIS-SELLING

The mis-selling of Payment Protection Insurance (PPI) is an example of how a poorly functioning market, and a failure to intervene at an early stage to fix it, can disadvantage customers. PPI is designed to cover your debt repayments if you can't work—for example, you become ill or have an accident, or you are made redundant. It is sold alongside loans, mortgages, credit cards and store cards. In the past decade, PPI has been subject to widespread mis-selling, and this has resulted in millions of consumers holding expensive insurance they would never be able to claim on.

PPI offers a clear example of a poorly functioning competitive market, as the sale of this product involved:

(a) lack of adequate disclosure to customers about the product they were buying, and the resulting asymmetry of information between provider and customer;

(b) inappropriate default settings, where it was left to the customer to opt out of buying the product when purchasing another financial product;

(c) the existence of inappropriate commission structures, which focused the rewards for salespeople on selling PPI, rather than serving the customer well; and

(d) accounting practices which allowed firms to book an upfront profit from selling single premium PPI policies.

The resolution of the problems in PPI has taken a long time. Which? first raised concerns about the mis-selling of PPI in 2002. An initial "supercomplaint" by Citizens Advice was made in September 2005 to the Office of Fair Trading (OFT). The OFT followed up this complaint with a market study, launched in April 2006, which subsequently led to a market investigation reference, in February 2007, to the Competition Commission (CC). In 2009, the CC ruled it would be banning the sale of PPI alongside credit products, stipulating that lenders and credit card providers would have to wait at least seven days before approaching a customer about the sale of PPI. Following an unsuccessful appeal by the banking industry, the CC provisionally confirmed this ruling in May 2010, and published its final remedies in July 2010, almost five years after the issue was first raised by Citizens Advice.

In 2005, the FSA conducted a series of mystery shopping and supervision exercises and in September 2005 called on firms to take "urgent action" to ensure that their selling practices for PPI were compliant with regulatory requirements. However, firms did not respond to the FSA's regulatory action and continued to mis-sell PPI. The FSA responded by conducting further rounds of mystery shopping and eventually conducting enforcement action and levying fines. However, these fines were such a low proportion of the revenue gained by banks from selling PPI they failed to have the desired effect. Despite, widespread mis-selling, no senior management in financial services organisations had enforcement action taken against them. The only senior management individual to have enforcement action taken against them for mis-selling unsecured loan PPI was the chief executive of a furniture retailer (Land of Leather).[52] Eventually, at the start of 2009, the FSA eventually secured "agreement" from the industry to stop selling single premium PPI

[51] COBS 20 February 20.
[52] http://www.fsa.gov.uk/pages/Library/Communication/PR/2008/039.shtml

on personal loans. The problems for consumers have been compounded by the failure of firms to deal with complaints fairly. Consumers have faced unreasonable delays and the Financial Ombudsman is upholding over 90% of complaints received about some firms. This indicates that many firms are dismissing valid complaints and hoping that consumers do not go to the Ombudsman. The FSA is currently consulting on an approach to require firms to review previously rejected complaints. The FSA announced in September 2009 that several banking groups had agreed to undertake a voluntary review. However, almost a year later, Lloyds TSB disclosed that it had yet to start its review of past sales.[53]

Written evidence submitted by the Financial Reporting Council

Thank you for seeking the FRC's views on the Government's proposal to merge the UK Listing Authority with the FRC. The FRC is the UK's independent regulator responsible for promoting high quality corporate governance and reporting to foster investment. The FRC and UKLA have much in common in terms of their principal objectives. Both seek to promote trust in the capital markets to encourage investment, whether through risk capital or other securities.

If the Government decides to pursue this proposal, the FRC believes it could make it work and that there would be important synergies between the FRC's operating boards and the UKLA. For example:

— the FRC publishes the UK Corporate Governance Code while the UKLA monitors the quality of governance and financial information of companies seeking to raise capital in the market;

— the Accounting Standards Board (ASB) provides guidance on narrative reporting in annual reports whilst the UKLA provides guidance on narrative reporting in listing documents;

— the Financial Reporting Review Panel (FRRP) addresses narrative reporting in annual reports and the UKLA addresses narrative reporting in listing documents; and

— the Auditing Practices Board (APB) provides guidance on the role of auditors in relation to listing documents which are then relied upon by the UKLA in assessing suitability for listing.

Success would, however, require co-operation between the CPMA, the Bank of England and the FRC/UKLA in two areas: on joint access to market monitoring and on a co-ordinated approach to representing the UK in EU discussions. We believe such co-operation is achievable, and will in any event be necessary between the Bank of England and the CPMA.

However, whilst the proposal can be made to work, we believe a much better option would be for the Government to create a UK securities regulator focussed on the wholesale markets, and to separate this from the protection of consumers throughout the whole range of financial services, which is an essentially different function. A new Securities Regulator would bring together the functions of the FRC and much of the Markets Division of the FSA. It would secure the synergies of an FRC/UKLA merger without the same boundary problems. The market monitoring issues would be reduced. The EU problem would be largely eliminated as the new body would closely match ESMA.

The FRC would oppose the merger of its functions with the CPMA given that the proposed structure of the CPMA combines consumer protection and markets responsibilities. The FRC is concerned primarily with the governance of, and reporting by, listed companies to shareholders. In the CPMA, consumer interests must dominate the agenda. A combination of these would create the same confusion of purpose as existed in the FSA before the crisis, and replicate one of the most serious regulatory weaknesses the split-up was supposed to address. The FRC strongly believes that this would be to the detriment of its work and indeed of other market-related activity.

14 October 2010

Supplementary written evidence submitted by the Institute of Financial Planning

Further to our giving evidence to the committee on 19 October we are responding as requested with an outline of how we think regulation can work more effectively in the area around the provision of professional financial planning and advice to consumers.

The original objectives of the RDR set out in the FSA's Feedback Paper1 of November 2008 were to:

1. improve the clarity with which firms describe their services so that customers understand the services they are being offered;
2. introduce new, higher professional standards for advisers;
3. address bias in adviser recommendations by reforming the system of commissions based remuneration; and
4. ensure that where independent advice is offered it is truly independent.

[53] http://www.lloydsbankinggroup.com/media/pdfs/investors/2010/2010_LBG_Interim_Results.pdf, page 122

We believe that points 2 & 3 are satisfied by the current proposals however we have concerns around points 1 & 4 which we expand on below.

According to cp 09/18, the RDR was set up with the following broad objectives which we completely support:

- an industry that engages with consumers in a way that delivers more clarity for them on products and services;
- a market which allows more consumers to have their needs and wants addressed;
- remuneration arrangements that allow competitive forces to work in favour of consumers;
- standards of professionalism that inspire consumer confidence and build trust;
- an industry where firms are sufficiently viable to deliver on their longer-term commitments and where they treat their customers fairly; and
- a regulatory framework that can support delivery of all of these aspirations and which does not inhibit future innovation where this benefits consumers.

Again looking at these broad objectives we fear that the first two and the last of these points are not being best served by the proposals. Regarding the last point, we believe that the growing regulatory burden on firms is stifling innovation. It is time that proposals were aligned completely with consumer needs in an understandable way rather than continuing to protect vested interests.

We believe the first paragraph of our response to cp 09/18 continues to set out our position clearly:

> *"The IFP believes that this Consultative Paper makes good progress towards achieving the original objectives of the Retail Distribution Review. Professional standards will be improved, commission bias will disappear and the consumer will potentially be better served. We remain concerned that this important initiative is still predominantly focussed on 'products' and distribution. It is not positioned to be concerned with 'advice' which not only adds value for consumers but will ultimately be the reason why consumers take action."*

Building on our evidence given at the hearing on 19 October, we continue to have concerns over the following key areas:

- Clarity regarding firms describing their services.
- Industry vested interests overriding the interests of consumers.
- A focus on products rather than process.
- A lack of emphasis on the need to educate and engage the public.

In our original responses to the RDR we suggested that the fiduciary responsibility of the planner is far more important as evidence of "independence" rather than just a focus on which products they are selling. The IFP would prefer to see the removal of misleading adjectives used to describe the service provided, and more straightforward and consistent descriptions to be used aligned with the key points below.

Clarity and honesty are the critical factors for disclosure, so as to ensure that consumers can make informed choices as to the status of the firms they are happy to engage with. There are a small number of key variables that consumers need to be aware of when selecting a source of "advice" and these are (in broad order of importance) as follows.

1. Service Offer—One Off Sale v Advice and Ongoing Support v Financial Planning

(a) A one off sale would be a single interaction to resolve an issue that does not involve any follow up. This would be paid for by a single one off fee/commission and no further contact would be required and therefore no further fee/commission payment would be made.

(b) Advice and ongoing support would be where a client has a need for advice on setting up a service like a trust, or setting up a product like a personal pension that may require ongoing review, and therefore may have ongoing contact and further fees/commissions payable.

(c) Financial Planning would be a full lifetime holistic service involving building recommendations (including products if required) to fulfil a clients life goals following the six steps of financial planning…

(i) Establish and define the client-planner relationship. The Financial Planner should clearly explain and document the services that he or she will provide to the client and define both his/her and the client's responsibilities during the Financial Planning engagement. The Financial Planner should explain fully how he or she will be paid and by whom. Client and planner should agree on how long the professional relationship should last and on how decisions will be made.

(ii) Gather client data, including goals. The Financial Planner should ask for information about the client/s financial situation. Client/s and planner should mutually define the client's personal and financial goals, understand the time frame for results and discuss, if relevant, how the client/s feel about risk. The Financial Planner should gather all the necessary documents before giving advice as needed.

(iii) Analyse and evaluate financial status. The Financial Planner should analyse the client/s information to assess their current situation and determine what they must do to meet their goals. Depending on what services client/s have asked for, this could include analysing assets, liabilities and cash flow, current insurance coverage, investments or tax strategies.

(iv) Develop and present Financial Planning recommendations and/or alternatives. The Financial Planner should offer Financial Planning recommendations that address their client/s' goals, based on the information you provide. The planner should go over the recommendations with their client/s to help them understand so that they can make informed decisions. The planner should also listen to client/s' concerns and revise the recommendations as appropriate.

(v) Implement the Financial Planning recommendations. The client/s and the Financial Planner should agree on how the recommendations will be carried out. The planner may carry out the recommendations or serve as the client/s' coach, coordinating the process with them and other professionals such as lawyers, accountants or stockbrokers.

(vi) Monitor the Financial Planning recommendations. The client/s and the Financial Planner should agree on who will monitor progress towards the client/s' goals. If the planner is in charge of the process, he or she should report to the client periodically to review their situation and adjust the recommendations, if needed, as their lives change.

2. Independent or Restricted

(a) We would argue Independent means that the person/entity giving advice free of any commercial agreement restricting their choice of product or provider.

(b) Restricted advice has taken many forms and in the past, many firms who have chosen for commercial reasons to restrict their offering to consumers have attempted to disguise that restriction in order to maximise their commercial gain. Whilst firms must be free to make such commercial decisions, this must be disclosed in a open and honest way, so consumers can consider what type of firm to form a relationship with. This disclosure must be written, and must be given early on in the relationship. The regulator should be especially aware of the tendency of these firms to use "weasel words" (adjectives) to hide their true status, and these should be specifically forbidden. Examples of these are: "Best of Breed" and any implication of "whole of market"—say in fund choice through a single product provider "bond" wrapper, for example.

(c) All advisers should be able to offer a Financial Planning service irrespective of how they are accessing products. We should at all times start with all advisers being able to act in the client's interest and establishing their needs before moving to the world of product and suitability.

3. Payment by Fee or Commission

(a) Product sales would generate a commission which is payable on the taking up of a product however this should be at a clearly disclosed level prior to any product being selected and the client should have a fee option provided.

(b) Advice and Planning should be by fees agreed by the customer up front but as per the current proposals some/all of this could be taken in the form of commission. All "costs" should be disclosed up front so that consumers can clearly compare offers.

So the hierarchy (in ascending order) could broadly be:

(A) Restricted Sales

(B) Independent Sales

(C) Restricted Adviser

(D) Independent Adviser

(E) Restricted Planner

(F) Independent Planner

Once the variables have been agreed we would suggest consumer research take place to confirm how each different offering can be described effectively in way that consumers recognise and understand.

Many of our members are IFAs and we clearly believe that truly independent advice is better than restricted; however we have a range of consumer research from around the globe that clearly shows consumers value the "planning" relationship most in terms of bringing them peace of mind about their future.

Much has been talked about simplified advice and simple products to better serve the mass market. This is an area that is completely unresolved. There is an expectation that simple products will excite the consumer and encourage them to take action. Products alone do not give people the context that everybody, irrespective of their wealth position, wishes to feel personally engaged with. Martin Lewis for example has built up an extremely loyal following from people who trust his integrity and believe that he is acting in their interests. Quite rightly the consumer reacts with sceptisism when a bank or other similar organisation suggests that they have created a product which is in the customer's best interests.

If we are ever to establish a means for the mass market to access Financial Planning, the profession needs to start with the consumer to properly understand their needs and then overlay the process to make it a compelling proposition for them to consider. Much around Financial Planning can be done by the individual if they are engaged and motivated to get involved. Most are too frightened or worried that they will end up with something that they do not need or can't afford or that the government will eventually help them out.

As for education there is also a huge amount to be done here. Ensuring again that the material presented is interesting and understandable is crucial. It must also be delivered by people who understand the subject itself and it must be relevant for the audience. Regulation has indeed stifled plain English and an ability to properly communicate with people at a level they understand and in a way which encourages them to take action. As stated earlier it has also stifled innovation in the right areas.

Financial Services is generally poor at communicating with its consumers. A lot could be learned from the work done by the retail industry with their customers, for us to better understand consumers' requirements and to focus on areas such as behavioural finance to engage more with people in an attempt to build confidence and trust in the process itself.

The IFP are members of the Financial Planning Standards Board Ltd. (FPSB) which is a non profit association that manages, develops and operates certification, education and related programs for financial planning organizations so that they may benefit the global community by establishing, upholding and promoting worldwide professional standards in financial planning. FPSB works in conjunction with its members to develop and promote rigorous international competency, ethics and practice standards for CFP professionals in member territories to ensure that consumers looking for qualified financial planners understand and value CFP certification. The FPSB produced document (enclosed) titled "Regulation and Oversight of the Financial Planning Profession" explains why use of the titles such as Financial Planner should be protected by law. Also enclosed is the FPSB document "The state of the Financial Planning Profession in the 'Post-Trust' Era" which looks into the future of Financial Planning globally.

The current regulatory focus on products in extremely unhelpful in educating the industry and consumers about the need for sound financial planning. As described in Martin Lewis' evidence to the committee, for many consumers the absolutely best piece of advice for them is to reduce their borrowing before undertaking any saving. In many cases consumers should be encouraged to take such non product related actions before giving consideration to using financial products, another example being the setting up of wills. However where a company/individual adviser is remunerated by, or has targets related to, product sales it will be unsurprising that they conclude that a product is the answer and it is vitally important that some process of fact finding is completed to assess properly whether clients should be taking out a product. It is vital that consumers are better educated and we would wholeheartedly agree again with Mr Lewis that the lack of financial literacy as a compulsory element on the national curriculum is a failure on behalf of government. It may be worth looking at compulsory education for consumers before undertaking major financial decisions as has been brought in elsewhere in the world.

One further point that I would like to cover is the claim that consumers will not pay fees. We support the concept of customer agreed remuneration as described within the RDR, where the customer understands the cost of the service/advice up front but where some/all of this may be paid by commission. Fees may be described in a number of ways ie not only £cost per hour, but what is essential is that these fees don't vary dependent on the product or product provider selected, and that the consumer is fully aware of them up front. We again have a weight of evidence from around the globe to show that where, as in the case of Financial Planning, the customer understands and values the proposition, that they will happily pay fees. We would argue that many of the issues some existing advisers are raising with fees and the unwillingness of consumers to pay them are a factor of a product based proposition. A proposition that is focused on products will be difficult to explain to a consumer in terms of fees, however, a proposition based on the six steps outlined above can easily be explained and broken down to reasonable fees for each stage. Looking at this from a consumer's point of view, which of these makes the most sense?

(I) "I will take a full factfind on your personal circumstances, I will review all of your existing products, I will recommend the most appropriate products and provider of each product from across the market place but you don't have to pay me anything unless you buy the product I recommend and even then you don't have to pay me anything as I can be paid a commission by the product provider. I'll then continue to get paid by the product provider as long as I am your adviser whether you need or receive any advice from me in the future."

Or

(II) "I will take you through the six steps of Financial Planning and will tell you up front how much each is going to cost. I will work with you to really understand your future goals, gather all of your financial information and recommend a plan of action that has the best chance of achieving your goals, and this may or may not involve products, and will agree with you annual fees for reporting and meeting with you to keep you on track with your goals."

Finally, regarding concerns expressed by many IFAs and linked parties over the impact the RDR will have on access to independent financial advice, we do not support the view that the requirements to pass an appropriate level 4 exam by end of 2012 will lead to consumer detriment. The industry has had an issue with an ageing population of advisers for some time now and it's very interesting that the vast majority of

examples given of those intending to leave the industry are in their late 50s or in their 60s. They were going to leave anyway, and it remains our opinion that the level 4 is the minimum that should be required to practice and that the timescales given to pass the qualification should be sufficient for anyone who is committed to proving that they possess the appropriate levels of knowledge and skills required, especially those who have many years of experience in the industry.

The issue of an ageing population of advisers is something the industry needs to address and only by increasing the professionalism and status of the profession will we attract new entrants and/or increase the numbers of graduates taking financial services related degrees. While there may be a short term blip (one we were going to have anyway given industry demographics) this will be resolved in the medium to long term only by increasing the professionalism of the industry which ultimately should increase the public's trust and confidence in the service that is provided to help them.

We welcome any further opportunity to expand on the points above in order to find a way to resolve the major issues facing UK consumers' financial future.

Enclosures:[54]

FPSB: "The state of the Financial Planning Profession in the 'Post-Trust' Era"

FPSB: "Regulation and Oversight of the Financial Planning Profession"

Supplementary written evidence submitted by APCIMS

Having represented APCIMS at the 19 October witness session as a member of its Board, I am writing to inform you that I have taken up the role of APCIMS Chief Executive with immediate effect.

I would also like to take this opportunity to provide you and the other members of the Committee with material from APCIMS which seeks to outline our members' concerns about both the current system of regulation as operated by the FSA and, more particularly, the RDR initiative.

The attachments to this letter have not been drafted specifically for the Treasury Committee—rather, they have been taken from various APCIMS working documents and help to show the concerns which we have been raising over a considerable time on these important issues. Briefly:

(1) In November 2009, APCIMS submitted a paper to Mark Hoban MP in response to the Conservative Party Policy White Paper titled "From Crisis to confidence: plan for sound banking". In our paper, we provided a detailed outline of how the consumer-facing regulatory body (which we titled the Retail Regulation Agency as opposed to then-proposed Consumer Protection Agency) could best be structured with a view to addressing the most persistent regulatory problem faced by our members, namely the FSA's undifferentiated, "one size fits all" approach to regulation. As you know, APCIMS firms operate in investment markets on behalf of individual retail investors and are, consequently, subject not only to "retail" regulation but also to "market" regulation. As a result of APCIMS firms straddling this divide, their business is impacted on both sides by regulation that is drafted primarily with other market sectors in mind—for example, (a) as CRD investment firms, APCIMS members are subject to prudential requirements that are predicated almost entirely on the business of banks and major principal trading houses and (b) as advisers and managers to reasonably sophisticated retail investors with wide-ranging investment portfolios, APCIMS members are subject to product regulation that is predicated almost entirely on the mass market activities of firms whose whole business is based on selling such products.

(2) In April 2010, APCIMS produced the attached briefing paper outlining members' major RDR concerns ahead of its Board meeting with Sheila Nicoll, FSA Director of Conduct Policy. While all of these issues have been repeatedly drawn to the FSA's attention throughout the life of the RDR project (via meetings, correspondence and formal responses to consultation), the FSA has completely failed to grasp either the inappropriateness of regulation based on product sales for firms which offer relationship-based services to clients across a wide range of different investment types or the immense practical difficulty which implementation of these requirements poses for our firms.

(3) In October 2009, APCIMS wrote to Hector Sants outlining its considerable concerns about the legitimacy of the cost-benefit analysis underlying the FSA's RDR proposals. APCIMS view was (and is) that the deficiencies of the CBA presented in FSA CP09/18 were so significant as to indicate that the FSA had failed to meet its obligations under FSMA section 155. Although the FSA rejected our criticisms, it did subsequently undertake further CBA work (about which we also had concerns) which resulted in massively increased costs with only very vague indications of likely benefits.

(4) This letter was drafted for submission to HM Treasury following a meeting with our Board and Sheila Nicoll from FSA on 21 May. It was decided that this would be covered at some future point

[54] Not printed.

with Mark Hoban. Given we are copying it to your Committee now, we have decided to pass a copy to Jonathan Taylor at the Treasury and will be following up also with Jonathan on the issue. The letter outlines the major competitive disadvantage that APCIMS members are put to as a result of the way in which the RDR's independent/restricted divide is structured. Traditionally, APCIMS firms have offered services in relation to market-orientated, portfolio investments, not in respect of long-term savings products such as pensions and life policies. The FSA's decision that independence requires a firm to be able to advise on all types of products from investment trusts to pensions means that the bulk of APCIMS members who currently fulfil the conditions for providing independent advice will in future not meet those conditions, regardless of the fact that they have not changed the way in which they do business.

I hope that these papers are of assistance to you and your colleagues in completing your inquiry on financial regulatory reform. APCIMS believes that the reform exercise offers a major opportunity for improving the UK structure of financial regulation but that the potential benefits will only be realised if sufficient attention is given to ensuring that regulation differentiates appropriately between different market sectors and types of firms and that regulatory bodies and their staff truly understand, and apply regulation on the basis of, such differences.

Finally, as per discussions at 19 October Committee witness session, APCIMS is working to put together some outline figures for the costs which individual firms face as a result of regulation. I hope to get these to you in the next week or so and understand that 15 November is our final deadline for submission.

2 November 2010

Attachment 1

EXTRACT FROM APCIMS SUBMISSION (NOVEMBER 2009) IN RESPONSE TO: CONSERVATIVE PARTY POLICY WHITE PAPER: FROM CRISIS TO CONFIDENCE: PLAN FOR SOUND BANKING

NOTE: In response to the White Paper proposal for a Consumer Protection Agency and taking account of the FSA failings commonly identified by firms in its membership, APCIMS suggested a Retail Regulation Agency that should be structured/operated as outlined below.

Diagram 2: Structure of Retail Regulation

While it makes sense for all financial activity which involves the provision of investment and savings services to private individuals to be regulated by a single body, it is vital that the very significant differences between the different types of firms operating in the retail space are recognised and reflected in (a) appropriately targeted and nuanced organisational arrangements and (b) regulatory personnel who have in-depth knowledge, experience and understanding of the specific sector in which they are working. This is why we believe that the bulk of the RRA's policy, supervision and enforcement activities should be undertaken in a risk-based fashion via a number of sector-specific divisions, not on a "one size fits all" centralised basis as they are now by the FSA.

(8) As regards the core operations of the RRA:

- we agree that the RRA's governing body should include enhanced levels of consumer representation—the creation of balanced and practicable strategy requires input from both consumer and industry perspectives;
- we believe that further representation mechanisms will be needed below Board level in the form of wide-ranging standing groups. Although these could operate along the same lines as the current Financial Services Practitioner and Consumer Panels, the RRA could also choose to use these groups to gain valuable input from other entities which are active in, and whose activities have an impact upon, the retail financial services environment—eg lawyers, accountants, auditors, data providers, providers of research and performance measurement services, financial journalists; and
- we believe that centralised policy formation should be limited to those areas which are genuinely common across all firms regulated by the RRA—referring to the current FSA Handbook, we would envisage high-level organisational requirements being covered in this way (eg general principles, senior management arrangements, threshold conditions for authorisation) while detailed requirements with specific bearing on firms' business activities would be set by reference to the risks inherent in such activities by policy staff within the sector-specific divisions.

(9) As regards the RRA's sector-specific divisions, although the definition of such sectors can never be an exact science and although certain broadly-based businesses will inevitably straddle the divides, we believe that the categorisation we propose is a reasonable reflection of both:

- the major retail business groupings currently in existence, namely (i) banking and deposit taking; (ii) product-based business, from both a creation/provision and a sales/advice perspective; and (iii) non-product investment advice/management. While product business is

structured across two divisions to reflect the significant differences in scale and risk between manufacturers and distributors, there will inevitably be close links between the two, with manufacturers operating their own distribution teams, using platforms to make their products more generally available and providing facilities aimed at assisting advisers who distribute their products. The fund management arms of product companies—managing large pots of pension, insurance and investment monies and not involved in either the creation or distribution of products—are more likely to fall within the institutional ambit of the MRA; and

— the way in which detailed regulatory requirements currently apply, eg for example, although APCIMS firms and IFAs both advise private individuals, the former, acting as intermediaries in respect of market-traded investments, are subject to the capital maintenance, systems and controls and risk management provisions of the Capital Requirements Directive while, the latter, acting as distributors of products manufactured by third parties, are not.

(10) Pursuing a thorough-going sector-specific approach as outlined in the bullets below, the RRA will have the opportunity to ensure that staff responsible for policy formation, supervision and enforcement in relation to particular types of firm develop an in-depth knowledge and understanding of those businesses and that this core of expertise drives the development of appropriate, risk-based regulation. Sir James Sassoon's report refers to industry concerns about "the level of remuneration, expertise and market experience of FSA supervisory staff"—this is a constant theme amongst APCIMS firms, whose experience of FSA regulation has frequently led them to question whether the organisation has any understanding of their business and how it differs from that of product advisers. While it is clear that no structural arrangement can guarantee "perfect" regulation, we believe that the approach suggested could have a number of significant advantages, including:

— career progression for regulatory staff relying not on moving from one department to another picking up wide-ranging but superficial knowledge but instead on individuals becoming experts in their fields, capable of serious analysis of specific business models, of forming reasoned judgements on the basis of the evidence available and of identifying both potential failings and the best means of addressing them;

— enhancing the overall credibility of the regulator amongst authorised firms, giving them confidence that, in discussing issues with regulatory staff, they are dealing with individuals who understand their business and who will engage with them in a well-informed, proportionate and constructive way; and

— defusing the adversarial flavour that often characterises the relationship between regulator and regulated. While a regulator's role requires it to be alert to failings and cautious about accepting information at face value, a regulatory approach based on a fundamental distrust of the industry is not healthy—as well as causing firms to react defensively and to have increasing recourse to their lawyers, it checks the possibility of constructive dialogue and makes it less rather than more likely that any difficulties will be speedily and effectively resolved.

More specifically, we propose that each sector-specific division should:

— have its own arrangements for securing input from practitioners, consumers and other stakeholders which, by maintaining a focus on the business area in question, complement rather than duplicate those in place at a higher organisational level. In the past, we have queried how FSA consumer research can be relevant to the regulation of our sector on the basis that it is almost always targets mass-market consumers with relatively small sums to invest/save rather than the more financially sophisticated and affluent clients of APCIMS firms—regulation predicated on consumers who have £500 per month to save does not make sense for firms advising clients who have sizeable investment portfolios;

— have its own arrangements for staff training and development—in keeping with the raising of professional standards which the FSA intends to apply via the Retail Distribution Review, we believe that all front-line regulatory staff should be expected to pass the same qualifications as individuals in the firms they regulate and should be subject to the same standards in respect of continuous professional development. The Sassoon Report suggests that financial institutions should be required to participate in secondment programmes for regulatory staff—we believe that compulsion is unnecessary and that many firms would be keen to assist the RRA in developing the expertise of its staff. A number of our member firms have already assisted the FSA with secondments while others have volunteered senior staff to provide training sessions for supervisors;

— have its own policy teams which develop policy not only on the basis of external influences (eg European legislation, changes to market structure) but with an in-depth understanding of the appropriateness of such policies for the sector they oversee. Our sector's experience of the way in which the FSA develops and implements policy has not been a happy one, largely because

the FSA's "one size fits all" approach is driven by extremes (eg catering for the highest risk activities or for the biggest populations of advisers). A few examples might help to illustrate this point:

- in implementing the Capital Requirements Directive, the FSA focussed entirely on the banking sector, failing to appreciate (a) that the nature and scale of the risks assumed by investment businesses (particularly those dealing with retail investors) were different or (b) that standards developed with the major banks in mind were both disproportionate to the activities of retail stockbrokers and impossible for them to translate into terms that made sense for their businesses;
- in operating its Treating Customers Fairly initiative, the FSA's industry benchmarks were developed around the concept of the product life-cycle while its output in terms of policy papers, guidance to firms and case studies was focussed almost exclusively on those areas of the product market where consumers were known to have received poor treatment (eg mortgage endowments, with-profits bonds, personal insurance). In spite of sustained effort on our part, the FSA completely failed to grasp how problematic it was for investment firms to apply regulation based on the one-off purchase of investment products to business predicated on the long-term provision of investment services; and
- in undertaking the RDR, the FSA has again focussed almost entirely on curing the ills which have plagued the market for life, pension, insurance and savings products (eg product bias, provider bias, lack of clarity about costs) but has, at the same time, been unable to articulate how its evolving standards might impact the activities of investment firms. While FSA policy has veered from one extreme to another during the project's development (eg from investment firms being fairly much exempt from the new standards to their being very significantly impacted by them), the FSA's ability to explain the basis for applying revised standards to investment firms has been uniformly poor.

- have its own supervision and enforcement teams whose staff have a thorough understanding of the business models of the firms they supervise and who are able to apply regulation in a proportionate and risk-based way, demonstrating in-depth knowledge, practical expertise and judgement. At present, the concerns most commonly voiced by APCIMS firms about the FSA's supervisory work are:
  - that many of the FSA's supervisory staff do not appear to have adequate knowledge or understanding of their business (ie the services involved, the types of clients acted for, the structure of business) and are, consequently, unable to address regulatory issues in the right context; and
  - that too many junior supervisors, inadequately trained and under-prepared, are entrusted with tasks that they are simply not competent to fill, working their way through lists of pre-prepared questions which have quite clearly not been tailored to reflect the business activities and circumstances of the firm and which the supervisors themselves do not understand; and
  - that supervisory teams change so frequently that there is no continuity or consistency of approach in the way a firm is regulated—this leads to huge duplications of effort (eg firms having to provide the same basic information about their businesses over and over again), to firms being unable to maintain routine dialogue with the regulator and to comments along the lines of "After 18 months, Supervisor X was finally beginning to understand how this firm works but now he's been moved/left the FSA and we have a new supervisor whose background is in insurance/pensions.".

Attachment 2

MAJOR RDR ISSUES—BRIEFING PAPER FOR APCIMS BOARD

Headlines

The bullets below outline APCIMS' major ongoing concerns about RDR policy as presented in PS10/6 with more detailed background given in the subsequent pages. This paper does not touch on the professionalism strand of the RDR on the basis that the comment period for CP09/31 has only recently closed and that final outcomes in this area are not yet known.

- The final rules presented in PS10/6 demonstrate the FSA's failure to deliver on the reassurances it gave APCIMS during the early stage of the RDR project that the business models of private client investment management and stockbroking firms would be taken into account in its policy formation. As a result, the resources which APCIMS and its member firms have put into engaging with the RDR initiative have been rendered null and void by the FSA's seeming inability to understand the nature of the business undertaken by APCIMS firms and to apply appropriate regulation to them.

— In determining the range of "retail investment products" to which the RDR applies, the FSA has (a) failed to take account of the different purposes for and ways in which investments may be purchased; (b) failed to provide sufficient clarity about exactly which instruments are captured by the definition; and (c) sought to apply UK-specific regulatory requirements to the PRIPs concept which is still being fleshed out by the European Commission.

— By requiring firms who wish to give "independent advice" to advise on all types of "retail investment product", the FSA is effectively forcing firms in the APCIMS community (whose business has historically been untainted by the ills that the RDR aimed to address) to either significantly re-engineer their business models or to re-designate as "restricted advice" services which meet the current criteria for independent, "whole of market" advice.

— Because the new requirements for disclosure of a firm's advisory status relate solely to retail investment products and require no indication of a firm's wider advisory service offering, APCIMS firms unable to advise on the full range of retail investment products will be at a significant disadvantage to independent product adviser firms notwithstanding that the latter will generally be unable to advise on other investments such as stocks, shares, bonds and derivatives. Furthermore, the requirement for oral disclosure of restricted advice status not only underlines the unfair presentational advantage which the RDR gives IFAs over APCIMS firms but also shows, in the drafting of the Handbook's sample disclosures, the FSA's failure to understand the nature of the advice which APCIMS firms provide in respect of certain types of investment product.

— Notwithstanding early recognition from FSA policy staff that APCIMS firms' charges were both transparent to and levied directly upon clients, the FSA's final rules requiring multiple disclosures of the charges applicable to business in retail investment products altogether fail to take account of the market-orientated way in which such firms undertake their business and the nature of both the advisory services they provide and the relationships they maintain with their clients.

— APCIMS maintains that the flaws in the FSA's CP09/18 cost-benefit analysis were so significant as to call into question whether the FSA had met its statutory obligations under s.155 of FSMA. Subsequent reworking of the FSA's analysis—undertaken in a very short timeframe and seemingly at a point when the FSA had already made its major policy decisions—has resulted in massively increased cost estimates.

Background

Failure of FSA policy approach

From the beginning of the RDR project, APCIMS expressed concern about how the RDR was intended to change the business practices of private client firms. It was told that, while all firms dealing with retail clients would be affected by the RDR to some extent, the FSA was aware that firms in the APCIMS community were already meeting many of the RDR's target standards (eg agreeing charges directly with clients ahead of service provision) and that APCIMS should be reassured by the fact that the person taking the project forward was an ex-SFA regulator with a good knowledge of the sector.

However, notwithstanding the comforting messages that Amanda Bowe and her team gave to APCIMS firms during the early stages of the project—ie about the FSA "seeking market-led solutions", being in "listening mode" and having "the private client asset management and stockbroking community very much in our thinking"—the final rules have clearly demonstrated both the FSA's complete focus on those retail market firms whose business is centred on mass market product sales and its inability to apply regulation in a nuanced fashion to firms whose business does not fit this description. So absolute has the FSA's disregard of the concerns of the APCIMS community been that, even in instances where APCIMS has identified practical implementation problems rather than querying policy intent, the FSA has failed to respond with the result that firms are now facing the prospect of implementing requirements that make absolutely no sense in the context of their business (see the material below about the disclosure of "total adviser charges").

Throughout the RDR project, APCIMS and its members have put considerable resources into trying to ensure that FSA policy staff understood the nature of the private client investment management and stockbroking business and how it differed from the mass market, sales-driven business of product providers and retail financial advisers. Detailed responses to DP07/1 and CP09/18 included worked—through examples of the likely impacts of proposed rules; the APCIMS policy team had frequent meetings with a whole succession of FSA RDR policy staff in order to explain the business models of APCIMS firms and how the different elements of the RDR proposals were likely to impact upon them; and a number of meetings were arranged to enable FSA policy staff to meet directly with APCIMS firms to augment their understanding of how such firms operated and how their services and relationships with clients were structured.

These efforts have had no result either in terms of securing amendments to proposed Handbook provisions or considered responses to the detailed queries set out in our response to CP09/18. Even more worrying, they appear to have had little impact in raising the FSA's minimal understanding of APCIMS firms' business. So much so that, even though the rules have now been made, the FSA-prepared agenda of a recent meeting to discuss PS10/6 listed the following item:

> *APCIMS to talk though the process a client will go through when a typical firm meets that client for the first time*
>
> — *What service is being provided?*
>
> — *How is that service paid for?*

We find alarming the ignorance of our sector that such a question displays and we query how the FSA can have arrived at the conclusions presented in PS10/6 when it has so evidently failed to understand the most basic features of the business undertaken by a significant sector of firms affected by those conclusions.

Retail investment products

The RDR's exclusive focus on RIPs and on the activities of provider/distributor firms whose business is wholly concerned with such products means that the FSA has given insufficient thought to how its revised rules will impact the business of firms whose services to clients extend beyond product advice. A regime designed to cover mass market sales of products to small-scale, financially unaware savers is not appropriate for the relationship-based services provided to affluent and financially able investors by APCIMS firms but the FSA has made no effort to recognise or accommodate the latter.

PS10/6 has also failed to respond to more specific concerns about the FSA's use of the extended RIP definition. Specifically that:

— including market-traded investments within the RIP definition (eg investment trusts, ETFs) means that product rules predicated on long-term, illiquid investment do not work, eg providing a pre-transaction disclosure of costs for investments the prices of which are subject to market fluctuation;

— including complex products such as unregulated collectives and structured products in the RIP definition may increase the likelihood of mis-selling given the enhanced levels of knowledge/due diligence required for the provision of advice;

— lack of precision about exactly which instruments are included in the RIP definition creates uncertainty for firms (and supervisors) about implementation of the new requirements and also falls foul of the EU Commission's acknowledgement of the need for a precise definition of PRIPs and for that definition to be supported by *clear designation of the products that fall within scope*. Are there practical problems ahead if the FSA's RIP definition ends up being broader than the EU PRIP definition?

— the FSA has made use of the PRIPs concept, not only ahead of the Commission having finalised its work in this area, but also to support UK-specific regulatory concepts (eg independence) which the Commission does not recognise and has shown no intention of extending to other Member States.

"Independent advice" v "restricted advice"

In PS10/6, the FSA says that it does not *feel there is a compelling case for an independent adviser to become restricted* and supports this assessment by reference to Oxera research that indicates *that 15% of independent firms would offer restricted advice or an execution-only service as a result of the RDR*. While 15% may be an accurate figure in respect of all firms currently offering independent product advice, we have no doubt following discussions with our members that it seriously underestimates the proportion of APCIMS firms who will move from providing independent/whole-of-market advice in relation to packaged products to providing restricted advice in respect of RIPs. Some APCIMS firms have discrete financial planning arms or sister companies and, by amalgamating these businesses into one corporate entity, will be able to re-structure their client advisory processes in such a way as to meet the new independence criteria. The business models of most APCIMS members, however, are firmly focussed on readily-tradable investments and have never involved providing advice on the sorts of long-term, illiquid products that are the natural province of financial planners—as well as failing to grasp this distinction between the service offerings of stockbrokers/ investment managers and financial planners, the FSA also seems to be unaware that many mass affluent clients retain a range of advisers and are quite specific about the services they require from each. The RDR's "one size fits all" approach requires all firms wishing to provide independent advice to be full-scope financial planners and effectively means that the bulk of APCIMS firms, that currently provide independent/whole-of-market advice in respect of collectives (the only readily-tradable form of "packaged product"), will in future find themselves providing restricted advice even though there will have been no change to the services they offer or to the way in which they assess the product types in which their clients are interested.

Furthermore, the FSA seems not to have realised that, if firms have to live with the restricted advice label, there may be little point in them continuing to expend resources on the market analysis and research which currently supports their advice, and that their advice may therefore become more restricted over time. By forcing firms to assume a marketing label that does not in fact describe their services, RDR requirements are likely to reduce the availability of unbiased advice to clients.

Disclosure of advisory status

The descriptions contained in the new RDR provisions as to what constitutes "independent advice" or "restricted advice" are completely inappropriate for the investment-based, relationship-driven business of APCIMS members. Taking COBS 6.2A.6R as an example, (2) in respect of "independent advice" seems to describe what APCIMS firms actually do (ie provide advice that is unbiased as to provider in relation to certain types of product) while (3) describes restricted advice in a way which simply does not accord with most APCIMS firms' business (ie because their advice is not limited to products offered by one company, one group or a limited number of companies). The fact that the rules have been framed by reference to the business of product provider and distributor firms means that they describe advisory activities in ways which altogether fail to reflect the service offerings of APCIMS member firms. This is most clearly demonstrated by the examples which the FSA provides in COBS 6.2A.10G (below) of the oral disclosure that firms providing restricted advice must give to their clients, neither of which is likely to describe the activities of the average APCIMS firm.

(1) *"I am a [Firm X] adviser offering restricted advice, which means that my advice is restricted to advice on [Firm X] [products/stakeholder products] only"; or*

(2) *"I am a [Firm X] adviser offering restricted advice, which means that my advice is restricted to advice on [products/stakeholder products] from a limited number of companies that [Firm X] has selected."*

More practically:

— while APCIMS firms advising across a wide range of readily-tradable investments (stocks, shares, bonds, collectives, warrants etc) will be forced to describe themselves as offering "restricted advice" and provide an oral disclosure of the type outlined above because they do not advise on all types of RIPs, IFAs will be able to hold themselves out as independent even if they only advise on products and are unable to advise on any form of direct investment. As well as giving clients an erroneous impression of the respective ranges of advice available from IFAs and APCIMS firms, this will undoubtedly place the latter at a distinct (and, we would maintain, unfair) disadvantage in terms of marketing their services; and

— many APCIMS firms derive a large proportion of their business from referrals by lawyers and accountants who are currently required by their own professional bodies to only refer clients to firms that provide independent/whole of market advice in relation to packaged products. If these requirements remain unchanged in respect of RIPs, many APCIMS firms will find a valuable source of business closed to them notwithstanding that their services are unchanged and that they can provide the direct investment services (including unbiased advice on readily-tradable investment products) that the majority of mass affluent clients require and which many IFAs are unable to provide.

Disclosure of adviser charges

Once again, the FSA's rules in this area are predicated on one-off sales of long-term, illiquid products to financially unaware savers and make no allowance for the fact that many of the investments within the new RIP definition may be bought and sold on a regular basis by relatively sophisticated and well-off investors for trading, speculative and portfolio purposes. In particular, PS10/6 fails to address any of the points raised in APCIMS' response to CP09/18 about the practicalities of disclosing "total adviser charge" in a context where exchange-traded investments are subject to price volatility, where clients wish to trade as soon as advice has been received, where contract notes are likely to reach the client at the same time as any total adviser charge disclosure and where transactions are undertaken frequently in the context of an ongoing relationship.

If a client phones his broker and asks for advice on which of a range of investment trusts he should purchase, the new disclosure rules require the firm to provide (and the client to agree to) a disclosure of its "total adviser charges" before any transaction takes place. As well as this disclosure having to be made in a "durable medium", be expressed in cash terms and seemingly cover any ongoing management fees that may be levied in respect of the investment in question assuming a specific growth rate, it also seems more than likely that by the time the transaction actually takes place the price of the investment will have changed so that the details of the disclosure are no longer valid. Given that clients receive contract notes with full details of the terms upon which a transaction has been effected the day after execution, the requirement for a separate pre-execution disclosure is nonsensical. In discussing this issue with FSA policy staff during our recent meeting, we found it alarming that they expressed surprise upon hearing that APCIMS firms provided advice to clients over the phone, a further indication that RDR policy has been determined without understanding of the way in which private client firms carry out their business.

FSA cost-benefit analysis

APCIMS continues to believe that the FSA failed to meet its statutory obligations in producing its cost benefit analysis of the CP09/18 proposals—briefly stated, the CBA was based (a) on earlier and substantially different proposals from those actually consulted on and (b) on responses to a survey that was drafted from the perspective of firms whose entire business was product-based and that failed to cover the entire universe of products which the RIP definition has since been expanded to include. While we are aware of the further CBA work undertaken by the FSA earlier this year, we note that this was centred on a survey which firms had a very short period to respond to, which was once again targeted at the business of product providers and distributors and which appeared to have been undertaken specifically with a view to providing post-facto support for policy conclusions which the FSA had already determined upon. Even taking these limitations into account, the reworked analysis indicated that the estimated costs of the RDR initiative have increased massively.

	CP09/18 estimates	*Revised estimates*
One-off costs	£430m	£605m–£750m
Ongoing costs	£40m	£170m–£205m
Present value of costs for the first 5 years	£0.6bn	£1.4bn–£1.7bn
Annualised	£135m	£305m–£370m

The FSMA rationale for requiring cost benefit analysis to be undertaken in relation to major policy proposals is that it should be taken into account in determining whether such proposals are carried forward. We believe that the FSA's approach to its CP09/18 CBA was deeply flawed and that as a result due process has not been followed in respect of the RDR

Attachment 3

15 October 2009

Mr Hector Sants

Chief Executive

The Financial Services Authority

25 The North Colonnade

Canary Wharf

London E14 5HS

Dear Hector

CP09/18: Distribution of Retail Investments—Delivering the RDR

We have submitted to the FSA our detailed response to the above consultation paper.

Regrettably, in our view the deficiencies in the cost benefit analysis published in support of the proposals in the consultation paper are so significant that they indicate that FSA has failed to meet their obligations under FSMA S155. We have received external legal advice which supports our view. We attach as an appendix to this letter an extract from our response which provides further information.

We would welcome further clarification from the FSA as to why, in light of the deficiencies we have identified, it is satisfied it has met its statutory obligations.

We look forward to your response.

Yours sincerely

David Bennett
Chief Executive

Extract from APCIMS' Response to CP09/18: Distribution of Retail Investments—Delivering the RDR

Cost benefit analysis

We struggle to understand how the FSA considers that it has met its statutory obligation under FSMA s.155 (or, indeed, vis-à-vis its own principles of good regulation, particularly as regards proportionality) to provide a cost-benefit analysis of the CP09/18 proposals when a large part of its analysis is based on *a survey of compliance costs and changes to business models by Deloitte* which *was based on early policy assumptions of the RDR proposals as published in Feedback Statement 08/06*. FSMA s.155(10) defines a cost benefit analysis as "an estimate of the costs together with an analysis of the benefits that will arise if the proposed rules are made"—however, because the CP09/18 CBA is based on research undertaken in pursuit of earlier

policy assumptions, it cannot be truly said to address the rules proposed in CP09/18. Given the potential impact of this initiative on the entire retire financial services industry, we do not think it is acceptable for the FSA to publish a CBA which does not actually address the proposals subject to consultation.

More specifically:

- the FS08/6 outline of the FSA's RDR policy was at such a high level of generality as to preclude firms from undertaking any meaningful assessment of the potential costs involved—as the FSA will be aware from the meetings and correspondence which we had between the publication of FS08/6 and CP09/18, APCIMS identified a large number of issues in relation to which its members considered the FSA's policy intent unclear and where further clarity was needed before firms could make any informed judgements about the proposals' likely impact;
- the extent of policy development that has occurred between FS08/6 and CP09/18 is particularly marked in relation to the concept of independence—while FS08/6 talked about *two outcome-focused principles for independence* which would apply *across all forms of investment advice* but would recognise that *the whole market means different things for different firms*, CP09/18 takes a far more stringent approach which basically limits the provision of "independent advice" to those who advise on all types of RIPs, regardless of whether those products are a natural part of their business offering or whether advice is given on any instruments outside of the RIP definition. We think it is fair to say that the high-level content of FS08/6 did not prepare our firms for the extremely restrictive proposals on independence published in CP09/18; and
- the "Deloitte survey of retail investment intermediaries" undertaken in February 2009 was very clearly drafted from the perspective of firms whose entire business is centred upon the sale of products, whose advisers are remunerated largely upon the basis of sales and whose continued existence might well be called into question by the ending of product provider commissions. At the time, we commented on the inappropriateness of the survey for the business undertaken by our members and indicated that APCIMS firms were unlikely to feel themselves under any compulsion to respond to a questionnaire that had so obviously been drafted with absolutely no regard for their business models. We also note that many of the questions in the survey focussed upon specific products (packaged products, collectives, annuities, mortgages and protection products are all listed several times) but that there was no reference to either the wider universe of financial instruments to which FS08/6 suggested that the concept of independence would apply or the non-packaged products which have since been incorporated into the RIP definition (ie unregulated collectives, investment trust securities, structured products and *any other designated investment which offers exposure to underlying financial assets, in a packaged form which modifies that exposure when compared with a direct holding in the financial asset*).

Consequently, APCIMS does not believe that the research undertaken on the basis of the outline proposals contained in FS08/6 is sufficiently relevant to form a major part of the CBA for the significantly altered proposals in CP09/18. As well as failing to take into account changes to the scope of and criteria for "independent advice", the CBA also fails to consider either the likely costs to firms of drawing complex instruments into scope (eg undertaking more research/due diligence, redrafting investment procedures, instituting further safeguards around risk assessment and suitability, providing more risk information to clients) or the serious potential for mis-selling and consumer detriment. We believe that the FSA's statement in Annex 2 of CP09/18 that cost estimates based on the Deloitte's survey *may be subject to a margin or error* is disingenuous to say the least. In addition, the suggestion that firms should *provide us with new information that may impact on these estimates as part of the consultation process* looks suspiciously like the FSA trying to offload its responsibility. It is the FSA that is required to support any draft rules which it publishes with a cost-benefit analysis with section 155(10) of FSMA requiring that analysis to be *an estimate of the costs together with an analysis of the benefits that will arise ….. if the proposed rules are made*. It is hard to see how a CBA which depends in large part upon research undertaken in respect of significantly different proposals meets those criteria.

We also query whether Deloittes itself was less than happy with the research it produced. While we appreciate that it is common practice for professional advisers to seek to limit their liabilities by the use of standard disclaimers, some of the comments in the "Limitations" section which prefaces the Deloitte report would appear to call into question the legitimacy of the data collected through the survey and, indeed, whether the FSA can be said to have acted in good faith in relying upon it, specifically as regards a later and significantly altered set of proposals. In this respect, we point specifically to Deloitte's comments that:

- *As firms are being asked to anticipate costs in relation to an event some years in the future, and in relation to proposals where details of these requirements have yet to be confirmed in some areas, firms may experience difficulties in providing accurate cost estimates.*
- *In some segments and cost categories, the sample size is small, meaning that the results cannot be considered statistically significant.*
- *The work has also been limited by the time frame made available to Deloitte to undertake this engagement. No follow-up or verification of cost estimates provided by respondents to the e-survey has been made. Due to these limitations and low response rates in certain categories the FSA will need to conduct more work to further explore the aggregate impact on the industry.*

Furthermore, we would contend that the FSA has not even met the standards which it has set for itself in relation to CBA. For example, there is little evidence in either Chapter 7 or Annex 2 of CP09/18 that the six-stage process set out in the third of the FSA's Occasional Paper series ("Cost-Benefit Analysis in Financial Regulation—How to do it and how it adds value") has been followed in respect of the proposals subject to consultation. It also appears that elements of the guidance which the FSA produced to help its own staff to adopt a systematic approach to CBA ("Practical Cost Benefit Analysis for Financial Regulators") have been lost sight of. For example, chapter 2 states that *Since it is more important to be sure about major policies than minor policies …. a major policy requires a CBA of greater scope than a minor policy.* Chapter 2's "Hints for Conducting a CBA Efficiently" also suggest that a CBA should *be as specific and concrete as possible*. While the RDR certainly falls within the definition of a "major policy" (with the FSA's own website describing it as *one of the core strands of our retail market strategy* involving changes that are *far-reaching and challenging*), the CP which aims to give effect to it carries a CBA which is neither wide-ranging nor specific to the detailed rule proposals involved.

Finally, we note the comment in the Practitioners Panel Annual Report for 2008-2009 that *In cases where the CBA case is weak or non-existent for an initiative, the decision should be taken not to proceed or any decision to proceed in the face of the CBA should require more extensive justification.* We believe that the cost benefit analysis in respect of the CP09/18 proposals is extremely weak and we will be writing formally to the Panel to inform them of our view.

Attachment 4

HM Treasury

1 Horse Guards Road

London

SW1A 2HQ

Dear

The FSA's Retail Distribution Review

I am writing to alert you to an issue which is causing a great deal of disquiet among the investment firms in APCIMS membership and which will result in the RDR having a significantly negative impact on the competitive position of a constituency which was not in the FSA's sights when it specified the original aims of the project. Both before and since the general election, the Conservative Party and the new Government has indicated that a change of government, while likely to result in a major rewrite of the UK regulatory structure, would not prevent the RDR from progressing to implementation. Given the nature and scale of the problems that the project sought to address and the time, energy and resources committed to it by all parties, that is absolutely the right decision. What we would like to do, however, is to encourage HM Treasury to bring its influence to bear in improving one particular aspect of the FSA's RDR implementation plan which promises to do more harm than good.

When the FSA first launched the RDR, it identified a range of problems with the distribution of retail investment products that undermined consumer confidence and resulted in many UK citizens being loath to seek financial advice or to engage with the financial services industry in any way. These problems—overly complex charging structures, high volumes of switching between products, low levels of product persistency and the prevalence of product/provider bias driven by advisers' focus on commission income rather than consumer interests—were clearly identified as being related to the distribution of mass market retail products and not to the provision of the sorts of on-going investment services that APCIMS member firms specialise in. Indeed, when APCIMS expressed early concerns about how the RDR would affect private client firms which are already subject to the enhanced regulatory requirements imposed by MiFID and the CRD unlike most product advisers, the FSA said that it was aware that firms in the APCIMS community were already meeting many of the RDR's target standards (eg agreeing charges directly with clients ahead of service provision) and that APCIMS should be reassured by the fact that the person taking the project forward was an ex-SFA regulator with a good knowledge of the sector.

Taking in good faith the FSA's indications that it was "seeking market-led solutions" and had the private client community very much in its thinking, APCIMS engaged fully with the consultative process, providing detailed responses to FSA papers, meeting regularly with FSA staff and facilitating contact with and the collection of data from our firms. It is, therefore, extremely disappointing that the RDR development process should have been marked by such major flaws. For example:

— Cost-benefit analysis : we firmly believe that the CBA which the FSA produced in support of its proposals failed to meet the required FSMA standards. As well as being based on substantially different proposals from those actually consulted on, the CBA also relied on responses to a survey that was drafted from the perspective of firms whose entire business was product-based and that failed to cover all the products impacted by the RDR proposals. Recognising the inadequacies of its original CBA and seemingly keen to provide post-facto support for policy decisions already

taken, the FSA carried out a further survey which indicated that the estimated costs of the RDR had increased enormously with one-off costs rising from £430 million to £605–750 million and on-going annual costs from £40 million to £170–205 million.

- Policy drift : as well as being unable to clearly explain how the RDR was intended to apply to different types of products, services and firms, the FSA has also been guilty of wide-ranging policy shifts between each of its public papers. Consequently, the scope of the RDR proposals has moved from the traditional range of "packaged products" to all designated investments (including securities and bonds) to a broad range of "retail investment products", only some of which are clearly defined. Similarly, the range of firms affected has shifted from product providers/distributors to all firms dealing with retail investors to retail advisers. This fluctuation—not aided by the many changes to the FSA's RDR policy team—has made it difficult for industry to engage constructively and consistently with the project, particularly when research undertaken and feedback provided in relation to one set of proposals is seemingly rendered valueless by the next phase of the project proposing something completely different.
- One size fits all : notwithstanding the FSA's assurances that the business models of APCIMS firms would be taken into account in forming policy, it is clear that the final shape of the RDR is wholly predicated on mass-market product distribution and that the concerns of other constituencies have been overlooked. Much of APCIMS' response to the FSA's last consultation was dedicated not to querying policy intent but to identifying practical implementation problems arising from rules drafted with one market in mind being applied to another with fundamentally different customers, services and investment approaches. Having finalised its rules without responding to these problems in any way, the FSA has since realised that certain of its requirements are not capable of sensible implementation in the context of APCIMS firms' business and has indicated that it will have to work with us to produce guidance which will effectively adapt the rules to fit hitherto ignored business models.

The FSA's blinkered approach has resulted in rules which will pose significant implementation difficulties for our firms—eg applying product regulation to market-traded investments, analysing markets for which public data is limited and providing product charge disclosures out of context with overall service tariffs. While these issues will be costly and resource-intensive for firms to address, they are not "show-stoppers"—firms will make the necessary changes to systems, procedures, documentation and business practices and will be compliant with the new RDR rules once they take effect. The one area where compliance will be altogether more problematic and where APCIMS firms believe that the RDR will be massively and unfairly damaging to their business relates to the rules whereby the advice that firms provide in relation to retail investment products is categorised as "independent" or "restricted".

Under the new RDR rules, a firm will only be able to hold itself out as offering "independent advice" if it advises on all types of product falling within the FSA's "retail investment product" definition, ranging from unit trusts and investment trusts to pensions and life assurance. The services of APCIMS firms are firmly focussed on readily-tradable investments (stocks, shares, bonds, gilts and collectives) and have never involved providing advice on the sorts of long-term, illiquid products that are the natural province of financial planners. In the past, this has not been problematic—firms have provided independent, whole-of-market advice in relation to unit trusts (which play an important, complementary role alongside direct investment portfolios) but have not advised on life policies or pensions, instead directing their clients to specialist financial planners for such services. Now, however, to attain "independent" status, firms will have to be able to advise across all product types regardless of how such products fit within the firm's business model and service offering. This has major practical ramifications including a marked distortion in the competitive base from which different types of firms operate. For example:

- while APCIMS firms advising across a wide range of readily-tradable investments (stocks, shares, bonds, collectives, warrants etc) will be forced to describe themselves as offering "restricted advice", IFAs will be able to hold themselves out as independent even if they only advise on products and are unable to advise on any form of direct investment. As well as giving clients an erroneous impression of the respective ranges of advice available from IFAs and APCIMS firms, this will undoubtedly place the latter at a distinct and unfair disadvantage in terms of marketing their services; and
- many APCIMS firms derive a large proportion of their business from referrals by lawyers and accountants who are currently required by their own professional bodies to only refer clients to firms that provide independent/whole of market advice in relation to packaged products. If these requirements remain unchanged, many APCIMS firms will find a valuable source of business closed to them notwithstanding that their services are unchanged and that they can provide the direct investment services (including unbiased advice on readily-tradable investment products) that the majority of mass affluent clients require and which many IFAs are unable to provide.

Although APCIMS has discussed this issue with the FSA several times in recent weeks, the FSA professes not to understand either the disadvantageous position in which the new rules place APCIMS firms or the anger which firms feel at finding that they are so negatively impacted by a project that was aimed at abuses arising in other sectors. The "sop" offered by the FSA is that the majority of APCIMS firms that do not advise on life policies and pension schemes, though obliged to declare that they provide "restricted advice",

may also use terms such as "unbiased", "focussed" and "exclusive" to highlight the advantages of their services. Given the clear difference in terms of quality of service which the FSA's rules on independent and restricted advice imply, the fact that the FSA's own consumer research clearly indicates that "independent" has positive connotations for consumers while "restricted" has negative ones and that consumer education initiatives ahead of RDR implementation will publicize this distinction, APCIMS firms do not believe that permission to add a qualifying adjective or two to their disclosures is a satisfactory response to major and well-founded concerns about both loss of business and the appropriateness of a regulator introducing measures without considering the very significant impact they may have on the relative competitive positions of different sectors of the retail financial services industry.

APCIMS accepts that major revisions to made rules which have passed through the FSMA-required processes of consultation and CBA (albeit in imperfect form) are highly unlikely. We do, however, believe that the regulatory burden which has been unfairly and unthinkingly placed upon our constituency could be ameliorated by changes to RDR guidance which would not themselves require further consultation or CBA. The made rules specify that, for a firm to provide offer independent advice, it must advise on all investments in its "relevant market" with guidance indicating that, for most firms, the "relevant market" will generally include all retail investment products. What would make more sense and allow for different constituencies' business models would be for "relevant market" to be construed in the context of the services offered by a firm—so, for a typical APCIMS firm advising on unit trusts and investment trusts but not on life policies and pensions, the "relevant market" would consist of the former and the firm's advice would be independent if it fulfilled the conditions specified for independence in the RDR rules, ie "unbiased and unrestricted" and "based on a comprehensive and fair analysis of the relevant market".

Conversations with senior FSA policy staff on this issue have indicated that the FSA has no appreciation of the potential which its rules have for significantly distorting competition in the retail financial services market. APCIMS' Chairman has taken this issue up with Lord Turner and I would very much welcome the opportunity to discuss it further with you to see whether there is anything that can be done to avoid APCIMS firms having to operate on a playing field made manifestly unlevel by the overly sweeping approach of the regulator.

Further supplementary written evidence submitted by APCIMS

We have now obtained some cost data which will hopefully begin to satisfy the Committee's desire to learn more about compliance costs in firms.

Firstly, here is specific data for six of our member firms with the annex to this letter indicating the types of firms covered:

APCIMS Member Firms: Costs of Compliance

	Costs	*% of Turnover*	*% of Profit*
Firm A	£280,000	4.2%	8.7%
Firm B	£8 million	3.8%	18.2%
Firm C	£4.1 million	3.6%	7.1 %
Firm D	£1.5 million	3.5%	12%
Firm E	£1.07 million	1.2%	1.5%
Firm F	£1.37 million	4%	33%

Secondly, it is worth noting that most of the percentage of turnover figures in the table above matches with a figure of 3.6% which was obtained recently across a broader sample of our members as part of an annual survey on costs and trends (ComPeer).

Thirdly, we have also begun to receive specific data related to how much the total compliance cost (including compensation scheme payments) has increased in the last few years. Some of this data will need more work as it needs normalising either because the firm has changed and/or their business model has changed. However, it is not unusual to find instances where the compliance cost has risen by 30% and, in extreme cases, more than doubled in the last three years.

We trust this gives you and your Committee sufficient information for now. If we can be of any further assistance, please do get in touch.

Annex

Firm A

— Small (Funds under Management)
— Predominantly Execution-only with Advisory and Discretionary
— Headquarters outside London
— Branch offices throughout the UK

Firm B

— Large
— Full Service (Ex-only, Advisory and Discretionary)
— Headquarters in London
— Branch offices throughout the UK

Firm C

— Large
— Discretionary
— Headquarters outside London
— Branch offices throughout the UK

Firm D

— Large
— Full Service
— Headquarters in London
— No Branch Offices

Firm E

— Large
— Discretionary
— Headquarters in London
— Branch office in Channel Islands

Firm F

— Medium
— Advisory
— Headquarters in London
— Branch offices in south England

Supplementary written evidence submitted by the Association of Independent Financial Advisers

Following AIFA's oral evidence session to the Treasury Committee on 12 October, I am pleased to enclose further written evidence addressing the issues raised by your members.

In addition, I believe it is appropriate to cover two areas.

Firstly, the assertion that the AIFA comments might be muted by "the long shadow of the FSA". In operating as a core part of the consultation process employed by the FSA to agree new regulation, AIFA has always adopted an approach of trying to achieve consensus, work to develop win/win solutions and be clear about the risk and outcome desired. In doing this we have found that a consultative approach based on listening ,understanding and providing positive feedback and engagement has worked best. When we have disengaged, become confrontational and "shouted" we have rarely won the hearts and minds of the FSA decision makers, as we have no "power".

It is this desire to work with and collaborate, as we should have the common agenda of delivering better consumer outcomes, that restricts our desire and ability to criticise. As we work closely together with the FSA on a range of issues it risks being "personal". Hopefully the direct answers on both the RDR fiasco

and grandfathering indicate that we are not afraid to state our case, but careful in our language to avoid offence. We work within the shadow as they have the ultimate decision making ability, without the trade bodies having any right of appeal.

Indeed in the area of grand-fathering the ultimate authority vests not even with the FSA, but with the awarding bodies. These are entities such as CII or IfS who undertake the examinations and agree the "Continuous Professional Development" schemes and "gap-fill" rules. It is their failure to have operated satisfactory CPD schemes for those with historic qualifications that brings us to the world today. That we cannot just apply new exam standards to new entrants and are able to evidence that existing advisers are at the right standard. It is these awarding bodies choice to enforce examinations and not adopt a CPD in-fill approach.

Finally, it is important to note that we represent a broad church, with many of our members believing that competence should be assessed to level 6, and AIFA was successful in reducing this to level 4. This was to avoid an even larger loss of available consumer advice. On the other wing there are those who consider that they should never be assessed by examination and that their record as advisers speaks for itself. This is as damaging in our view, as a base level of demonstrable competence has to be the foundation of any trade or industry.

I hope you find that our written evidence addresses some of the Committee's concerns in more detail.

Written evidence

About AIFA

The Association of Independent Financial Advisers (AIFA) is the representative body for the IFA profession. There are approximately 16,000 adviser firms that employ 128,000 people, and turnover is estimated at £6.5 billion (including £4.5 billion from life policies, £1 billion from fund management and £1 billion from mortgages and general insurance). Around 20% of the UK population regularly use an IFA, with c45% consulting one from time to time.

Membership is voluntary and on a corporate basis. IFAs currently account for around 70% of all financial services transactions in the UK (measured by value). As such, IFAs represent a leading force in the maintenance of a competitive and dynamic retail financial services market.

About IFAs

In every year for the last five, consumer trust and confidence in the IFA profession has grown. Research by Nottingham University shows that IFAs are the most trusted part of retail financial services (by a considerable margin) and that, in the midst of the banking crisis demand for independent advice increased—and the level of confidence in IFAs increased.

IFAs are regularly cited as offering low-cost barriers to entry into new markets, and the European Commission last year commented positively on the role of intermediaries as a force for driving competition (to the advantage of consumers) in financial services.

The UK has experienced the worst banking crisis in a century. The financial services industry has emerged with a tarred reputation from this period: yet no IFA firm posed a systemic risk, or contributed to the failures in this turmoil.

IFAs will be regulated by the CPMA under the proposed structure. However, clearly the decisions made by the FPC will impact IFAs, and a number of IFA firms in AIFA's membership are part of a wider banking, insurance or mutual group and therefore will form part of a group regulated by the PRA. In our response we have focused predominantly on the CPMA, as this is the area with most interaction with members and consumers, but we have also addressed the necessary interaction between the three regulatory bodies.

1. Executive Summary

Regulatory intervention has become the hallmark of the retail financial services market given the significant importance it has to individuals. However while AIFA welcomes the need for regulation as a means of making the market safer for consumers, we are also adamant that it must improve its effectiveness, and make absolutely clear its purpose. Constant regulatory flux deters financial investment in firms and weakens consumer trust in the sector. In some cases the implementation of the regulatory system actually threatens to undermine the existence of the market as a viable entity, restricting the ability of consumers to obtain the products and services that they need.

For the future, we have therefore identified six high-level principles that we believe should apply to the governance of regulation.

First and foremost we believe regulation must enable better outcomes for more consumers. This means regulation must not only protect consumers from unscrupulous market participants, but also facilitate more access to advice for consumers, particularly at this stage in the economic cycle. But there is evidence to suggest that in recent years, UK regulatory practice has failed the consumer in a number of ways. The

number of people saving has fallen dramatically, the cost of advice has risen, consumer confidence and trust have been damaged, and many of FSA's efforts to promote public awareness through information and disclosure overload have been ineffective.

The new regulator therefore needs to address the wider public policy agenda in order to help consumers re-engage with their long term financial well-being and making more, and better, provision for themselves. This should involve closing the savings and protection gap as a statutory objective of the CPMA. We also need to see consumers take on increased responsibility for their own financial future, as this will ultimately help yield the optimum outcomes for them.

However there is little evidence that the majority of consumers—even sophisticated consumers—wish to be educated about the intricacies of financial products and services. On the other hand there is a lot of anecdotal evidence that people want help in dealing with their financial issues which is why financial advice has emerged over the last few decades as an important component of the market. The CPMA must therefore act in a way which increases consumer access to real advice, rather than limit the supply of it through excessive regulatory burdens.

Secondly, we believe it is essential that regulation has the appropriate checks and balances in place to ensure accountability. In the past the system of accountability for the regulator has relied too heavily on internal self-assessment, with the result that there were no effective checks and balances in places. Any future regulator should therefore be held far more tightly accountable to the delivery of their objectives in the most efficient and cost-effective way. We believe that the necessary degree of rigour can only be achieved by an independent body, external to the regulator.

This principle is derived from the single most important lesson learned from the history of regulation. There is no reason to believe that initial objectives, no matter how well-intentioned and well-articulated, will be achieved when a new system is established—unless there is a rigorous process in place to keep it aligned to those objectives.

We therefore see a greater role for the National Audit Office (NAO) and Public Accounts Committee in reviewing the new regulatory structures, the continuation of the Regulatory Decisions Committee (RDC), the continuation and strengthening of the three "consultative panels" including new statutory footing for the Small Business Practitioner Panel as well as a wider role for the Treasury Select Committee.

Thirdly, we believe regulation must work in a proportionate and risk based way, focusing on those aspects of the financial services industry that pose the greatest risk.However this has certainly not been the case under the FSA who, in order to avoid criticism, have tended to pursue actions they viewed as bomb-proof, and cascaded them to adjacent markets. The result of this approach has been that IFA firms, who pose no systemic risk to the economy, and are working in the best interests of their clients, have been at the receiving end of FSA's intrusive supervision to a far greater extent than large banking institutions at the other end of the "risk" scale.

In fact it is our view that well-managed firms, which treat their customers fairly, should be given regulatory incentives for doing so, in order to incite positive behaviour. It would be these good firms that would benefit from regulatory change. Regulatory dividends, whether based on fees, capital requirements or supervision, would provide a clear demonstration of a regulator that wishes to work with the sector to bring about consumer benefit—and this would be welcomed by all participants.

Fourthly, we believe regulation must change less, with fewer "new ideas" and more consistency of delivery. Although the history of regulation under FSA has been relatively short, there have already been a considerable number of waves of different requirements with the result that a degree of regulatory fatigue has set in. The costs of coping with FSA regulation keep rising, and the combined effect of this and fatigue is to drive members of the market out—to the detriment of consumers.

Our members also report that the messages they receive from different parts of the regulator are inconsistent. The Policy division is often seen as open, receptive and understanding about the real issues of operating in the marketplace, while Supervisors are left to stick to the rules in their own way. Enforcement, while necessary, can become unnecessarily and excessively aggressive in an environment where the regulator is investigator, judge and jury.

At this stage a radical change of direction, or complete rewrite of the rulebook, would be both unwelcome and counterproductive. However we do believe that there is considerable scope for improvement in how regulation is implemented.

Looking forward to the new regulatory structure it is essential there is close and continuous co-operation between the newly formed statutory bodies to ensure consistency of delivery. Each of these bodies should formally benefit from each other's objectives as specified secondary objectives, with the establishment of a college of supervisors to ensure cross-body cooperation, coordination and control.

There also needs be a higher standard of staff across the system as well as far more joined up working from the policy, supervision and enforcement teams. Remuneration also has a role to play here, and we recommend any financial rewards for staff should be based on long-term outcomes, just as has been proposed for the financial services industry which they regulate.

Fifthly, it is essential that the regulator use its resources in the most cost effective and economic way, in order to deliver the best possible value for money for both the industry and ultimately consumers. By definition, consumers will not be able to obtain the products and services they need if the provision of those services is eliminated or made expensive by the actions of the regulators. Yet that is exactly what has been happening under FSA.

IFA firms bear a disproportionate brunt of the rising fees, especially considering they pose little or no systemic risk to the economy, are the lowest causes of complaints to the Financial Ombudsman service, and are consistently found to be the most trusted part of the financial services sector. It is also worth pointing out that the true cost of regulation to all of these firms currently increases with experience—the lack of a long stop for the industry means that businesses, especially the smaller ones, have the burden of making provision within their accounts for the increasing risk of complaints as well as the proposed increases to Capital-adequacy provisions.

In order to ensure cost effectiveness there must always be an identifiable market failure, and a cost/benefit analysis undertaken, before regulatory action is considered. We also believe CPMA's policy in setting fees should be risk-based, and use the tools at their disposal to reward firms that invest in their business and its people.

The sixth and final high-level principle is that regulation must take fully into account the European dynamic at play. Increasing amounts of financial regulation are now emanating from Europe, and it is therefore crucial that the UK is best placed to achieve positive engagement on the continent in the coming years and ensure we remain a leading player, for the benefit of consumers. We also feel there is potentially much to be lost at a European level in the near future, as highlighted by Sharon Bowles' recent letter to Vince Cable, further highlighting the need for UK regulators to be fully cognisant of the European dynamic at play in the market.

These six principles run the risk of looking so obvious that they could easily be dismissed out of hand. But the point is that no matter how the principles are espoused: in practice, they have not been delivered—and that is what needs to be fixed by the new regulatory structure. The success or failure of regulation in the future needs to be capable of being measured against these yardsticks.

2. Introduction

AIFA clearly recognises the important role that regulation plays in making the retail financial services market a safer place for consumers, and a place in which they can have trust and confidence. We are therefore fully in favour of cost effective, proportionate regulation which builds on that which already works.

To achieve this, AIFA welcomes the current debate on the purpose of regulation, and hopes that a revised regulatory structure, and the supervision within that structure, will result in better consumer outcomes.

We believe the opportunity to develop a regulatory regime, which facilitates the provision of independent, impartial advice to consumers, is vital. The need for access to advice is currently magnified by the increased need for people to save for a longer retirement, against a background of decline in company pensions—and state benefits that are becoming less and less affordable.

At a time where consumer responsibility and the need for self-provision are so high on the political agenda, AIFA therefore feels it is appropriate that the overriding purpose of regulation is to encourage better access to more consumers, thus leading to better outcomes.

With a new government which intends to reform and improve financial regulation in the UK, this is a good opportunity to step back and ask some key questions:

- How can regulation most effectively promote and protect the interests of consumers?
- Knowing what we know now, how do we need to adjust the way that regulation works so that it has the best chance of meeting this objective?

In this paper we intend to propose the high level principles that are essential for good regulation, how FSA has failed in these principles in the past, and how they should best work with the newly proposed structure.

3. High Level Principles of Good Regulation

While AIFA welcomes the need for regulation, we also strongly believe that it must improve its effectiveness, and make absolutely clear its purpose. Constant regulatory flux deters financial investment in firms and weakens consumer trust in the sector. In some cases the implementation of the regulatory system actually threatens to undermine the existence of the market as a viable entity, restricting the ability of consumers to obtain the products and services that they need.

For the future, we have therefore identified six high-level principles that we believe should apply to the governance of regulation.

(a) Enables better outcomes for more consumers.

(b) Has the appropriate checks and balances in place to ensure accountability.

(c) Works in a proportionate and risk-based way.

(d) Changes less, with fewer "new ideas" and more consistency of delivery.

(e) Is cost effective.

(f) Takes into account the European dynamic at play.

These principles run the risk of looking so obvious that they could easily be dismissed out of hand.

But the point is that no matter how the principles are espoused: in practice, they have not been delivered—and that is what needs to be fixed by the new regulatory structure. In the absence of a strong and independent sanity check, all organisations tend towards self-preservation and self-justification, irrespective of the motivations of their founders. Regulation as operated by FSA is no different.

So the significance of these principles is that they need to be delivered. The success or failure of regulation in the future needs to be capable of being measured against these yardsticks.

(a) *Regulation must enable better outcomes for more consumers*

We believe in duality of regulation when it comes to consumers—not only must it protect them from unscrupulous market participants, but regulation must also facilitate more access to advice for consumers, particularly at this stage in the economic cycle.

But there is evidence to suggest that in recent years, UK regulatory practice has failed the consumer in a number of ways.

— It is has resulted in the number of people saving and investing to improve their financial future falling dramatically—complexity and rising regulatory costs under FSA have increased barriers to the supply of savings products. Meanwhile it has been far easier for consumers to obtain debt, due to relatively lax legislation in this area. Regulation has also increased the cost of advice, meaning large numbers of mid and low earners are effectively excluded from financial advice, since its provision has become uneconomic—without this advice people are more prone to get into debt than they are to save for their future.

— It has damaged consumer confidence in the financial system—since inception FSA has seen its primary role transform into "stopping bad things happening", which has had unhelpful consequences for the market. When working primarily from a definition of "bad", "good" has tended not to get promoted. FSA's public pronouncements have also tended to be about what's bad in the market: regulatory interventions, fines, criminal prosecutions—and even speeches (the infamous "be very afraid" speech by Hector Sants). By the time a consumer actually engages in the financial services market, all the procedures that have to be gone through, including large amounts of mandatory documentation, communicates one clear and consistent message: "this is a dangerous market". So although the purpose is to protect the consumer, the overriding focus on bad practice has given consumers a distorted impression of the market and reduced their confidence.

— Many of its efforts to promote public awareness have been ineffective—FSA's awareness objective was somehow converted into an overall drive towards giving consumers as much information as possible through lengthy disclosure documents. However there is little evidence that the majority of consumers—even sophisticated consumers—wish to be educated about the intricacies of financial products and services. And the actual effect of information overload is to produce less transparency and lower awareness because the consumer simply doesn't read it. Indeed FSA's own research into Financial Capability entitled "A Behavioural Economics Perspective" confirms that attempts to improve knowledge may not necessarily lead to better outcomes and "what people choose to know and what they do with their knowledge may primarily depend on their intrinsic psychological attributes". Consumers can therefore be given all the financial information in the world but if they do not trust the information or the person giving it to them, then the information is ultimately pointless. Hence whilst information is an important building block, "advice" is the essential "ingredient X" that makes all the difference. Because the information is delivered by a trusted source, the IFA, people have confidence to act on it. That is why financial advice has emerged over the last few decades as an important component of the market and as a useful behavioural "nudge" to push consumers in the right financial direction.

The new landscape

Given the current state of the UK market, the new regulator needs to address the wider public policy agenda in order to help consumers re-engage with their long term financial well-being and making more, and better, provision for themselves.

We need to see the next decade become focused on the "enfranchisement of savings" and a return to thrift and prudence—but regulation has a role to play in facilitating this journey. We also need to see consumers take on increased responsibility for their own financial future, as this will ultimately help yield the optimum outcomes for them.

We call for:

- CPMA to address the wider public policy agenda in terms of helping consumers re-engage with their long term financial well-being and making more, and better, provision for themselves.
- an additional statutory objective for the CPMA of restoring a savings culture to the UK.
- consumers to take on increased responsibility for their own financial future, as this will ultimately help yield the optimum outcomes for them.
- CPMA to increase access to financial advice for consumers.
- the new regime to make absolutely clear to consumers whether they are receiving truly independent advice or merely being sold a product.
- the introduction of a 15 year long stop to bring financial services into line with the Statute of Limitations.

(b) *Regulation must have appropriate checks and balances in place to ensure accountability*

In the past the system of accountability for the regulator has relied too heavily on internal self-assessment, with the result that there were no effective checks and balances in places.

Any future regulator should therefore be held far more tightly accountable to the delivery of their objectives in the most efficient and cost-effective way. We believe that the necessary degree of rigour can only be achieved by an independent body, external to the regulator.

This principle is derived from the single most important lesson learned from the history of regulation. There is no reason to believe that initial objectives, no matter how well-intentioned and well-articulated, will be achieved when a new system is established—unless there is a rigorous process in place to keep it aligned to those objectives.

There must also be a relationship of "legitimate expectation" between the regulator and regulated—this is when the principles of fairness and reasonableness are applied where a regulated firm has an expectation or interest in the regulator retaining a long-standing practice or keeping a promise.

Payment Protection Insurance (PPI) is a case in point. Whilst there is a clear an demonstrable issue from the consumer perspective, the regulator has not performed well as they have been retrospectively influenced by the actions of the Competition Commission and the Financial Ombudsman Service. Whilst issues surrounding PPI were well-known to everyone in the market, including the FSA, we saw little direct action taken. For the FSA to later turn around and attempt to retrospectively punish firms for carrying out the regulated activity which the FSA had itself permitted, reviewed and in some cases approved, is a breach of this legitimate expectation.

Further, when it comes to Judicial Reviews, we believe it should be the Treasury that bears the cost of action rather than forcing the industry to effectively pay twice, when they may well have a legitimate case against the regulator.

The new landscape

We call for:

- any future regulator to be held far more tightly accountable to the delivery of their objectives in the most efficient and cost-effective way;
- a greater role for the National Audit Office (NAO) and Public Accounts Committee in reviewing the new regulatory structures;
- a wider role for the Treasury Select Committee to play in scrutinising the entire regulatory architecture;
- the continuation and strengthening of the role and powers of the three "consultative panels" including new statutory footing for the Small Business Practitioner Panel. Also deeper engagement from the panels with the industry to ensure they fully understand the effects of the regulator's policies on the industry and in turn, consumers;
- a role for a "consumer champion", that is separate from the CPMA. We believe there may be merit in considering the DG SANCO approach, the consumer directorate in the EU;
- the continuation of the Regulatory Decisions Committee (RDC) in the new structure;
- the publication of Board minutes as a means of deepening accountability and transparency;
- the further proposed mechanisms to be set out in statute, notably:
  - a requirement to produce an annual report to be laid before Parliament by the Treasury;
  - a requirement to hold annual public meetings;
  - a duty to establish consultative panels;
  - a duty to maintain a complaints mechanism similar to that required of FSA; and

— decisions to be subject to appeals in the Upper Tribunal, and where appropriate reviews and inquiries.

(c) *Regulation must be proportionate and risk-based*

Regulation must be proportionate as well as focused on those aspects of the financial services industry that pose the greatest risk to the economy.

However this has certainly not been the case under the FSA who, in order to avoid criticism, have tended to pursue actions in recent years that appear to be "bomb-proof". But this is a classic case of the "perfect" being the enemy of the "good". In its pursuit of "perfect" regulation over "good" regulation, it has actually had the detrimental effect of limiting access to financial services products when in fact the absence of them is much more likely to generate hardship.

The result of FSA's approach has been that IFA firms, who pose no systemic risk to the economy, and are working in the best interests of their clients, have been at the receiving end of FSA's intrusive supervision to a far greater extent than large banking institutions at the other end of the "risk" scale. To put this into context, one of our members, a medium-sized provider of independent advice, which has never been fined or sanctioned by the regulator in any way, was the recipient of three intrusive and formal "ARROW" visits by the regulator over a period of four years. During the same period, immediately prior to its demise, Northern Rock had none.

This example reflects the way that regulation is often administered in the market: organisations that are large and complex require the existence of people within the regulators who are capable of dealing with them. The majority of the people who work within the regulator will naturally use their energy dealing with issues within their comfort zone. While this is human nature, an undue degree of attention on relatively small firms is bad regulation and damages the market.

The new landscape

We call for:

— the new regulators to focus on those aspects of the financial services industry that pose the greatest risk—a continuation of the "follow the money" approach being undertaken by FSA at present and not just "point of sale" regulation, as per FSA's Retail Conduct Strategy;

— regulation to not be applied to adjacent markets without due consideration being undertaken;

— well-managed firms, which treat their customers fairly, to be given regulatory incentives for doing so, and it should be these firms that benefit from regulatory change; and

— The publication of a "regulatory dashboard" so firms can be sure of accessing dividends in their regulatory journey, and making any changes appropriate for their business.

We propose three types of dividend are adopted by the CPMA:

— Regulatory fees—the new fee system should favour firms that have invested in compliance and management ability and so pose lower regulatory risks to CPMA or their client base. It is our contention that well run firms that take their regulatory and corporate responsibilities seriously should attract regulatory dividends through lower regulatory fees.

— Regulatory capital—we think there is a prima facie case for the new regulator to tier its regulatory capital requirements based on a firm's compliance record—and other behavioural indicators. The information that is currently collected through firm reporting and within FSA risk profile methodology should be intelligently used to tier firms' capital requirement. This would see a tangible reward for better run, lower risk, firms.

— Supervision—intelligent use of the regulator's data should be deployed to recognise those firms that pose lower risks than others. This would see low risk firms subject to less intensive scrutiny.

These are only examples of how the new regulator could seek to incite positive behaviour. They would provide a clear demonstration of a regulator that wishes to work with the sector to bring about consumer benefit—and this would be welcomed by all participants. We would be happy to assist in developing this proposal further.

(d) *Regulation must change less, with fewer "new ideas" and more consistency of delivery*

For market regulation to be effective, it needs to meet the following criteria:

— The participants of the market need to know what is permitted and what is not, so that they can get on with doing their jobs with confidence;

— Regulation needs to be applied consistently across the market in order to avoid arbitrage;

— Regulation needs to be applied reasonably consistently over time; and

— The different parts of the regulatory structure need to act congruently.

However there is little evidence of such consistency from the FSA. Although the history of regulation under FSA has been relatively short, there have already been a considerable number of waves of different requirements with the result that a degree of regulatory fatigue has set in. The costs of coping with FSA regulation keep rising, and the combined effect of this and fatigue is to drive members of the market out—to the detriment of consumers.

The full FSA rulebook is a large document written in language that is difficult to comprehend: as a result there is a new industry of expensive compliance experts who do their best to interpret what they think the rules mean. At the same time the regulators apply principles, most notably "Treating Customers Fairly", that while sounding perfectly reasonable, are vague and open-ended. The result is that those being regulated do not know how to behave, and live in fear of unintentionally putting a step wrong.

Over time, generations of management at the FSA have taken different positions, meaning that practical agreements about how the rules are to be implemented often change when the management team changes. Our members also report that the messages they receive from different parts of the regulator—whether the policy team, supervision team or the enforcement teams—are often highly inconsistent.

An example of regulatory inconsistency is FSA's "Make a Real Difference" (MARD) initiative, a £50 million initiative which aimed to improve the effectiveness, skill and attitude of FSA staff and support the shift to more principles based regulation. However MARD was effectively abandoned, yet the industry have been paying for it for at a cost of £5 million a year since 2007, and will continue to pay £5 million a year for the next seven years, with little or no identifiable benefit.

The new landscape

At this stage a radical change of direction, or complete rewrite of the rulebook, would be both unwelcome and counterproductive. However we do believe that there is considerable scope for improvement in how regulation is implemented.

Below sets out how we believe the new regulatory landscape can address the problems outlined above, while ensuring consistency of delivery in the new regulatory structure.

We call for:

- — close and continuous co-operation between the newly formed statutory bodies and the FPC to ensure consistency of delivery;
- — clear objectives of the individual regulators which fit logically together. History has shown us that failures happen when there are gaps in regulatory oversight, when regulators fail to co-operate or when they fail properly to fulfil their obligations;
- — each of the three regulatory bodies to formally benefit from each other's objectives as specified secondary objectives, rather than just as "have regards to";
- — a college of supervisors as the best method for cross-body cooperation, coordination and control;
- — a higher standard of staff as well as more joined up working from the policy, supervision and enforcement teams; and
- — financial rewards for staff based on long-term outcomes and visible success measures of policy initiatives.

(e) *Regulation must be cost effective*

It is essential that the regulator use its resources in the most cost effective and economic way, in order to deliver the best possible value for money. This value for money must be both in terms of the industry and ultimately consumers who are the ones who will end up bearing the cost of increased regulation through higher product and advice charges.

By definition, consumers will not be able to obtain the products and services they need if the provision of those services is eliminated or made expensive by the actions of the regulators. Yet that is exactly what has been happening under FSA.

As we have stated previously the complexity and ever rising regulatory costs under FSA meant the cost of advice was also forced to rise rapidly, meaning large numbers of mid and low earners became effectively excluded from accessing independent financial advice, since its provision became uneconomic.

IFA firms bear a disproportionate brunt of the rising fees, especially considering they pose little or no systemic risk to the economy, are the lowest causes of complaints to the Financial Ombudsman service, and are consistently found to be the most trusted part of the financial services sector, as evidenced by the independent annual "trust index", carried out by the University of Nottingham Business School.

Example of regulatory costs:

Below are just a handful of examples of the cost burden of regulation faced by IFA firms under FSA's regulatory regime.

Example one:

A large IFA network puts the cost of regulation at the equivalent of 20–25% of their turnover.

Example two:

A mid-size IFA firm, made up of 27 advisers, faced regulatory costs this year of approximately £430,000. This was made up of the following:

FSA fees	£ 83,000
Compliance	£196,000
Finance	£ 24,000
MD	£ 17,000
Professional indemnity insurance	£110,000
TOTAL	£430,000

This means the average cost per adviser for the year was almost £16,000.

This overall cost of regulation to the firm is five times the direct cost of FSA fees—given FSA directly costs the industry £450 million, it must therefore indirectly cost the industry in the region of £2.25 billion.

Example 3:

During the financial year 2009–10 one of our sole trader members spent £1,948.59 on FSA fees and levies, broken down in the following way:

Financial Services Authority Periodic Fee	£ 925.00
Financial Capability Periodic Fee	£ 10.00
Financial Services Compensation Scheme Levy	£ 978.59
Financial Ombudsman Service Levy	£ 35.00
TOTAL	£1,948.59

However he spent £8,772 in cash terms on regulation, over 4.5 times the direct cost of FSA fees. This is another indication of how regulatory costs go much wider than just fees.

Example 4:

A mortgage intermediary member put the cost of compliance alone last year (including people, systems, PI insurance) at £150,000, which was approximately 7% of their gross revenues. On a per case basis they calculated this as a cost of about £50 per mortgage transaction.

It is also worth pointing out that the true cost of regulation to all of these firms currently increases with experience—the lack of a long stop for the industry means that businesses, especially the smaller ones, have the burden of making provision within their accounts for the increasing risk of complaints as well as the proposed increases to capital-adequacy provisions.

IFA firms would not be so exasperated about regulatory costs if they felt FSA had been putting this money to good use, and there were clear benefits to be gained from the money spent. However many of FSA's Cost Benefit Analysis were seen as "highly questionable". Post Implementation Reviews also do not provide proof of value, or evidence of the policy being successfully delivered.

The RDR is a case in point with its estimated £1.7 billion cost out of kilter with the benefits which will be judged with hindsight. Latest figures from FSA suggest this initiative will target just 48,000 advisers across the broad industry, equating to the equivalent of over £35,000 per adviser in costs. This is surely not cost effective regulation.

Another good example is FSA's initiative "Make a real difference" (MARD) initiative, referred to earlier in this paper. Again this was an initiative that was effectively abandoned by FSA, but one which the industry are still paying for at a cost of £5 million a year for 10 years, with little or no identifiable benefit. Other examples of these ongoing costs include Treating Customers Fairly (TCF), More Principles Based Regulation (MPBR), the Enhanced Supervision Strategy, and the ARROW framework.

The regulation of the mortgage industry proves further evidence of increased regulatory costs under FSA. In 2004, the Mortgage Code Compliance Board (MCCB)—FSA's predecessor in terms of mortgage regulation—covered 10,388 intermediary firms, comprising 38,147 sales staff, in addition to having responsibility for monitoring the activities of 156 lenders. The incurred cost of this operation was £4 million.

Fast forward to 2010 when FSA is now responsible for the mortgage regulation, and the costs have skyrocketed to £24 million, of which £14.4 million is paid directly by intermediaries, despite the number of regulated firms dropping to just 5,477.

The new landscape

Going forward we therefore wish to see the following from the new regulator:

- there must always be an identifiable market failure, and a cost/benefit analysis undertaken, before regulatory action is considered;
- any new regulatory interventions need to be subject to the highest levels of public scrutiny—and their benefits clearly articulated and measured; and
- CPMA's policy in setting fees should be risk-based. We would also encourage CPMA to use the tools at its disposal to reward firms that invest in their business and its people eg through regulatory dividends.

It is also worth pointing out that we are very concerned by the overall cost of the proposed new regulatory structures—£50 million as a transitional budget is potentially insufficient, yet still a considerable further sum to the industry.

Whilst many other Government funded regulators are facing substantial cost pressure, the industry funded FSA is not and this needs to be considered carefully. IFA firms are already facing a barrage of costs due to regulatory changes in 2012, and we therefore call on Treasury to carefully consider all aspects of the costs of any changes, as well appropriate weighting towards different parts of the financial services sector; the cost of the RDR alone is equivalent to over £35,000 per "adviser" in the UK.

AIFA would also like to continue the debate relating to the cost allocation model within the CPMA structure. AIFA has engaged heavily with FSA over recent months on this issue, including substantial work with external consultants. We feel that there are more appropriate allocation methods for the cost of regulation, and would welcome the opportunity to consider this further in light of the revised regulatory structures when they are confirmed.

(f) *Regulation must take into account the European dynamic at play*

Increasing amounts of financial regulation are now emanating from Europe, and it is therefore crucial that the UK is best placed to achieve positive engagement on the continent in the coming years and ensure we remain a leading player, for the benefit of consumers.We also feel there is potentially much to be lost at a European level in the near future, as highlighted by Sharon Bowles' recent letter to Vince Cable, further highlighting the need for UK regulators to be fully cognisant of the European dynamic at play in the market.

The new landscape

AIFA continues to believe that European regulatory powers are not sufficiently addressed within the proposed new architecture, and that lead regulators may not be most appropriate.

Of most concern is the split between PRA and CPMA of the three new European Authorities. It is proposed that CPMA will lead on European Securities and Markets Authority (ESMA) related issues, whilst PRA will lead on European Banking Authority (EBA) and European Insurance and Occupational Pensions Authority (EIOPA) areas. The UK is therefore taking a vertical approach, in which the division of regulatory responsibilities is based on the type of institution.

However this does not tie in with the horizontal approach at the European level, whereby regulation is based on the type of product. Whilst work such as Basel III and Solvency II are addressed by EBA and EIOPA respectively, and therefore appropriately sit with the PRA, there are much wider streams of work which fit less well. IMD and the associated work of the PRIPs initiative is also part of EIOPA's work.

However, whilst PRIPs will impact the conduct of business practices of all firms engaged in providing "investment" advice in the UK to retail clients, the lead UK authority would be the PRA, not the CPMA. To have the prudential regulator as the lead authority on conduct of business related activity would seem wholly inappropriate.

We therefore call for:

- further consideration given to the lead authorities on prudential issues and conduct of business related activity; and
- enhanced co-operation between regulators at a European and international level. There has been some support for a more formal context for this co-operation, particularly for prudential matters, amongst our membership.

4. Delivery of Regulation—The Retail Distribution Review

The Retail Distribution Review (RDR) is a prime example of how FSA has failed in its delivery of regulatory policy. While AIFA supported the six original RDR objectives throughout the three year discussion period, we are highly sceptical that the final proposals will see these original outcomes ultimately delivered. This would be a wasted, not to mention highly expensive, opportunity.

(a) *Does the RDR enable better outcomes for more consumers?*

No. Indeed the RDR started from a point of aiming to achieve better outcomes for consumers, through increasing their confidence and trust in retail financial services, whilst also increasing consumer access to advice. These were all laudable aims and ones which the IFA profession were fully behind.

However over the three year consultation process FSA seem to have forgotten their original aims, to the point where they now seriously risk driving out good firms, increasing the costs of advice and reducing access to the financial services market for UK citizens. This will serve the regulator, industry and consumers badly and a generation will be robbed of the security of improved protection, savings and investments that professional, independent, financial advice can bring.

The RDR threatens to bring about consumer detriment in a number of different ways:

Access to advice

AIFA strongly supports the raising of professional standards, as a key element of retaining and building consumer trust in financial services. However, professional requirements do not necessarily mean traditional examinations, and more pragmatic and adviser-orientated solutions should be sort.

There is a danger that FSA's RDR qualification requirements, and in particular the 2012 deadline imposed for achieving them, may result in a significant number of advisers leaving the industry, thus decreasing consumer access to advice.

Indeed if there is a rush to implement the RDR, there could be a real danger of consumer detriment. Ernst & Young produced research showing that 30% of advisers would leave the sector as a result of a rushed implementation. If only 10% of advisers left, our figures show that:

- A drop of £650 million in long term business would result in just one year.
- £1.76 billion of net sales of OEICs and Unit Trusts would be lost.
- For individual pensions there would be a drop of around two million in policies with the result that pension benefits paid out would reduce by £4.4 billion.

A longer transitional period may be the answer to this, as may better vocational routes for advisers which are not currently available today.

Remuneration

We recognise that commission had a negative image in the past, which is why AIFA and our members have been completely behind the move to adviser charging, supporting it throughout the whole RDR process. In fact many of our members have been operating a fee based system for a considerable time.

However FSA's decision to ban the practice of "factoring" runs counter to the Government's desire to restore a regular savings culture in the UK which can be delivered by encouraging people to buy regular premium pensions. Factoring is the cost-effective way that consumers can receive impartial advice at outset, with the cost of advice split over a period. The removal of factoring will significantly impact any consumer seeking advice on regular premium accumulation products—such as pensions.

Consumer Trust

One of the main opportunities the RDR has to restore consumer trust was to create a market which has the fewest possible divisions, builds on consumer understanding of simple words like "advice" and which throws open the doors to market improvement. This improvement is essential, for, as the FS Consumer Panel stated:

> "The current advice landscape is characterised by confusion and negative emotions. The RDR proposals should reduce distrust and confusion in the advice market and in theory may enhance the propensity of consumers to seek advice."

Consumers therefore need to be absolutely clear as to whether they are receiving "advice" or being "sold" a product. AIFA believes that the benefits to the consumer in offering absolute clarity of whether a firm is the "agent of the client" or "agent of the provider" will go a long way to restoring trust in the sector. Unclear motivations have damaged trust in the past, and the RDR could have been the opportunity to restore trust through the distinction afforded by those working for the client without potential conflict of interest. We believe this clarity is fundamental to the success of the RDR.

However while FSA recognised this clear distinction between advice and sales in its Interim Report, it has since shied away from this stance following pressure from the banking community. Instead there will now be a distinction between independent advice, which is unbiased and unrestricted, and "advice" that does not meet these requirements and is therefore restricted (more appropriately labelled "sales").

Whilst those offering restricted "advice" will have to make this clear in written and oral disclosure, it is highly disappointing that FSA decided not to enforce a specific set of words to ensure consistency across the market. As a result, this does nothing to help consumers understand the motivations of those purporting to give "advice". We believe this is a missed opportunity to create real clarity in the market place for consumers.

(b) Are there appropriate checks and balances in place to ensure accountability?

No. While the three FSA Consultative Panels fed into the RDR debate, and gave feedback to FSA on its proposals, these views were often overlooked. The Financial Services Consumer Panel (FSCP) in particular strongly recommended that FSA make a strong distinction between sales and advice to make it easy for consumers to distinguish services offered by IFAs and those from paid salesmen from financial services providers. FSCP chairman at the time, Lord Lipsey, strongly criticised the distinction proposed by the FSA as "devoid of meaning" and "nonsense language". His successor Adam Phillips also shared a similar view which he publicly expressed to FSA. However this appeared to have little effect on FSA's thinking in this area.

It is also only now, at this late stage in the process when the final rules have been decided, that the proposals are being scrutinised by MPs in Parliament, via the Treasury Select, the recent Westminster Hall debate, and plans for a backbench debate in the Commons. This parliamentary scrutiny should have happened much earlier in the process in order to fully hold FSA to account in this area.

While we welcome the commitment by FSA for a post implementation review of the RDR, it will not necessarily provide proof of value, or evidence of the policy being successfully delivered. We would rather see increased access to independent advice as a metric to measure the RDR's success—if access to advice decreases it would bring consumer detriment. Latest figures from FSA suggest this initiative will target just 48,000 advisers across the broad industry. This equates to the equivalent of over £35,000 per adviser in costs.

(c) *Does the RDR work in a proportionate and risk-based way?*

No. The wider economic situation has changed dramatically since the RDR started which FSA failed to recognise accordingly in its proposals. IFA firms were not the cause of the crisis and have weathered the storm in good shape. However, firms do not have the financial base that they had at the start of the RDR and FSA should have recognised this in any new regulatory intervention.

Change is expensive and change on this scale, and during these economic conditions, demands the co-operation of the regulatory authorities with the industry. The RDR was a prime opportunity for FSA to seek to incite positive behaviour through providing "regulatory incentives and dividends" for firms who invested in their business and people to deliver the RDR outcomes. Indeed at the start of the RDR, FSA discussed ways of doing this which included statements in DP07/01 such as "well-managed firms, which treat their customers fairly, should be given regulatory incentives for doing so, and it should be these firms that benefit from regulatory change", and that "Firms with good market practice would receive a regulatory dividend but those with riskier market practice would need additional FSA supervision".

This was echoed by the RDR Sustainability Group who recommended that "…there should be a regulatory dividend for having robust management, systems and controls". There was a recognition that firms would need to invest in their people, and may need to change their business models, if the RDR's objectives were to be seen through. AIFA welcomed this regulatory support and proposed a "regulatory dashboard" which could be published so firms could be sure of accessing dividends in their regulatory journey, and making any changes appropriate for their business.

However the impact of the banking crisis saw the notion of dividends removed, which we believe was an unfair response given that IFA firms did not cause the crisis. The new regulator should offer lower fees for firms that invest in developing their people, compliance and management, which then lowers the risk factor. Lower risk should bring less intensive regulatory burdens commensurate with the lower risk posed.

Given the wider state of the economy, there was also a prima facie case for FSA to tier its regulatory capital requirements based on a firm's compliance record—and other behavioural indicators. The information collected within FSA risk profile methodology could have been used intelligently used to tier firms' capital requirement. That would see a tangible reward for better run, lower risk, firms.

(d) *Has the RDR been consistently delivered?*

No. Throughout the entire RDR process there have been numerous U turns, and changes of heart by the regulator. The labelling issue is a prime example. In the initial RDR paper, FSA proposed three different labels for advice—"professional financial planning", "general financial advice", and "primary advice". By the time of the Interim Report this had changed to a single tier professional advice sector in which advice offered must be whole of market, independent advice. The sales regime had to be strictly non-advised and labelled as such. A few months later this had changed again, with FSA proposing a muddy landscape of "independent advice", "sales advice" and "guided sales". By the time of the Policy Statement last year, these labels changed yet again, divided down by "Independent advice", "restricted advice", "simplified advice" and "basic advice". FSA's proposals for remuneration structures, professionalism and qualifications have also changed numerous times over the three year consultation period.

The number of personnel changes within the RDR team has undoubtedly not helped this inconsistency. Whilst a degree of turn-over is expected, and should be planned for, the wholesale changes within the RDR team have contributed to mixed messages being communicated to the industry and a number of policy misalignments and re-prioritisations. The new regulator should learn from this experience and projects

should either be shorter—or teams and individuals should be expected to stay the course (ie not moved internally). This is not a comment on the competence or professionalism of the individuals concerned but a statement about a better way of working.

(e) *Is the RDR cost effective?*

No. The intermediary market could be hit with costs of more than £1.7 billion as a result of the RDR, which is out of kilter with the benefits which will be judged with hindsight. Indeed the publication of FSA's Cost/Benefit Analysis on the RDR drew widespread criticism for its lack of depth and failure to grasp the true costs of change for firms. The costs will have a major impact on firms without delivering genuine consumer benefit which was the original objective of the RDR. These additional costs to firms also come at a time of difficult trading conditions, with firms being required to hold more capital and pay higher regulatory fees.

(f) *Does the RDR take into account the European dynamic at play?*

Again the answer is no. IMD, PRIPS and MIFID are all due to be published by the European Commission in the next three months, and all will have huge ramifications for the market. However FSA has failed to take account of the impact of these pieces of legislation on the intermediary market, and how in turn the various streams of the RDR will thus be affected.

3 November 2010

Supplementary written evidence submitted by the Financial Ombudsman Service

1. Natalie Ceeney, Chief Executive and Chief Ombudsman at the Financial Ombudsman Service, and Tony Boorman, Principal Ombudsman and Decisions Director at the service, appeared before the Committee on Thursday 14 October 2010. At that session, the Committee asked for supplementary information in four areas:

(a) the compliance costs for industry of handling complaints;

(b) the relationship between the number of consumer enquiries received and the number of full-blown cases investigated, and our views on whether consumers should be charged a fee for using the service;

(c) a breakdown of where in the United Kingdom cases come from, with data on the service's accessibility for different groups; and

(d) a view from the ombudsman service on the regulatory landscape and, in particular, the regulatory powers that the CPMA should have.

2. This supplementary memorandum provides further information on those four areas.

Complaint Handling Compliance Costs

3. The direct costs of the Financial Ombudsman Service are forecast to be £110 million in the current year. These costs are paid entirely by the financial services industry in the form of a levy and a case fee. In 2010–11 the levy paid by firms amounts to £18 million (which is equivalent to less than 3% of the total levy raised by the FSA to cover their costs and those of the FSCS, CFEB as well as our own). The case fee in the current year is £500 per case, and the first three cases a year for each financial business are free. In the previous financial year more than 95% of FSA regulated firms paid no case fees at all.

4. But, of course, these figures give a misleading impression of the total cost to the industry of handling complaints:

— Only a small proportion of complaints made to firms ever come to the ombudsman service. FSA figures show that firms received 4,344,109 complaints in the year to 30 June 2010. The number of cases received by the ombudsman service was under 4% of this number—163,012 in the last financial year.

— In around half the cases we investigate we award redress to the consumer which may range from a modest amount up to (in a few cases) the maximum of £100,000 that we have power to award—although the majority of awards are at the lower end of that spectrum.

— If they are doing their job properly, firms should take account of ombudsman decisions in previous cases when dealing with other complaints they receive, so ombudsman decisions may have an impact on many other cases which never get us far as the ombudsman service.

5. However, it would be wrong to regard the cost to the industry of handling complaints, whether they come to us or not, as “compliance” costs—as if they were something imposed on them from outside. A proportion of complaints are, of course, vexatious. But many complaints refer to things the firm should never have been doing in the first place, either because it was in conflict with the financial business’s legal or regulatory responsibilities or because it was against any basic principle of customer service. The redress we award is usually intended simply to put the customer back in the position they should have been in the first place.

6. The rules about how firms handle complaints from consumers, and the wider handbook of rules and regulatory requirements, are determined by the FSA. Those rules are set by the FSA following consultation and cost benefit analysis. Our own responsibilities under the Financial Services and Markets Act are focused on resolving promptly and with a minimum of formality those individual complaints that are referred to us by consumers. In this evidence, however, we have looked across the whole system, working from the basis of our own experience in resolving individual complaints.

7. A critical part of our work is feeding back to regulators, firms and customer groups the experience we have gathered from complaints about how problems can occur in financial services and how complaints can be handled fairly. We work closely with firms and customer representatives to ensure that our decisions have the intended impact and that there is an opportunity for similar problems to be avoided in future. This does give us some influence over the total costs of complaint handling, and an opportunity to help firms to reduce overall costs, and the industry improve overall customer satisfaction.

8. The following paragraphs look at the six main drivers of the cost of complaint handling for firms in more detail, together with the steps we are taking to help eradicate unnecessary costs.

Cost driver 1: How well is the underlying business managed?

9. As noted above, complaints are an indication that something has gone wrong in the firm. Data recently published by the FSA has shown that the volume of complaints varies significantly from firm to firm in a way that is not readily explained simply by the relative scale of the businesses concerned. In our experience, well managed firms that focus on responding to the needs of their customers experience few complaints. In contrast, where a firm generates large volumes of complaints, there are normally underlying problems with the way in which its customer functions and/or products have been managed.

10. While it might seem obvious to most that poor management of a firm costs that firm money, it is disappointing that some firms see complaints as an unwelcome business cost rather than an indicator of where business improvement is needed. It would be wrong, therefore, to see the costs of complaint handling within firms as a “compliance burden”—it has to be seen as part of the customer service cost of running an effective organisation, and a potential differentiator of good service.

Cost driver 2: How do firms treat complaints?

11. The Financial Ombudsman Service sees a wide variation in the way financial services firms treat complaints. Some see complaints as an ‘insight’ that indicates areas for business improvement and provides an opportunity to engage positively with their customers. Others see complaints as a regulatory compliance cost. However, the evidence shows that good complaint-handling pays dividends for businesses. The TARP (Technical Assistance Research Project), for example, found that customers who complain and who are subsequently satisfied are 8% more loyal than if they had no problem at all. So the costs of effective complaint handling may actually produce a positive return for firms.

12. We work with firms of all sizes across the financial services sector to help get this message across, and we also publish data to show firms the differences between good and poor levels of complaints referred to us. Positively, we are already seeing firms changing their practice to deal with complaints more swiftly, which not only lowers their costs, but is far more likely to retain the loyalty of that customer.

Cost driver 3: Customer reactions and claims management companies

13. Of course, complaining is about the reaction of a customer to the actions of the firm. In our experience, most customers try to avoid complaining. Indeed raising a “formal complaint” against a large financial institution can be a daunting experience even for the most capable of customers. One of our key objectives is to ensure that our service is accessible to all customers that need it. But, of course, there are a small minority of customers who raise vexatious disputes. The ombudsman service dismisses these promptly. Similarly, we have a front-line contact centre which is expected to deal with around one million customer contacts this year, which allows us to give many consumers the information that they need on the phone, without needing to take their issue further into a formal complaint. Our goal is to only take on cases where there is a genuine dispute to be resolved.

14. The past decade has seen the growth of claims management companies (CMCs)—businesses who take on complaints for customers in exchange for a fee paid by the customer. The service we provide is informal and accessible, designed to ensure that consumers do not actually need assistance from third parties, such as CMCs. CMCs can drive perceptions of a "compensation culture", encourage vexatious or unnecessary complaints, and add unnecessarily to the costs of both customers and firms by the antagonistic way in which some pursue complaints. But CMCs can also provide a helpful service for some customers who feel unable (perhaps because of time constraints, or lack of confidence) to raise a complaint against a financial firm. And CMCs, through their marketing, can help draw customers' attention to cases of widespread detriment and customer concern.

15. There is clear concern within the financial services industry that CMCs are adding to the total cost of complaint handling across the sector. Our view, from seeing the CMCs at close hand, is that, like any industry, there are good companies and poor companies in the sector. Poor CMCs are bringing the good ones into disrepute. Regulation of the CMCs is the responsibility of the Ministry of Justice, not of the Financial Ombudsman Service or the FSA. We believe that stronger and more effective regulation of the CMC sector would both reduce the total compliance costs and improve the experience for firms and consumers alike.

Cost Driver 4: the rules and requirements surrounding complaint handing

16. While complaints are an inevitability in any industry, every industry structures the rules for handling complaints differently. In the financial services sector, there is a formal approach, codified in the dispute resolution (DISP) section of the FSA Handbook, for the way in which firms need to handle complaints. The responsibility for making the complaint-handling rules and overseeing how firms operate them is that of the FSA.

17. Our view is that the financial services sector does appear to have become overly "rule bound". This is not just a regulatory issue though—we see cases where the firm will argue to us that "the rules didn't say that I couldn't do X". But sometimes X is clearly against the general law which applies alike to regulated firms and unregulated businesses, and often X is clearly against any basic principle of customer service. In the supermarket sector, for example, it would be considered ludicrous if Sir Terry Leahy considered it a regulatory burden that his staff had to deal with complaints that say his company's meat products kept going off, or if he were to question "where in the rules does it say meat needs to stay fresh?". He would of course do the reverse—fix the products, and do so without the need for regulatory intervention.

18. Inevitably, the rules-based culture endemic in the sector does create costs for all concerned. It allows poor customer service to be tolerated, where "compliance" and "rules" overtake common sense. Moving away from this culture requires a different mindset across the whole sector. If this shift could be made, it would both reduce costs and improve customer service.

Cost Driver 5: Costs of dealing with the Financial Ombudsman Service

19. Under the rules set by the FSA, financial firms have up to eight weeks to resolve their customer's complaint. Only if a firm has issued its final decision on a complaint (or has failed to do so within eight weeks) and the customer refers the matter to us, can the ombudsman service consider a complaint. So firms have an adequate opportunity to resolve matters without the need for the ombudsman to be involved.

20. There are two ways in which firms could reduce the number of complaints that come onto the ombudsman service. First, some firms—including some large groups (as our published data shows)—could change their practice whereby they reject significant numbers of cases that they know or should know the ombudsman service will uphold, presumably hoping that some consumers will just give up. Second, many firms are poor at explaining things—so that, in many of the cases where we do not uphold the complaint, it is only when the consumers get to the ombudsman service that they receive a clear explanation of why their complaint is misconceived.

21. If a complaint is referred to the ombudsman service the firm will, of course, incur some additional administrative costs. First, it will normally incur a case fee of £500 if it has already had three cases with the ombudsman service that year (the first three cases being free). In our last financial year, more than 95% of FSA-regulated firms paid no case fees to the ombudsman service at all. More than half of all the case fees were paid by just four of the UK's largest financial groups.

22. Second, the firm may incur some additional administrative costs of its own as a result of the need to respond to our investigations. But generally those costs should not be significant for a firm that has already complied with the FSA's requirement for it to carry out an adequate investigation of a complaint when it is first referred to the firm. Where the firm has done what FSA requires, it should usually have the information we need on hand in its complaint file.

23. Our costs are significantly lower than the costs of using the civil courts—as we explained in our evidence before the Committee. Importantly, we don't require lawyers to represent either consumers or firms, which reduces the total cost to firms compared to working with the courts. We do, particularly with smaller firms who are unused to using the ombudsman service, sometimes see firms expecting to engage with us in a very legalistic way, which incurs costs for the firm concerned. We are working across industry, and particularly with trade associations, to stress that firms do not need to do this, so that we can reduce their costs of engaging with us.

24. Sometimes, however, the firm's perception of the costs it needs to incur in handling complaints fairly is based on misapprehensions about the actual approach that the ombudsman service takes. Certain myths seem to persist and can shape perceptions of "compliance costs". For example, whilst it is not helpful if firms no longer have records of transactions, this is far from necessarily fatal to their ability to defend complaints about those sales.

25. We recognise that false perceptions of requirements can be a significant issue in shaping business costs. We therefore take considerable care to explain our decisions and "bust myths". We do this, for example, through our on-line technical resource which clarifies and illustrates our approach to the various types of complaint that we see most frequently (see: http://www.financial-ombudsman.org.uk/publications/technical.htm).

26. We acknowledge that the control of our direct costs is important for both firms and consumers. That is why we are mid way through an internal cost reduction programme and, among other things, why we have commissioned a value-for-money review by the National Audit Office.

Cost driver 6: Cost of redress

27. In around half of the cases we investigate, we award redress to the consumer, which may range from a modest amount up to (in a few cases) the maximum of £100,000 that we have power to award. The majority of awards are at the lower end of that spectrum—in PPI cases, for example, the average award is around £2,500. It is important to note that our awards are invariably intended simply to put the customer back into the position they would have been in but for the error by the financial firm. We do not "fine" or penalise financial firms, rather our awards are restorative.

28. A common concern we encounter from industry is that of 'back book liability' from a single ombudsman service decision. In short, firms can become concerned that a single ombudsman service decision will require them to review all of their sales practice or product in an area, with potentially significant costs. It is certainly true that, on occasion, we encounter cases which all stem from a single underlying issue—and where it would be sensible practice for the firm to learn from it, and apply the lessons from our decisions more widely. Typically this occurs in cases of systemic failure—as with mortgage endowments and PPI—where the regulator is normally heavily involved. So costs here might more accurately be seen as responding to such systemic failures and not around the cost of ombudsman decisions. But whilst they receive a great deal of attention, such circumstances are relatively rare. In the majority of cases, we are simply looking at the individual circumstances of the case, and our findings will have no bearing on the next case. We are working with trade associations and firms to explain this clearly as we believe it will help firms to reduce their concerns over the costs of redress.

What we are doing to help reduce the total cost burden

29. Since the ombudsman service was established, we have actively shared our knowledge and experience with the outside world—to help consumers and firms settle disputes without the need for our involvement, and to try to help prevent the need for complaints in the first place. Enhancing the transparency of our work can only assist firms and customers better understand the reality of what we do—and hence reduce the need for cases to be referred to us. As we said at the committee hearing, we believe that more transparency will help firms and consumers alike do even more to reduce complaint volumes, and to learn from the underlying issues—all of which will reduce costs.

30. We publish data about the volume and outcome of cases both by product type and by major firm. In addition to the on-line technical resource mentioned above our technical helpdesk handled over 16,000 queries last year in an effort to assist firms and customer advisors resolve cases without our formal involvement. We describe our general approach to topical and emerging issues through our ombudsman news publication, and by talking to individual firms and trade associations at meetings and seminars on a range of complaint related topics.

31. In respect of our own costs and plans we consult each year with key stakeholders about our plan and budget—describing our plans for the year and the costs that this will impose on firms. As mentioned above, we are actively looking at ways to reduce our costs and to improve our efficiency, and we have commissioned an external value-for-money study by the National Audit Office in order to provide assurance that our service is delivered efficiently and effectively.

Consumer Fees and Access

32. The Committee asked about the relationship between the number of consumer enquiries we receive and the number of full-blown cases we investigate, in the context of whether consumers should be charged a fee for using the service, together with a breakdown of where in the United Kingdom cases come from, with data on the service's accessibility for different groups. The Annex to this memorandum gives the statistical evidence requested, using data that is found in our *Annual Review* for 2009–10.

Accessibility

33. The data in the Annex shows that the consumers who used the ombudsman service in 2009–10 broadly reflected the distribution of the population across the UK, the proportion from minority ethnic backgrounds and the proportion with some form of disability. It also showed a steady socio-economic shift in consumers using the service, with a higher proportion now coming from semi-skilled or skilled (rather than professional or managerial) backgrounds. The data also showed that the age profile of users broadly reflected the ownership of financial products across the population. The Annex also explains how the number of complaints received by firms translates into the number of enquiries, investigations and ombudsman decisions that we handle—showing that the complaints we handle is a very small proportion of those that firms handle.

Free access for consumers

34. We believe that there is a strong case for continuing to provide free access to the ombudsman service for consumers. Accessibility to the service is fundamental to the objective of building confidence in the financial services sector. Requiring consumers to pay an up-front fee for using the service would be unlikely to deter the small number of vexatious consumers that approach the service (whose complaints we summarily dismiss in any case), but would instead be likely to deter consumers with financial hardship with more meritorious complaints.

35. In our experience, the charging structure that the ombudsman service has for many years adopted (primarily a case fee payable for the fourth and each subsequent case referred in relation to the financial firm and a levy payable by all firms by reference to size), has been generally supported by financial firms as a practical and fair means of recovering the service's costs. It is worth noting that the voluntary ombudsman schemes established by the banking and insurance industries before the Financial Ombudsman Service was set up adopted very similar fee structures and did not make any charge to consumers.

36. The suggestion of a fee or deposit payable by customers is made from time to time by some commentators—who suggest that it would deter vexatious or unnecessary complaints. We doubt that in practice this would be the impact. In our experience the determined complainant is unlikely to be deterred by a fee (after all far larger fees do not avoid vexatious litigants appearing in the courts). And the administration of small fees or deposits could add significantly to ombudsman service overheads. But, more significantly, a fee would detract from the assurance that the ombudsman service provides that if things go wrong there is an independent, accessible, impartial service that is free to customers and available to resolve complaints. It is a significant part of the recognition criteria adopted by the British and Irish Ombudsman Association that "those complaining to the Ombudsman should be entitled to do so free of charge".

37. In the particular circumstances of the financial services sector, consumer fees are likely to be a significant barrier for many consumers with meritorious cases, particularly those who are in financial hardship. Equally, just because some consumers pursue their complaint in an unfocused way that may seem unreasonable to a firm does not mean that the case has no merit—or that the complaint should be categorised as "vexatious". In fact, in 2009–10 we concluded that only 0.4% of our total caseload could be categorised in that way.

Mass Failings and Regulatory Powers

38. Inevitably many of the perceptions of the impact of the work of the ombudsman service have been set against the background of mass failings—complaint issues like mortgage endowments, splits and PPI. In these cases large volumes of complaints were made but regulatory solutions were, for whatever reason, slow to emerge. In such circumstances the ombudsman service has needed to continue to make decisions on complaints—decisions that some have seen as filling a regulatory vacuum. The absence of clear and effective mechanisms for regulators to handle these mass failings has led to particular pressures on the ombudsman service over the past decade.

39. So, in our view, a critical component of the regulatory structure going forward is that there are clear mechanisms for dealing with such cases in future. That would mean not only ensuring that the new regulator has an effective power to address "back book" issues (similar to the new-style s404 enacted in the Financial Services Act 2010), but also a wider armoury that delivers effective deterrence and credible redress promptly.

40. There is, of course, a wider public policy debate about the appropriate weight of the various checks and balances FSMA puts in place over regulatory decision making. But, from our perspective, the present system has been too slow to respond to developing pressures and has in consequence too often left the ombudsman service as the sole means of safeguarding customers when more concerted action on redress would have been appropriate. If those powers are not in place within the reformed system then the ombudsman service will need to continue to fill a policy and regulatory vacuum by resolving thousands of individual complaints on the basis of what is fair and reasonable in all the circumstances of the case.

41. The ombudsman service will continue to play an important role in this new architecture. Our ability to respond rapidly and fairly on individual complaints is a critical safeguard for customers—regardless of any wider background to their case. However, we recognise the wider benefits that can be achieved for all parties from broadly based regulatory settlements in areas of mass claims. The ombudsman service has been supportive of the new powers that the regulator has been given (Section 404) to enable the ombudsman

service to be positioned clearly in line with a regulatory decision on general redress. And we continue to work with the regulator and others to find solutions to systemic issues. But we would urge the Committee to resist any approaches that suggest that the ombudsman service automatically "put on hold" cases when there are in the view of some parties wider issues that should be explored. If the ombudsman service were required to put case handling "on hold" whilst systemic issues were investigated by regulators, the service would be paralysed across significant parts of its workload. The result would be significant consumer detriment. The answer to the issue of how we deal with systemic issues is for us to improve the regulatory architecture to enable swifter action, not to paralyse the body which is dealing with the consumer detriment in the meantime.

42.As we contended earlier, this set of regulatory powers should not be a regulatory armoury built around the need for an extensive rule-book. That simply encourages a "tick-box" compliance approach by many firms, and leads some firms to see treating customers fairly as a compliance issue rather than simple good business sense as in many other sectors of the economy. In our view, the regulator's armoury would be more effective if it were instead one which recognised that transparency can be a more powerful tool than traditional rules-based regulation—where both the successes and failings of firms are "out there" for all to see, and where both the regulator and ombudsman service can support good business behaviour by being given, and using, powers to be more open about things that they see.

43.Consistent with this, we continue to believe that the existence of an independent ombudsman service at arm's length from the regulator is an important way of ensuring proportionate and risk-based regulation. The regulator will be better able to focus on the key risks to consumers as long as there is an ombudsman service in the background that is capable of resolving the day-to-day disputes between firms and consumers that arise. To that extent the ombudsman service can, without itself being a regulator, provide an effective "nudge" towards fair and reasonable behaviour by firms without the attendant compliance costs.

Annex

The following tables give a breakdown of where the consumers who use the Financial Ombudsman Service come from and what groups they belong to, and give a breakdown of the outcomes of the inquiries that the service receives.

OVERVIEW OF CASES RECEIVED AND RESOLVED BY THE FINANCIAL OMBUDSMAN SERVICE

Case Handling Process	*Number in 2009–10*
Initial enquires and complaints from consumers handled by our Customer Contact Division	925,095
New cases referred to our adjudicators and ombudsmen for further dispute-resolution work	163,012
Total number of cases we resolved	166,321
Cases resolved through mediation, recommended settlements and adjudications	155,591
Cases resolved by our ombudsmen making formal decisions at the final "appeal" stage of our dispute-resolution process	10,730

Data published by the FSA show that financial firms received 4,344,109 complaints in the year to 30 June 2010—and these numbers do not include complaints which the firm is able to resolve by close of business on the next business day. The ombudsman service's processes are designed around the principle of "subsidiarity", whereby a complaint should best be resolved at the most local possible level—preferably by the firm itself direct with the consumer. For the small minority of complaints that ultimately reach the ombudsman service, we first "triage" them to see if they can be resolved quickly and without our formal involvement—or if they can be dismissed straight away as vexatious. This means that only around one is six of these enquiries need to be dealt with formally by the ombudsman service—using mediation, recommended settlements and adjudications as appropriate. And of those, only 6.5% in 2009–10 were "appealed" by either party to the final stage of our dispute-resolution process—a decision by an ombudsman.

WHERE DO CONSUMERS LIVE
WHO COMPLAIN TO US?

Region where consumers who complained in 2009–10 live	*%*
South East (Including Greater London)	29
Midlands	19
North West	12
South West	9
North East	9
Scotland	8
East Anglia	5
Wales	5
Northern Ireland	2
Living outside the UK	2

The location of people using the ombudsman service continues to broadly reflect the spread of the population across the UK as a whole—although a proportionately higher number of people from Wales and London used the service and fewer complaints came from Scotland and Yorkshire. There was generally a similar pattern of complaints across all areas of the UK, although a higher proportion of complaints from the North related to PPI than in the South.

WHAT WAS THE SOCIO-ECONOMIC BACKGROUND OF CONSUMERS
WHO COMPLAINED TO THE OMBUDSMAN SERVICE IN 2009–10?

Year ended 31 March	*AB professional and managerial*	*C1/C2 skilled and semi-skilled*	*DE unskilled*
2010	36%	57%	7%
2009	41%	53%	6%
2008	48%	47%	5%
2007	59%	36%	5%

There has been a steady socio-economic shift in the consumers using the ombudsman service. Over the last three years, the proportion of complaints from skilled and semi-skilled workers has risen by 21%, while those from professional and managerial backgrounds have decreased by 23%. We have seen a significant increase in complaints involving current accounts, overdrafts, credit and PPI—products which are held by a wide socio-economic range of consumers. Almost two thirds of complaints to the ombudsman service about PPI were from consumers in socio-economic groups C1 and C2.

BREAKDOWN OF THE 14% OF CONSUMERS WHOSE DISPUTES
WE SETTLED IN 2009–10 THAT HAVE TOLD US THEY HAVE
SOME FORM OF DISABILITY

Disabled consumers who complain to the ombudsman	*%*
Mobility difficulties	27
Arthritis and manual dexterity difficulties	16
Heart and circulatory problems (eg stroke)	10
Respiratory disease and breathing difficulties (eg asthma)	7
Mental health issues	6
Organ and nervous system disorders & disease (eg diabetes, MS)	6
Hearing impairment	4
Sight impairment	4
Learning difficulties (eg dyslexia)	2
Other	18

Being accessible is something the ombudsman service takes very seriously. A person's background or ability should not act as a barrier to having their complaint considered fairly and impartially. The 14% of consumers that told us that they have some form of disability is in line with estimated number of disabled people in the UK. Many of our disabled users do not ask for—or require—any adjustment in the way we deal with their case. But we ask all users when they first contact us whether they would like us to adapt the way we communicate with them, to meet any particular needs they may have. This might include providing information in, for example, Braille, large print, sign language recorded on DVD, or using Text Relay.

ETHNICITY OF OUR WEBSITE USERS IN 2009–10

What ethnic background are our website users?	%
White	81
Asian	8
Black	4
Chinese	1
Other	6

The proportion of people who brought complaints to the service and who defined themselves as belonging to a non-white ethnic group broadly reflected the figure for the population as a whole. However, our research shows that consumers from minority ethnic backgrounds are generally less likely to know about the ombudsman service, although this varies significantly between different communities. We have therefore focussed our outreach activity to reflect this, for example through our long-term relationships with ZEE magazine and Black History Month. We have also worked with the traveller and gypsy community, following complaints about the way in which firms require proof of address and identity. We have also seen similar issues in our work with the migrant worker community.

WHAT AGE WERE CONSUMERS WHO COMPLAINED TO THE OMBUDSMAN IN 2009–10?

Age of Consumer	%
Under 25	4
25–34	16
35–44	24
45–54	24
55–65	20
Over 65	12

Two thirds of consumers who use the service are between the age of 35 and 65. Around half the UK population is between these ages. This "over-representation" of people in the middle age brackets reflects the fact that they are more likely to own a wider range of financial products—and are also more likely to know about their consumer rights, including their right to complain to the ombudsman service. However, almost a quarter of complaints during the year about investments were brought by consumers over 65. And consumers under 25 were proportionately up to three times more likely to complain to us about car or motorbike insurance compared with all other age groups.

Written evidence submitted by the City of London Police

Introduction

1. The City of London Police (CoLP) has led the delivery of the National Lead Force (NLF) and National Fraud Intelligence Bureau (NFIB) since 2008. Prior to this, the City Police had been designated lead force for fraud for London and the South East since 2003. These fraud functions come together as the Force's Economic Crime Directorate (ECD).

The National Lead Force (NLF)

2. The NLF provides specialist advice on law enforcement dealing with often highly complicated and detailed criminality. Its objectives are to provide advice to all police forces, industry investigators and other law enforcement agencies to disseminate best practice, deliver training and act in an independent advisory capacity to other forces on request. The Lead Force provides a national investigative capacity to deal with all types of fraud (subject to agreed case acceptance criteria) and to assist other forces in local investigations and acts as a single point of contact for anti fraud advice.

The National Fraud Intelligence Bureau (NFIB)

3. The National Fraud Intelligence Bureau (NFIB) was created to help UK law enforcement agencies and their partners catch and disrupt criminals and to alert communities to threats from fraud. The Bureau gathers a large volume of information on suspected fraud much of which is not reported to or made routinely accessible to the police. This is analysed and turned into intelligence such as the identification of the scale of fraudsters' criminal activities. The intelligence is then used to support law enforcement operations.

Working with Other Agencies

4. Although the deployment of the NLF is subject to agreed case acceptance criteria, in practice there is a lack of clarity over referrals with the result that overlap occurs with other agencies responsible for the investigation and prosecution of economic crime. The need to overhaul structures gives rise to a question of whether the existing architecture should be remodelled, or whether doing so would unnecessarily compromise arrangements which have been shown to work. The NLF/NFIB model has been shown to be effective in providing a delivery arm for other agencies.

The City of London Police's Capabilities in Dealing with Economic Crime

5. The cost-benefit ratio of CoLP's capability has, arguably, never been more apparent or more important. A wide range of policing resources each with expertise in their given area is available to the Economic Crime Directorate of CoLP.[55] This feature, combined with established experience in general fraud investigation, allows CoLP to undertake a wide-range of investigations, invariably requiring methods and bringing skills, knowledge and experience which are often beyond the cumulative capability of other agencies.

6. More specifically, CoLP is the UK lead for delivering and managing covert investigations linked to financial crime. This includes possessing an independent infrastructure to both authorise and review covert activity in line with current legislation, an ability recognised by partners, which leads to regular requests for assistance from overseas law enforcement agencies.

7. Intrinsically linked to this is CoLP's expertise and existing infrastructure for dealing with duty of care issues for victims and witnesses, including when required complex witness protection issues. CoLP has already adopted ACPO best practice guidelines, so as to manage and disseminate products which are linked to either confidential or sensitive intelligence sources.

8. CoLP has pioneered the management of mass-victim cases. The processes and relationships developed to deal with often hundreds of victims within one case, have taken considerable time, experience and trust to develop. The techniques now regularly used for mass marketing investigations and other types of investment fraud are now being recognised as national, and in some cases, international, best practice for victim care and management. These relationships have flourished and reflect the Force's long experience of fraud investigation and its history of partnership working.

9. The Force's reputation is an essential ingredient of the Force's ongoing operational success. The willingness of other agencies, both private and public sector, to engage with CoLP across its range of operational and strategic activities is a significant enabler for the Force's joint operations and prevention work.

10. CoLP has well established working practices with the Bank of England, central to the work of the Force in terms of both economic crime and security functions, along with its strong relations with colleagues in the Security Services. The Force has built on established relationships within the UK and internationally to enhance its effectiveness with the US Federal Bureau of Investigation (FBI), US Immigration and Customs Enforcement (ICE), the Spanish National Police, the German Federal Police, the Royal Canadian Mounted Police (RCMP), the Australian Federal Police, Interpol and Europol. Other parts of the Force also contribute to the delivery of National Lead Force and National Fraud Intelligence Bureau functions. by providing supporting services.

11. Progress since the establishment of the lead force arrangements in 2008 has been rapid, with over 600 investigations currently underway dealing with financial crime involving assets valued at over £5.2 billion.[56] A total of 603 suspects are linked to current ECD investigations of which 338 are on police bail, 129 have been interviewed under caution (but not arrested) and 68 are wanted/missing. There are 32 defendants wanted on warrant and a new process has been completed to assign responsibility to ensure these are monitored and actioned. 188 defendants have been charged and are awaiting prosecution. The detection rate is currently 80%. The total number of victims linked to ECD investigations is 3,080.

12. The CoLP has an established reputation within the Criminal Justice System, especially among defence counsel. It utilises a tried and tested case management system which is supported by a dedicated and effective team, with an over-arching CPS unit. This is undoubtedly a direct contributor towards a conviction rate of 85% for CoLP's Economic Crime Directorate.

13. Until recently, the true extent of fraud was not visible to the police or public despite accurate data being held by numerous parties outside the police service. This situation prevented the police and public from seeing the true extent of fraud and making appropriate judgements on how to deal with it. CoLP adopted a different approach by securing agreements with partners to allow their data to be fed legally, securely and automatically into the NFIB. Working with partners, CoLP has built "Know Fraud" (probably the most sophisticated police intelligence system in the world), which is able to analyse millions of records to identify crime networks.

[55] An annualised estimation of the value of these services is indicated in the Annex.
[56] ECD Monthly Performance Report, September 2010.

14. NFIB allows the police and others to see for the first time, crimes, and the organised criminals who perpetrate them along with the thousands of victims who suffer as a result. It has enabled law enforcement bodies across the UK to arrest criminal groups which had previously escaped the attention of the police because crimes were not reported or shared with the police. The Force's Economic Crime Directorate has the ownership of and resultant responsibility for the management of the serious organised crime threat in relation to non-fiscal fraud (including money laundering) on behalf of the Organised Crime Coordination Centre (led by the Home Office). Currently, this stands at approximately one hundred and fifty organised crime groups across the country.

15. The CoLP has an international brand and an established track record of delivery, leading and supporting complex investigations, and looking after the needs of victims. Its geographical placement within a global financial centre enables the force to continue to build and extend the reach of NLF and NFIB by conducting further major cross border investigations against serious organised crime groups of which those with Northumbria Police and the FSA and West Midlands Police are current examples.

16. In performing its role as NLF, the City provides support and leadership to local forces in their counter-fraud work. In most cases, smaller scale local frauds are remitted back to local forces to act as the lead enforcement agency. This maintains local democratic accountability but with the reassurance that forces are able to draw on without recharge, the wider resources of the force that are required to support NLF investigations and the continued development of NFIB. In addition, many operations on larger frauds continue to involve local forces.

NLF and NFIB as Part of a New Agency

17. It is possible at least in theory to consider the possibility of extracting the economic crime functions from the City police and placing them in a new Agency. But in practice it is likely such a move would be hightly disruptive both to the contiued smooth running of those functions, and also to the City of London Police whIch would become a "residual" force. Stakeholders that supply CoLP with fraud data for the NFIB do so under legal agreements that took two years to negotiate and may not be transferable. Loss of these agreements would prevent the NFIB from operating, thereby denying the police and public access to vital data on criminals and victims that has taken so long for the police to acquire. Continuation of the existing financial and related support currently provided to CoLP by the City of London Corporation could not be assumed.

18. But more than these concerns, uprooting arrangements which have been shown to work for those which are untested and will require relationships to be rebuilt and confidence earned would be risky. Examination of alternative models, including those where the investigative and prosecution arms are contained within the same agency provide no grounds for assuming they achieve better results. A recent report suggests,[57]that the number of investigations conducted and successful prosecutions secured by SOCA, SFO, FSA and others is disappointing given the level of investment in those bodies. In the same paper, it is inferred that the City of London Police remain the most cost-effective response to fraud with a budget of approximately £8 million per annum and 140 personnel, compared with the FSA (£43.7 million and 35) and SFO (£43.4 million and 300) respectively. The current figures for the City of London Police are shown in the Annex.

Conclusion

19. The need to avoid overlap and consequent inefficiency in the work of the agencies dealing with economic crime is clear. The CoLP would welcome clarification of the case referral criteria. An Economic Crime Agency could provide such clarification in respect of the agencies with which CoLP deals as NLF in high level fraud cases.

October 2010

[57] Fighting Fraud and Financial Crime, Jonathan Fisher QC, Policy Exchange, 11 March 2010.

Annex

CITY OF LONDON POLICE—SUMMARY STATISTICAL DATA[58]

(a) ***ECD Budget***

	£m	***Notes***
South East Lead Force Grant	£2.430	*Includes £1.215m from City Corporation*
City Funds	£4.635	*mixture of Police Authority grant (not specific grants), local authority grant, council tax and City Corporation business rate premium.*
Home Office Grant for Fraud	£0.350	
National Lead Force Grant	£2.700	*Includes £1m from City Corporation*
Home Office NFIB Grant	£2.536	
Overseas Anti Corruption Unit Funding	£1.096	*from DFID/BIS*
Total	£13.747	*20.44% of CoLP Budget of £67.249m*

The figures above show a direct contribution of £6.85 million from City Corporation sources. This represents just under 50% of the ECD Budget.

In addition, the City Corporation contributes approx £490,000 to the rent of ECD Headquarters.

(b) ***Support to ECD from other CoLP directorates***

Support from Counter Terrorism and Serious Crime Directorate	c£500,000
FDFT (Force Digital Forensics Team)	c£1,400,000
TOTAL	c£1,900,000

(c) ***Manpower***

The current Force complement is 879.

The ECD complement stands at 154 Police Officers and 51 other staff.

(d) ***Value of Cases under investigation as of October 2010***

1. 664 reports are under investigation.
2. Value of crimes under investigation—£5.2 billion.
3. Of this sum—
   (a) £1.5 billion was subject of attempted criminality which was prevented so the assets were not, in the event, lost;
   (b) £168 million has been recovered.

Supplementary written evidence submitted by the Finance and Leasing Association

FINANCIAL REGULATION INQUIRY—RETAIL CREDIT

Thank you for the opportunity to give oral evidence to the Committee on 11 November. This letter responds to your invitation to write with any further thoughts.

During the hearing, I mentioned my concern that the UK's retail consumer credit markets were contracting and becoming more polarised. To put this in perspective, before the credit crunch 16 FLA members operated in the direct unsecured loans market. There are now five. In the second charge mortgage

[58] *Revenue and Capital Budgets—2009–10 and 2010–11,* Report of the Chamberlain and the Commissioner of Police to the City of London Police Committee, 15 January 2010.

market, the figures are 17 and six respectively. Inevitably, this means less choice for consumers and a greater risk of financial exclusion. Any changes to the current regime need to avoid making this situation worse. At the very least, uncertainty and transitional disruption must be minimised.

As we discussed on the 11th, the main new development since the FLA submitted its original written evidence is the announcement by the Government of its intention to merge the competition responsibilities of the Office of Fair Trading (OFT) and Competition Commission, and devolve the consumer protection functions of the former to other organisations.

On the face of it, this would appear to pre-empt the Government's intended consultation on whether responsibility for retail consumer credit regulation should be transferred from the OFT to the new Consumer Protection and Markets Authority (CPMA).

As I indicated last week, the FLA is not opposed to this in principle. But we would be concerned if it were seen by the Government as a residual issue, to be dealt with after the rest of the new regulatory regime is set in place. Design work on the shape and size of the new regime, including its funding and the necessary transitional arrangements, needs to start now. The existing body of UK consumer credit law is complex and extensive, and the last revision (implemented as recently as 2008) took two years to plan and the same again to implement.

The Government also needs to recognise (a) that any new regime will be seriously constrained by European legislation, including the maximum-harmonisation Consumer Credit Directive, currently being implemented in the UK; and (b) that credit is fundamentally different from the other kinds of retail financial services which will be regulated by the CPMA. The primary risk in a credit transaction lies with the lender, not the borrower. For deposit-taking operations the main risk lies with the depositor rather than the bank.

New regulation for consumer credit also needs particular care because existing regulation is designed as an integral part of the UK's overall consumer protection regime. For example, the Consumer Credit Act (CCA) and the Sale of Goods Act interlock through Section 75 of the CCA, which allows a consumer to seek redress from the lender if satisfaction cannot be received from the supplier of goods. As a result, consumer complaints to the Ombudsman often involve elements of both Acts.

As we discussed on the 11th, in many ways the current system has done a good job. The OFT is, for example, a relatively low-cost organisation compared with the FSA. But any system can be improved. The FLA's shopping list for a new regime would include the following. It should:

- Do no harm (ie avoid shrinking the market further, raising costs to consumers, or driving mobile capital from the UK);
- Drop the remaining archaic elements of the current CCA (eg the complex way changes to credit agreements need to be dealt with, which inhibits lenders' forbearance);
- Avoid product regulation like interest rate caps (which evidence from overseas markets shows would result in higher prices and even thinner markets) and "cooling off" periods (which would gold-plate existing EU regulation and threaten the viability of store cards, which support an important element of high street sales);
- Be clear and predictable for lenders and borrowers (avoiding the retrospection which is a feature of the current system, particularly those aspects regulated by the FSA);
- Clarify the role of the Financial Ombudsman as an impartial complaint-handling body;
- Deal sensibly with existing, as well as future, lending;
- Be properly resourced; and
- Prioritise the needs of the 4,000 firms who actually lend, rather than the nearly 100,000 entities currently licensed by the OFT.

Given these points, we have some concern that the Government's original consultation document *A new approach to financial regulation* (July 2010) suggested that the CPMA's powers would simply be based on those provided to the current FSA by the Financial Services and Markets Act. Our recent discussions with the FSA over the possible application of their new mortgage proposals to the second-charge market (currently regulated by the OFT) have reinforced this concern.

For all the reasons set out in this letter, simply applying a standard FSA-style rulebook to consumer credit is unlikely to meet the needs of the market or of consumers.

22 November 2010

Supplementary written evidence submitted by the Investment Management Association

1. This note is supplemental to the oral evidence given by Richard Saunders of the Investment Management Association on 14 October 2010.

2. At that hearing the Treasury Select Committee noted (to the IMA and ABI) that it would be interested in trying to establish what is the real compliance cost of regulation. More specifically the Committee stated that "It would be hugely helpful if, on behalf of your respective industries, you could examine in detail what you think the full compliance cost is of existing regulation at this time of turbulence in the regulatory structure, which would help inform us about what structure is most suitable in the years ahead."

3. These are very difficult issues. We have liaised with the ABI and are aware that they are providing a summary of many of the previous pieces of research into the subject.

4. We have sought to complement that response and have, after a brief reference to the FSA/Practitioner Panel survey in 2005:

(a) provided data on staff numbers and a narrative analysis as to how these have changed over recent years; and

(b) described a further piece of work which is already in progress which may further assist in informing the Committee.

Cost of Compliance

5. We have since the oral evidence considered some of the existing pieces of research on the cost of compliance. The ABI response deals with these more widely, but we would also identify, as they do, the Cost of Regulation Survey produced by Deloitte in 2005 and commissioned by the Financial Services Authority (FSA) and the Practitioner Panel jointly. It is we think the most comprehensive survey into the cost of regulation and have recently sent a link to the Report to the Committee.

6. A major issue always in a discussion on absolute regulatory cost is the extent to which any rule can be said to impose an incremental cost, that is to say whether, but for a rule, a firm would act similarly, perhaps because it is seen as good business practice. As the study found, commonly smaller firms identify higher incremental costs from specific rules than larger firms do. This was reported as due to larger firms, once processes are embedded, seeing such activities as good practice. A firm's risk appetite concerning compliance and tendencies to over-comply are also factors.

7. The methodologies used in the Survey remain in our view a good model; we have not sought to replicate its work (nor could we in the time available and given our resources). However in the next section we have re-analysed some data already held by the IMA.

8. Without deflecting the Committee from the importance of the absolute costs of regulation, the differential costs (or perception of such) across different parts of the financial services industry and across European and global competitors increasingly dominates business decisions on location and expansion. For this reason regulatory initiatives in Europe and by the new UK regulators which place regulation on an increasingly level-playing field domestically and internationally are to be welcomed. Proposals to regulate equivalently the selling of structured deposits, unitised insurance contracts and funds would be an example.

Staff Numbers

9. Every year IMA surveys its member firms. The annual survey measures the size of the UK industry as well as looking at the main drivers and trends behinds its evolution. It covers areas such as:

(a) The size and structure of the industry.

(b) Client types.

(c) Asset allocation.

(d) Mandates.

(e) Profitability.

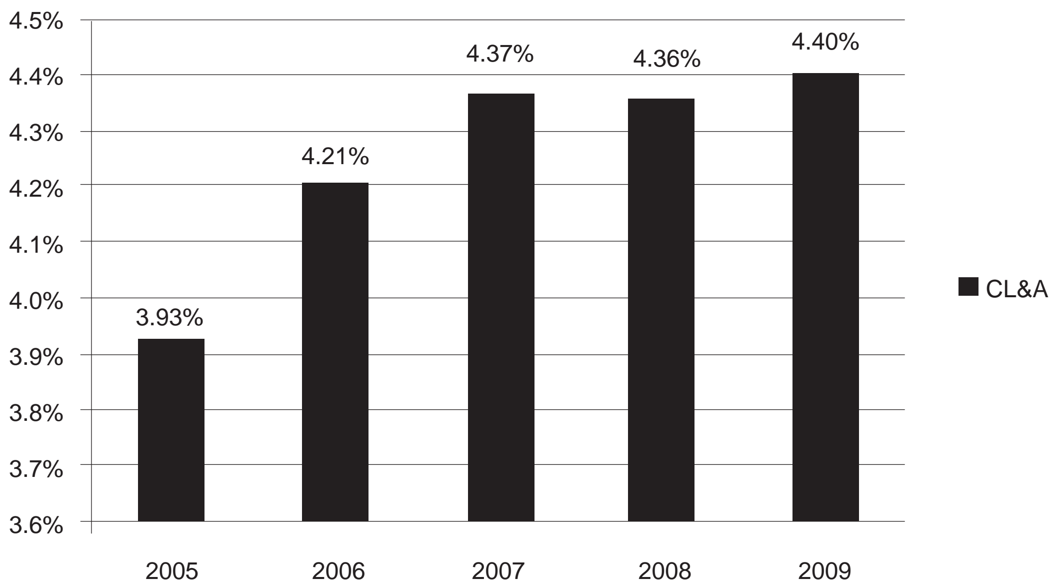
It also features in-depth interviews from senior figures from across the industry.

10. Member firms are requested to provide the numbers of staff occupy compliance, legal and audit positions in their firms. We have taken the underlying data since 2005 and have subjected it to a variety of analyses.

11. Table 1 shows for 2005 to 2009 a matched sample of firms which provided the aggregate number of directly employed personnel who were in any of Compliance, Legal and Audit (and without necessarily providing any analysis of how many were in each). The data is displayed as a percentage of the total number of staff employed by those firms together. The requirement for a complete match of data across the five years period means there are only nine firms in this sample. On present day values they manage a little over £500 billion between them however. Despite the financial crisis (and presumably some redundancies and cutbacks) 2009 saw the Compliance, Legal and Audit (CL&A) group now reaching 4.4% of staff numbers.

Table 1

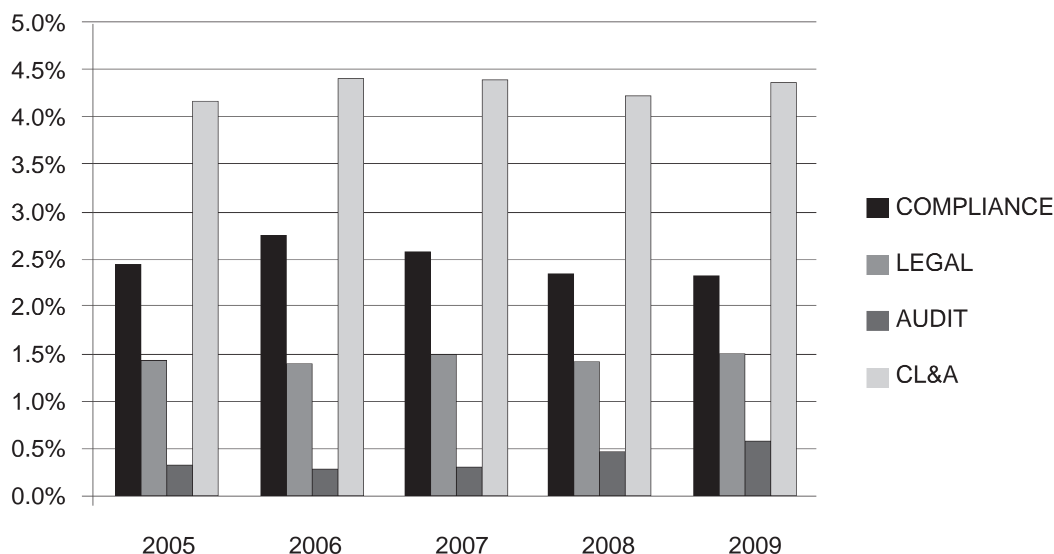
AGGREGATE CL&A AS % OF TOTAL UK STAFF (MATCHED SAMPLE)



12. Table 2 shows 2005 to 2009 the matched sample of firms which provided the aggregate number of personnel who were in any of Compliance, Legal and Audit and provided an analysis of how many were in each. Seven of the nine firms make up this set. This identifies the growing number of internal audit personnel.

Table 2

BREAKDOWN OF CL&A AS % OF TOTAL UK STAFF (MATCHED SAMPLE)



13. Between different firms the distinction between legal and audit roles may be fairly clear but compliance can often blend into both or be entirely separate. This may also be an artefact of the size of firm. Nevertheless whether individual components are compared or the total number they do not appear to be any significant changes across the years being considered. But we consider anecdotally that the underlying trend in risk compliance and audit are upwards, notwithstanding the generally downward pressure on

personnel numbers arising from the financial crisis. The number of lawyers seems fairly stable, but recent years have shown a small drop in compliance numbers. Again, anecdotally, we think the need to trim budgets has been a main cause.

14. One caveat with respect to larger—particularly international—firms is that asset management firms may also be drawing on other resources within their group. Direct headcount will not therefore necessarily fully reflect the resources being deployed for compliance, legal and audit activity.

15. Given the small size of the matched sample, we have also presented the responses in 2005, 2007 and 2009 from a wider group of firms which provided details in each of those years. These are unmatched sample so care must be taken to draw any conclusions in the form of trends. They do show a fairly consistent picture of staff numbers in compliance and compliance-like roles. This however may mask a resource re-allocation process in which as regulatory initiatives have increased since the crisis and risk management initiatives have increased since Lehmans in particular.

16. Table 3 presents the unmatched sample of firms which responded across those years and provided the aggregate number of personnel who were in any of Compliance, Legal and Audit (and without necessarily providing any analysis of how many were in each). The data is displayed as a percentage of the total number of staff employed by those firms together. Table 4 below displays the number of respondents each year, split into firms by size of the assets under management.

Table 3

AGGREGATE CL&A AS % OF TOTAL UK STAFF (UNMATCHED SAMPLE)

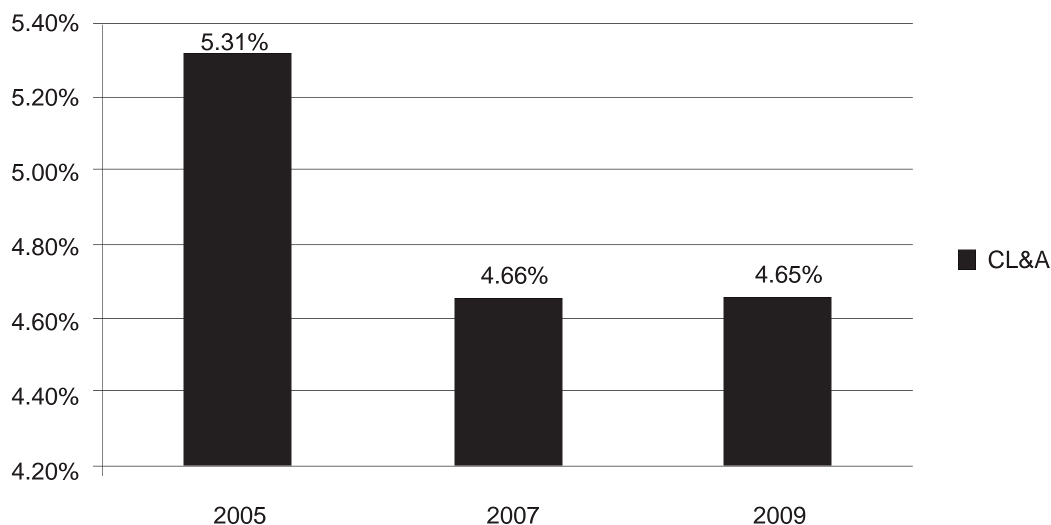
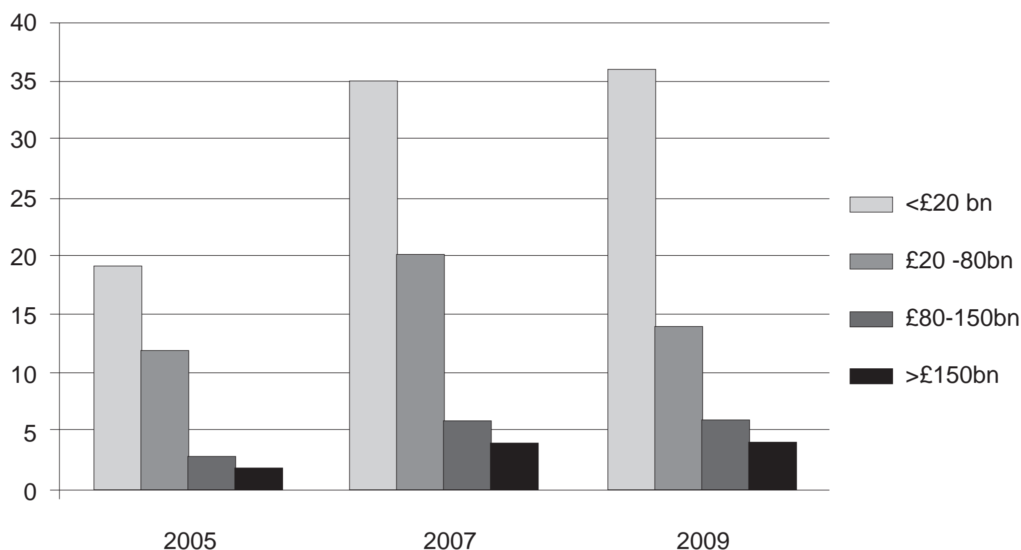


Table 4

NUMBER OF RESPONDENTS BY SIZE OF AUM



17. Table 5 presents the unmatched sample of firms which responded across those years who provided an analysis of how many personnel were in each category. The data is displayed as a percentage of the total number of staff employed by those firms together. Table 6 displays the number of respondents each year, split into firms by size of the assets under management.

Table 5

BREAKDOWN OF CL&A AS % OF TOTAL STAFF

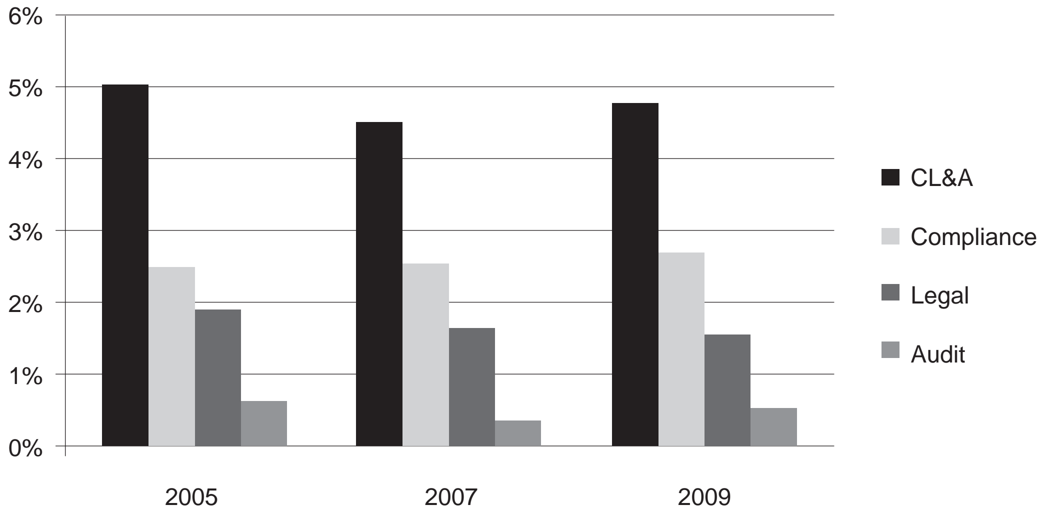
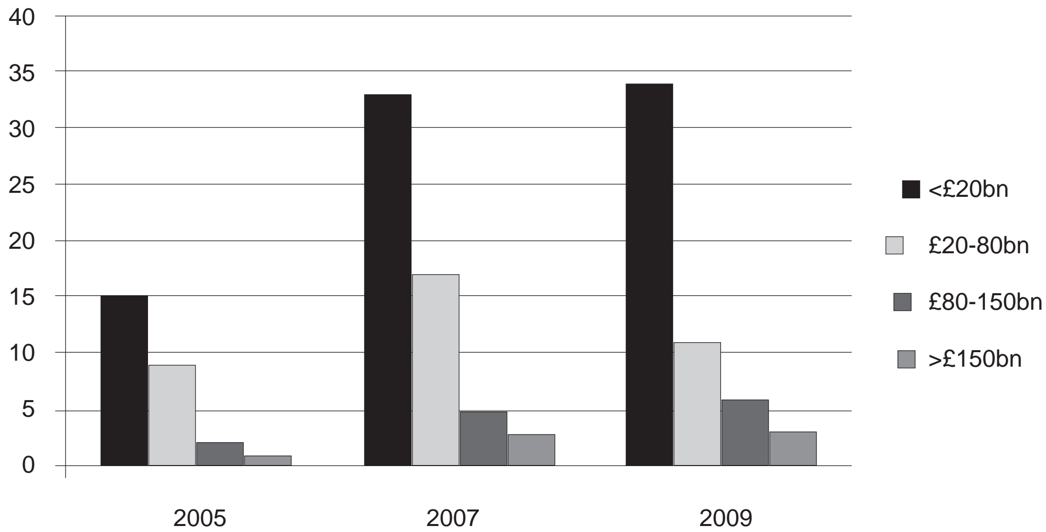


Table 6

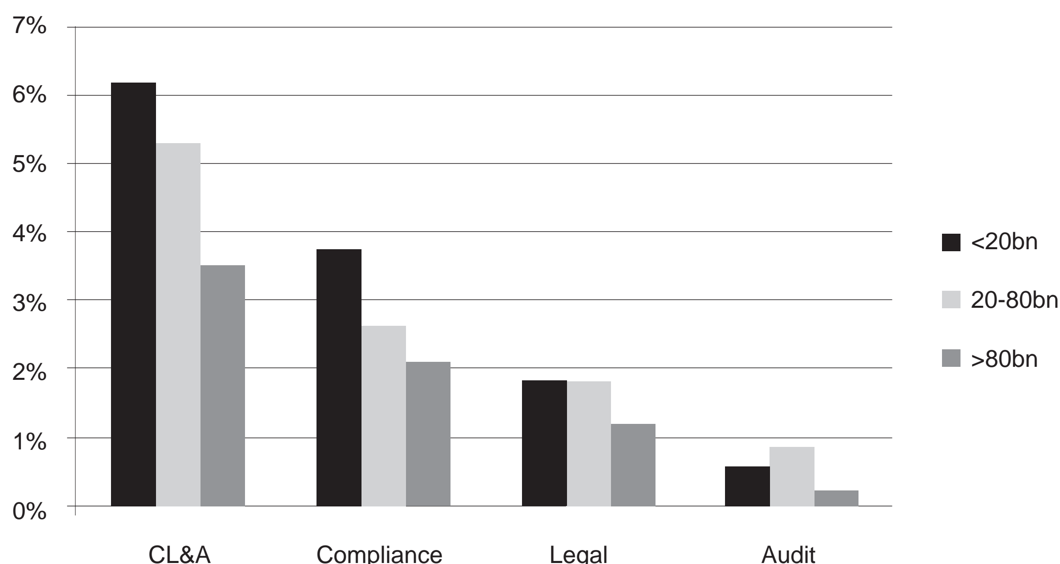
NUMBER OF RESPONDENTS BY SIZE OF AUM



18. We have presented in Table 7, the 2009 data received by IMA from firms providing an analysis of personnel numbers between the three categories, split by firm size.

Table 7

Breakdown of CL&A as a Share of Total No. Of Staff by Firm Size



19. Broadly this supports the experience that smaller firms have to bear a higher cost of compliance (though it says nothing about salaries). The figures behind the above chart are as follows:

	<£20bn	*£20–80bn*	*>£80bn*
CL&A	6.18%	5.30%	3.51%
Compliance	3.77%	2.63%	2.10%
Legal	1.83%	1.81%	1.19%
Audit	0.58%	0.86%	0.23%

And the number of firms, the average number of employees and average assets under management for each size group were as follows:

	<£20bn	*£20–80bn*	*>£80bn*
Number of Firms	34	11	9
Average No. of Employees	122	463	723
Average AUM (£bn)	7.33	43.31	145.54

20. We consider the above supports a view that:

(a) In the region of 4 to 5% of the number of staff at IMA member firms are in compliance, legal or audit.

(b) Smaller firms have a proportionately greater number of compliance staff and a proportionately smaller value of AUM per head of staff.

(c) The numbers remain relatively stable overall though individual firm changes are likely to be more significant.

Further Work

21. Given the challenges involved in addressing the costs of regulation and the existing evidence base, the IMA thought that it might be more practical—and informative—to undertake a short sectoral case study, based on a recent regulatory initiative. We propose to focus on the RDR. Such a study would aim:

(a) to provide granularity about precisely what is involved in regulatory change—eg. inputting into policy discussions, responding to consultations, planning for changes in business practices;

(b) to provide granularity about who is involved: ie. that this is not just about compliance costs, but a whole range of business processes; and

(c) to approximately measure both direct staff time/costs and cost of services such as external support.

22. It is important to emphasise, however, that this is not an exercise that would try to offer a judgement on the RDR itself—it is purely an exercise to look at process and cost.

23. IMA would hope to provide further evidence in early January 2011 if the Committee would find that informative.

Other Costs—Arrow Visits

24. We had begun to seek information as to the cost incurred in Arrow visits, including management and preparation time. The cost of supervision is not frequently discussed, and after the crisis we recognise that the level of supervision of all firms will increase. Some firms are subject to Arrow visits and others are not, then given a recent suggestion to the IMA that the internal costs of a visit would be in the region of £50,000, the costs of such should be kept in mind in determining the appropriate scope of visits and firms to be visited.

November 2010

Supplementary written evidence submitted by the Association of British Insurers

Costs of Regulation

1. When the ABI gave oral evidence to the Treasury Committee's inquiry into Financial Regulation, the Committee asked for further evidence on the "total costs of regulation".

2. This note summaries existing research into regulatory costs, outlines some of our findings and experiences, and identifies learning points for Government and regulators. Perhaps the most important issue for the CPMA and PRA to be alert to is that the costs of regulation are shared by all consumers, including potential consumers who may not be able to access products that could meet their financial needs.

The Total Costs of Regulation

3. In 2010 for major insurers the average cost of running their UK compliance programme for existing regulation (and ignoring the direct cost of regulators, such as FSA fees) is over £10 million p.a.

4. The FSA commissioned Europe Economics (EE), an independent economics consultancy, to assess the costs of compliance (report published June 2003). EE found that regulation imposed average annual costs on financial services firms equal to 3.3% of operating costs. This had increased by 42% since the FSA had taken over regulation. Regulatory capital was a major driver of compliance costs.

5. The FSA later commissioned Deloitte to assess the costs of regulation (report published June 2006). Their report focussed on three sectors: corporate finance, institutional fund management, and investment and pension advice to retail customers. It found that firms in the investment and pension advice sector reported the highest level of incremental regulatory costs. For firms in the investment and pension advice sector conduct of business rules imposed the highest costs (after regulator fees and levies).

6. The FSA also commissioned Real Assurance Risk Management to estimate FSA administrative burdens (report published June 2006). Real Assurance estimated that the total administrative burden imposed on financial services firms by the FSA Handbook is around £600 million a year. Money laundering rules account for 40% of the total administrative burdens.

Direct Costs of Regulation

7. The "direct" costs of regulation—the annual fees and levies that regulated firms pay to the FSA and associated bodies such as the Financial Services Compensation Scheme and the Financial Ombudsman Service (FOS)—have increased substantially in recent years, particularly for general insurers (See Annex 1). The total cost of these fees and levies for insurers in 2010–11 is £138 million.

8. We are concerned that splitting the FSA into two separate organisations could lead to further increases in the total direct costs of regulation. Most statutory bodies are under pressure to deliver value for money, so we think it essential that the PRA and the CPMA should be required to use their resources efficiently and economically. We strongly support the Government's proposal to make the CPMA subject to audit by the National Audit Office (NAO).

9. We are also concerned about increases in the direct costs of FOS upon the industry in recent years (although we support the rebalancing of FOS revenues away from the levy and towards case fees). Its productivity performance is a source of concern –FOS productivity fell sharply from 4.8 to 4.1 cases per adjudicator per week in 2009–10. Given this context, we welcome the prospect of an NAO study of the value for money offered by FOS in 2011 and suggest the statutory requirements on FOS may merit strengthening, to require it to act in an efficient and economic way.

One-off Implementation Costs

10. The largest regulatory costs for insurers arise not from ongoing compliance costs but from the one-off costs associated with implementing major changes in regulation. Changes in IT systems or customer documentation can be highly costly for example.

11. The insurance industry is currently making plans for implementation of two highly significant regulatory changes over the next couple of years—Solvency II and the Retail Distribution Review (RDR). We are broadly supportive of these initiatives which should deliver significant benefits to consumers. However, Government and regulators need to appreciate that the costs of implementation are very high.

12. Earlier this year, the FSA substantially increased their estimate of the cross-industry costs over the first five years of RDR to the range of £1.4–£1.7 billion.

13. We estimate that for major firms within the industry, the average cost of implementing Solvency II (excluding any capital increases) will be more than £100 million per firm.

14. There is some anxiety within the industry that these major changes coincide with a wholesale reworking of the UK regulatory architecture. It is therefore very important that during the transitional period Government and regulators work with the industry to avoid creating additional uncertainty or cost. We also suggest that, following implementation of these changes, the PRA and the CPMA should have an assumption towards stability and should be sceptical about pursuing further significant changes with impact upon insurers.

15. In general, regulators should seek to coordinate implementation deadlines for major regulatory changes, in order to avoid the same systems having to be changed twice in short succession, with all the associated cost implications. The timeline at Annex 2 provides a flavour of the major regulatory initiatives which have impacted, or will impact, upon insurers.

Costs v Benefits

16. When considering whether to introduce new regulatory requirements, regulators need to assess whether the benefits are justified by the additional costs. We highlight below some cases where the cost-benefit balance has been questionable.

ICOB:

17. In January 2005 the FSA introduced conduct of business regulation for general insurance products (ICOB). The FSA estimated that financial services firms would incur one-off compliance costs of £197 million (to change systems, retrain staff, etc) and ongoing compliance costs of £166 million per year (to provide disclosures, etc).

18. Charles Rivers Associates (CRA), an independent economics consultancy, conducted research for the ABI to look at the consumer benefits of ICOB. CRA found that the overall impact of ICOB was to impose a cost of £122 million a year on consumers (partly driven by frustrated customers doing less shopping around as regulation meant the sales process took longer and they were not willing to go through another phone call). The impact of regulation varied by product. For motor, home, travel and pet insurance, regulation imposed costs on customers of £362 million a year. This was partially off-set by benefits for customers of payment protection insurance, critical illness, and similar products, of £239 million.

19. CRA found that £72 million of the £362 million a year cost imposed on customers of general insurance products was due to regulations the FSA introduced that went over and above the rules necessary to implement EU Directives. After this research was published, the FSA removed some of these additional regulations. While this will have reduced the £166 million a year ongoing costs to financial services firms and consumers from ICOB regulation, the one-off costs of £197 million that firms incurred cannot be recovered.

20. The European Commission is currently reviewing the Insurance Mediation Directive. The ABI is concerned this may eventually lead to the reintroduction of costly regulations which were removed in the UK. This underlines the importance of ensuring that the UK is an effective voice in EU negotiations on financial services regulation, during and after the transition to a new regulatory structure.

The menu:

21. In June 2005 the FSA introduced the "menu". The menu was a new disclosure that described the maximum amount an adviser of packaged products (eg personal pensions) is paid for intermediation and, for benchmarking, the average amount that is paid across the whole market. The FSA estimated that financial services firms would incur one-off compliance costs of £40 million (to change systems, retrain staff, etc) and ongoing compliance costs of £22 million per year (to provide the menu in each sale, etc).

22. The FSA later commissioned CRA to assess the benefits of the menu. CRA concluded that the menu had delivered few significant benefits, to the extent that they did not attempt to place a monetary value on these benefits. After this research was published the FSA removed some of the regulations relating to the menu. However, while the ongoing costs of £22 million can be reduced, the £40 million one-off costs that firms incurred to introduce the menu cannot be recovered.

Total Premium Disclosure (TPD):

23. The FSA requires that quotes for pure protection products (income protection, term and whole-of-life policies, and critical illness) include information on the product's "total premium" (the amount the customer will pay over the duration of the contract).

24. The ABI commissioned Cragg Ross Dawson (CRD), an independent market research company, to conduct customer research to establish how TPD could best be disclosed and how customers would use this information. CRD concluded that the two key issues for customers when buying pure protection products was confidence that the insurer would pay out and affordability (based on the level of monthly premiums). The total premium (lifetime cost) was rarely considered and was seen as irrelevant to monthly affordability. Consequently, few customers thought that the disclosure of total premium would have much, if any, impact on their decision-making. Despite this, the industry is required to disclose total premiums by the end of 2010 at an estimated one-off cost to financial services firms of £20 million.

Pension regulations:

25. The ABI believes there is scope to remove a number of pension regulations which add costs for insurers, without compromising consumer protection. As a case study, a life insurer has estimated it could yield the substantial cost savings below if some simple regulatory changes were made:

- Remove requirement on insurers to retain details of employees that opt-out of occupational pension schemes when auto-enrolment is introduced in 2012 (this is duplicative as employers have the information)—Estimated saving to one life insurer: £528k p.a.

- Allow "paperless product" information, removing requirement to send hard copy post-sales documentation (which can be too big to fit through letter boxes)—Estimated saving to one life insurer: £235k p.a.

- Remove cost of holding very small pension pots for contract-based schemes and return contributions to employees (in line with commutation rules that apply to occupational schemes)—Estimated saving to one life insurer: £100k p.a.

- Take employees automatically enrolled into approved pension schemes outside of FSA conduct of business rules (in line with occupational schemes)—Estimated saving to one life insurer: £498k p.a.

26. If these savings were replicated across the market, then removing these regulations could lead to total savings in excess of £15 million per annum.

Wider Market and Consumer Costs

27. The Deloitte study highlighted above identified conduct of business regulation of investment and pension advice as an area of high cost. Earlier this year, the ABI commissioned research into the time and costs associated with providing "full" regulated investment advice. On average, full advice takes around 7 hours 40 minutes from start-to-finish and includes meetings with the client, preparing recommendations and post-sales administration. This is reflected in an average total cost of £670. Given this cost, the research suggests that consumers with less than £257 per month to save (or £13,730 to invest as a lump sum) cannot be economically served by full advice. As a result, over 30 million UK adults—or about two-thirds of the adult population—are beyond the target market of full advice and do not get the advice that might help them protect their family or better save for the future. This highlights that the indirect costs of regulation can extend beyond the compliance costs incurred by the industry—it can also lead to some consumer groups being unable to access financial products and services.

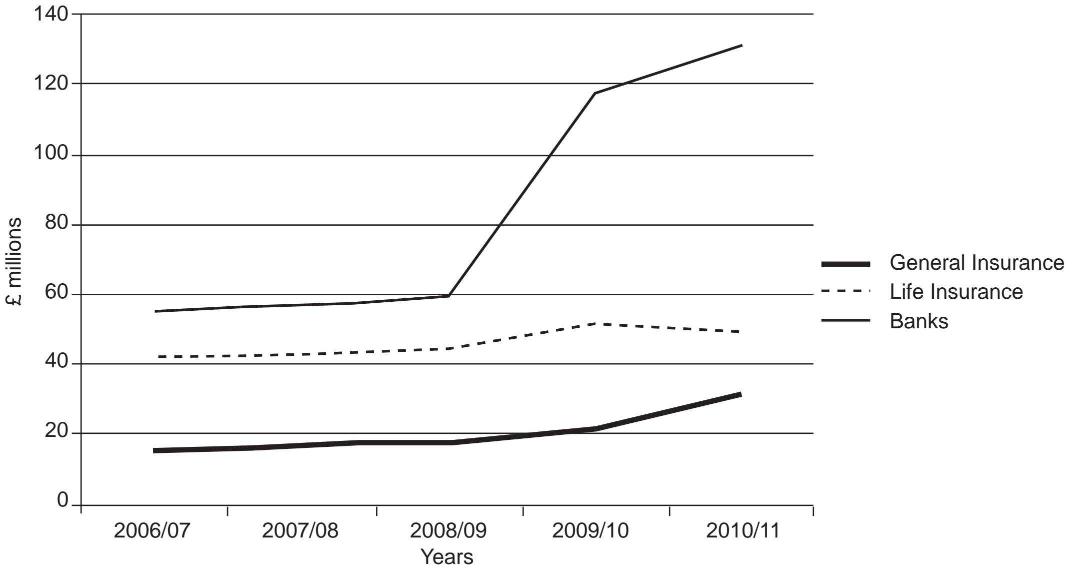
28. The ABI has therefore proposed to Government and the FSA that a new financial advice process is needed—"simplified advice". This process is designed to address straightforward consumer needs through a limited assessment of their financial circumstances. As a simpler service, it could be delivered in a shorter time period and at lower cost than full advice. However, for this service to be viable, it requires a proportionate approach to regulation from both the FSA and the FOS, which focuses on delivering the best outcomes for consumers.

Conclusion

29. As this paper highlights, the insurance industry is already highly regulated, subject to significant conduct of business and prudential requirements which involve significant compliance costs. While regulation can be justified if it successfully addresses identified market failure or consumer detriment, this has not always been the case. Both the PRA and the CPMA should be required to assess if the costs of their regulations exceed the benefits, and are delivering good outcomes for consumers.

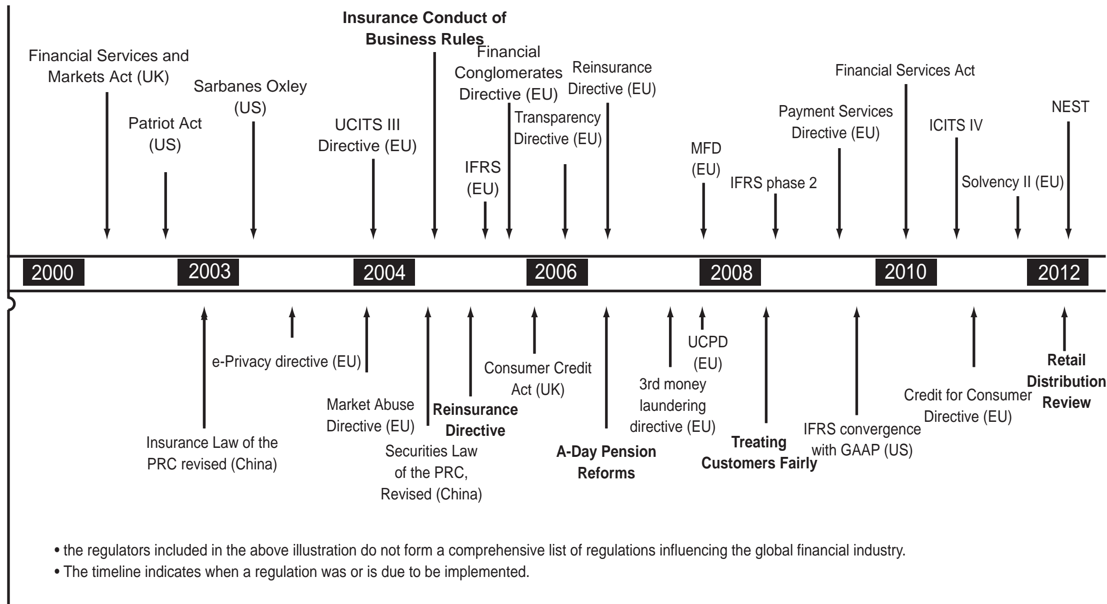
Annex 1

FSA FEES



Annex 2

TIMELINE OF MAJOR REGULATORY INITIATIVES



November 2010

Supplementary written evidence submitted by the Financial Services Practitioner Panel

I am pleased to provide you with further information from the Financial Services Practitioner Panel following the meeting on 18th November as part of the Treasury Committee's Inquiry into the future of regulation. You were particularly interested in further evidence relating to the costs of regulation at the current time, and the accountability of the Bank of England in the new regulatory structure.

Support for Regulation

I would like to start with reiterating my view at the evidence session on 18 November, that the industry is fully supportive of the need for better regulation. From that perspective, our most significant concern is the need for regulation which is both effective in securing appropriate outcomes and delivered efficiently in a cost sense.

Costs of Regulation

In response to mounting concerns in the industry about the increasing cost of regulation, in 2005–06, the Practitioner Panel and the FSA jointly commissioned a study into the cost of regulation. It was undertaken by Deloitte, and I enclose a copy for your reference. The report is now somewhat dated, as there have been many regulatory changes since 2005.

However, some of the conclusions are interesting to note as providing still relevant insight into how firms respond and operate in the regulatory environment. The study identified not only the problems in extracting the cost of regulation itself compared to what a well run firm would do otherwise, but also the huge variation of costs attributed to regulation amongst firms even in the same sector. "We also found that there was a wide distribution of costs identified by firms within the same sector, which indicates that the link between the cost of regulation and firms is a particularly complex one." P8 Deloitte Report.[59]

The other major issue highlighted by the report was that it is the cost of changing business processes due to the introduction of new or changed regulatory requirements which imposes the most costs on firms. However, once the requirements are embedded into a business' ongoing operations, the degree to which such processes are seen as incremental is often quite limited. Indeed many firms will keep processes in place even when the regulator removes the requirement.

As no general conclusions about the total cost of regulation could be drawn from the report, the FSA has not followed up with any further studies on the cost of regulation within firms since the 2005/6 report. However, the FSA has recently commissioned a benchmarking study into its organisational effectiveness compared to other financial sector regulators across the world which we understand will be presented to the FSA Board shortly.

The 2006 Deloitte report's finding, together with members' own experiences, has stimulated the Practitioner Panel's emphasis in recent years on holding the FSA to account on its use of Cost Benefit Analysis when introducing new regulatory initiatives, and challenging the FSA's tendency towards a "one size fits all" approach to regulation.

Costs and Benefits of Regulation

The FSA is required by FSMA to undertake a cost benefit analysis (CBA) when it introduces new rules, although not all decisions have to be driven by CBAs. For the last few years we have consistently highlighted industry concern to the FSA about their use of CBAs. We have seen that the FSA has introduced some changes when the CBA has not supported the case for implementation—such as with the publication of firms' complaints data started in 2009. There have also been initiatives, such as Treating Customers Fairly, where a CBA was not carried out because it did not involve a rule change, even though significant changes were required of firms.

Most recently, we have seen problems with the CBA associated with the FSA's Mortgage Market Review proposals for affordable lending (CP 10/16). The Council for Mortgage Lenders provided a robust challenge to the FSA's CBA in their response. They pointed out that the FSA had not assessed the impact of its various affordability proposals and draft rules, and had not fully considered the wider economic, social and demographic pressures on house prices which also contributed to the increase in house prices between 1997 and 2007. As a result of widespread concern being expressed by the industry and the FSA's independent panels, the FSA has now announced that it will be undertaking further cost benefit analysis early in 2011 to feed into revised proposals for the Mortgage Market Review.

At the same time, the Treasury Committee is well aware of concerns being raised on the costs and benefits involved in the proposals as part of the FSA's Retail Distribution Review. We are concerned about the FSA's "one size fits all" approach to this area. A particular example of this is the new recommendations for Continuing Professional Development (CPD). The new regime puts the onus on the individual (so weakening a firm's power to control this element of its culture). It increases the CPD hours to 35, of which 21 hours "must involve structured learning with verifiable and measurable activities". This is a higher level than other professions—solicitors and lawyers must complete a minimum of 16 hours of CPD per year. The new FSA system also requires external monitoring of individuals' CPD. It seems that for FSA relationship managed firms at least, the existing CPD regime could be amended with larger firms retaining control, as they already have significant monitoring in place. However, the FSA is applying new requirements across the industry with little flexibility to reflect the range of different firms covered by these requirements—from small IFAs to major City of London institutions.

Accountability of the Bank of England in the New Structure

We have raised our concerns about the level of accountability of actions of the FPC and the Bank of England in the new structure. Although we support the strengthened focus on financial stability, we are concerned that the range of accountability and transparency mechanisms proposed in the Treasury's Consultation are less than those currently applied in the existing regulatory framework.

[59] The Cost of Regulation Study—Deloitte commissioned by the Financial Services Authority and the Financial Services Practitioner Panel—June 2006.

In order to address this matter and support the FPC and Prudential Regulatory Authority (the PRA) in their decision making processes we are advocating that a range of enhancements be made as follows:

- extend the role proposed for a Practitioner Panel and all the current FSA independent Panels from the Consumer Protection and Markets Authority (the CPMA) to include matters falling within the PRA mandate, with an additional right to raise major concerns on financial stability matters directly with the FPC;
- the establishment of a non-executive advisory group comparable to the previous Board of Banking Supervision that will provide commercial and international input, support and expertise to the FPC and broader supervisory decision making processes at the highest level. This will bring several benefits: appropriate commercial input, a forum for discussion on international issues and improved coordination of prudential, conduct and financial stability matters;
- ensure that the independent members of the FPC are senior, highly regarded and influential industry figures who collectively are able to represent the broader views of the financial services industry and challenge the executive members effectively.

Our Panel is due to discuss shortly, the ways in which we should request for the powers of the independent panels to be increased under the new regime. I will, if I may, follow up with some further thoughts in this area when they have been discussed by the Panel at our meeting next week.

3 December 2010

Supplementary written evidence submitted by the Smaller Businesses Practitioner Panel

At our meeting on 18 November, you encouraged the Chairmen of the FSA Independent Panels to come back to you with further evidence relating to the costs of regulation at the current time, and the accountability of the Bank of England in the new regulatory structure. I am pleased to be able to provide some further evidence from the Smaller Businesses Practitioner Panel, which I hope may be of assistance.

Cost of Regulation

The costs of regulation are difficult to quantify, because much of what is demanded by regulation is what a well run business would want to do anyway, such as having clear controls, checks and balances, and treating customers fairly. However, there are additional costs associated with having to report to an external regulator, and also in having to contribute to the costs of regulation—in recent years in particular, we have seen a huge increase in the levy for the Financial Services Compensation Scheme (FSCS). Perhaps more importantly for smaller firms, we believe it is the burden of compliance which can be heavier, as we have a lower volume of activity to cover fixed costs. Although the FSA has worked hard, with input from ourselves, to develop a small firms regime and to provide more targeted communications, there is still a great amount of additional work required within firms to comply with regulatory requirements, and particularly when those requirements change.

As it is not possible for us to strip out quantitative information for the Committee on the specific cost of regulation, I have asked members of our Panel to provide some examples of the regulatory burden which they have experienced recently. They are contained in the attached document. I hope this gives you a picture of some of the requirements, and gives further background on why we are not in favour of further regulatory changes unless they give clear benefits to smaller firms.

Accountability of the PRA, FPC and Bank of England

In our written evidence to the Committee, we raised our concern that the FPC and the Bank of England will be very powerful influencers of regulatory policies, and ultimately, the whole business environment in the UK. The Chairman asked us for further thoughts about accountability in the Bank under the new regulatory structure. Our greatest concern is that the needs of smaller firms—particularly those not involved in banking per se—are understood and the businesses are not overly burdened with inappropriate regulatory requirements.

We appreciate that smaller firms are not going to be high up on the agenda of the FPC and PRA, and it is probably not realistic to expect small firm experience or representation within high level structures at the Bank. However, we would like to see, as a minimum, specific executive resources within the PRA devoted to smaller firms. At the moment, the FSA has a Small Firms Division, to coordinate the policies for, and supervision of, smaller/lower risk firms. Going forward, as we understand it, smaller firms under the PRA will still not have a devoted relationship manager, but will have to submit returns and comply with new requirements remotely, and it is not clear at the moment what contact mechanisms there will be. However, we will urge that there must be a voice for the needs of smaller firms clearly identifiable, at Director level and/or as a unit within the PRA.

We believe it is essential to have a Director within the executive of the PRA who has responsibility for small firms in all sectors. Otherwise, there is a danger of regulatory requirements being developed for firms

across the board which are inappropriate and unnecessary for some small firms, such as insurance companies and credit unions, and overly burdensome for others, such as small banks and building societies.

We have already suggested that the FSA's current independent panels should be given a remit across the regulatory system, with the ability to consider issues at the PRA and FPC as well as the CPMA. If there was a Director at the PRA with responsibility for small firm issues, this would additionally provide a channel for the SBPP to have a specific relationship with on issues which affect the small firm community regulated by the PRA.

SBPP Examples of the Cost and Burden of Regulation Visits by the FSA

Those firms who have had to host in depth visits from the FSA (ARROW visits), which occurs at a minimum every three years for those holding significant client money, report that these require a lot of work. A small bank estimates it probably takes around four weeks for one person; and a mortgage network three weeks to prepare; or a small insurance broker gives an example of an FSA visit lasting approximately six days, with time out of the business to prepare being estimated at one month for two people.

In addition, the FSA undertakes thematic visits, where it looks at a particular issue of compliance across a sample of firms. One asset management firm has had around two to three visits per year in the last few years (on investment advice, TCF, client money and ICAAP). Each thematic visit takes around 10 man days of preparation time.

Regular Compliance Costs

The larger smaller firms employ people specifically to undertake compliance work and coordination. In an insurance broker and mortgage network respectively, two out of 55, and 15 out of 48 staff undertake compliance. In a small bank, two out of 45 staff spend 30–35% of their time on regulatory matters.

Credit unions are currently under a much lighter regime. So for one of the largest credit unions the full time staff spend around 30 days per year on regulatory compliance costing annually in the region of £3,500, plus the time of a volunteer unpaid director.

For smaller firms, much of the supervision is carried out remotely, with firms submitting returns electronically via the GABRIEL system. This means that once a system is set up, it does not add a large additional cost to provide the reporting to the regulator.

Additional Requirements from the Regulator

It is often the additional requirements from the regulator that bear down on firms and cause the most problems, and we have a number of recent examples of this. From a small bank, this year there has been a need to prepare an ILAA (Individual Liquidity Adequacy Assessment), which has taken the equivalent of 40 man days to produce. They are also currently working on developing a "Single Customer View" for new FSCS payout purposes which will take 30 days of bank staff time and cost £25k in IT work to address.

The FSA's mortgage market review, has already taken one small mortgage network 10 man days to go through and respond, even though they do not feel that this addresses the current market issues, and is creating more difficulties for lenders to lend. It is estimated that adhering to the revised approved person regime will cost the network 50 man days to set up the new systems, and an extra £15,000 in costs of external checks.

The FSA has a procedure called a "Dear CEO letter, or Dear Compliance Officer letter" where it writes to the chief executives or compliance officers/proprietors of all firms authorised to undertake the relevant function, to highlight areas where problems have been found and they wish the industry to address inadequacies. However, this sometimes results in a blanket approach with small firms having to undertake significant project work to report back to the regulator on their compliance. One current example is the "Dear Compliance Officer letter" sent by the FSA on oral disclosure in sales of non-investment insurance: protection products on 29th November 2010, and attached as Appendix 1 here. For a small IFA who has permission but does not sell many of these products, just responding to this letter and getting everything set up will probably take about 10–12 hours' work at a cost of £3,000 without consideration of the additional costs required for implementing the proposal with individual clients. For larger firms the costs will be higher because there are so many more variables to control.

Contract certainty in the insurance market developed as an issue after problems in the insurance of the Twin Towers emerged after 9/11. The FSA wanted to ensure that all brokers and insurers had complete contract certainty of the terms and conditions of insurance. The FSA issued a challenge to the whole insurance industry in 2006 to establish contract certainty, and insisted that it applied to the whole industry, beyond the London market. It resulted in a huge amount of work for all sectors of the industry. However, most provincial and small intermediaries deal through conventional markets, where copies of the contract are readily available on their website, and brokers can easily attach copy policy wordings at the point of sale. Many smaller firms struggled to collate the data as the software systems could not report, and additional resources had to be found.

Additional Levies

The Financial Services Compensation Scheme (FSCS) is funded by a levy from the industry, and exists to compensate customers of financial services firms which go into liquidation. The current structure is under review by the FSA, and at European level. However the fact remains that the firms which are well managed in the industry are liable for the faults of those who are less well managed. In the past, this has been seen as a necessary cost for maintaining overall confidence in the financial services industry. However, as the size of firms which have collapsed, or have been on the brink of collapse has increased, there is mounting concern, particularly amongst smaller firms over potentially huge liabilities in the future which are impossible to quantify or insure against. The July 2010 Treasury Consultation referred to the need to consider the funding of the FSCS, and the SBPP advocates serious scrutiny of this area.

3 December 2010

Supplementary written evidence submitted by the City of London

The following commentary deals with issues raised during the oral evidence session on which further information was offered.

Government Support for Retaining and Attracting Key Business Interests

The French Treasury in particular has put together working groups on specific financial services topics such as clearing and SME finance, sponsored by Christine Lagarde, the Finance Minister. Although France has traditionally taken a dirigiste approach, there are a number of issues where the involvement of Treasury-led expert groups can provide a longer-range view on the future shape of the financial services market than can typically be provided by the industry, with its shorter-term perspective. An exercise for the UK would be the development of the fixed income markets in a climate of greater demands for transparency.

Nevertheless the Government's work in promoting inward investment should be acknowledged, as should support of the concept of the City as a major national asset. It is now important that this should be reflected in policy on regulation, competition and tax.

Basel III and Bank Capital

There is nothing further to add to my comments to the Committee.

UKLA

The Government has announced the UKLA will not be rolled into the FRC and thus no further comment is therefore offered.

London's Competitive Position

The financial services sector provided £66 billion in tax revenue in 2009 accounting for 10% of GDP. London and the UK must remain competitive if it is to continue to provide that level of contribution to the exchequer. Recent research,[60] however, has shown that the competitive edge has been affected by a sustained deterioration in the UK tax regime relative to other international locations. This deterioration comes not just from headline rates of corporate and personal tax but also the unpredictability of the UK tax regime and of fiscal policy development.

Although London and New York have always led the pack, decision-makers need to recall that our standing as a world-leading global financial centre should not be taken for granted. Damage has been done to the Square Mile's perceived competitiveness relative to New York[61] but this is not irreversible provided policy makers provide clear, positive statements on their "direction of travel" with regard to tax and regulation. Not everything can be achieved at once but businesses need confidence that over the longer term the government of the day is supportive of the financial services industry as a wealth generator for the UK economy.

Neither can we afford to be complacent in the face of growing competition across the world, not just in the USA but also increasingly Asia. There is a danger that over-prescriptive new regulation could accelerate this shift in the financial centre of gravity towards fast-developing markets by undermining the UK's competitive position. Industry and government must work together to ensure that this does not happen.

At a European level and in conjunction with the Scottish Financial Executive and TheCityUK, the City of London is a founding member of the Roundtable of European Financial Centres which brings together on a regular basis the financial centres of Amsterdam, Dublin, Edinburgh, Frankfurt, London, Luxembourg,

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[60] Z/Yen Global Financial Centres (seven reports to 2010); CRAI The Impact of Taxation on Financial Service Business Location Decisions, February 2008; Bourse Consult, The Competitive Impact of London's Financial Market Infrastructure, April 2007; Oxera, Stamp Duty, its impact and the benefits of its abolition, May 2007.

[61] *Global Financial Centres*, March 2010, above.

Madrid, Milan, Paris and Stockholm. We share a common view on possible joint initiatives mainly aimed at "promoting Europe's financial services industry in a global context". The City Corporation facilitates the Roundtable process.

PROMOTION OF COMPETITIVENESS OBJECTIVES

It is acknowledged that there is a need for effective regulation and a regulatory structure which protects consumers, the integrity of markets and the stability of the financial system. However, it is suggested that this does not conflict with the promotion both of competition in the domestic market and of the UK's competitive position internationally. The national interest, as well as the interests of those who use financial markets, will be served most effectively if the new regulatory agencies acknowledge the importance of a competitive, outward-facing financial services sector and, while insisting on high standards of governance, competence, market behaviour and capital adequacy, also make it possible for new domestic and foreign companies to establish and develop new areas of business.

The FSA currently imposes an obligation of "treating customers fairly". It is suggested that there should be a similar responsibility imposed on the new regulatory agencies to treat regulated businesses in a way that encourages rather than drives away competition and does not reduce the ability of British-based firms (regardless of national ownership) to provide established and innovative financial products in a competitive global market.

ADDITIONAL COSTS OF NEW REGULATION

It is very difficult to quantify the cash cost to regulated firms of the proposed changes in the regulatory structure and no robust attempts have been made. These are, however, likely to be substantial, especially for complex firms such as investment banks and major insurers, operating across a number of business areas. It is also difficult to separate out the costs of regulatory restructuring from those of compliance with other domestic, EU or international requirements, including MiFiD, AIFM, Solvency 2 and Basel 3. Nevertheless, our International Regulatory Strategy Group will discuss how more specific figures might be obtained, at least to illustrate orders of magnitude.

Conformity with regulation is an acknowledged and accepted business expense but it is suggested that Government has a duty to try and minimise these costs in the interests of competition and in the knowledge that some compliance costs are likely to be passed on to the consumer.

REPRESENTATION AT THE EU COMMISSION

The UK contributes a lower percentage of Commission staff than any other major member state. Intake figures suggest a fall in the number of British entrants being groomed for future senior posts.

It is worth examining how experts from the financial services industry could be induced to contribute to this area by undertaking limited secondments, although of course this would involve finding solutions to issues on remuneration and Union membership.

December 2010

Supplementary written evidence submitted by the City of London Police

1. This Supplementary Memorandum provides further information on points arising from the Committee's oral evidence session on 16 November with the Commissioner of the City of London Police, Mike Bowron and the Head of Economic Crime at the City of London Police, Detective Chief Superintendent Steve Head. It is hoped that the additional information will be of assistance to the CommIttee.

RECOVERY OF ASSETS

2. The Committee questioned the level of assets recovered, stated in the written submission as £168 million, against the value of crime under investigation, £5.2 billion, less the £1.5 billion of losses which had been prevented and noted that this represented a recovery rate of around 5% on the outstanding sum.

3. The context of these figures deserves further elaboration. The National Fraud Intelligence Bureau (NFIB) went fully operational in June 2010. At that point, the Bureau received a very large quantity of fraud data. The figures given in the written submission to the Committee refer to the situation as at October 2010, at which time, apart from the frauds which had been interrupted before they could be carried out, £168 million had been recovered and returned to victims. This does not however reflect the amount which will ultimately be recovered. It is important to recognise that the majority of investigations resulting from the fraud data are at their formative stages. Most of the asset recovery is likely to be secured later as the resulting cases near prosecution and conviction.

4. The ultimate extent of recovery of assets will also be increased after the cases go to court as asset recovery can also continue after a suspect has been sent to prison and subsequently released. Court orders

are used to monitor individuals still owing money to victims and assets not previously declared are seized. This is subject to the significant proviso that where a plea of guilty is accepted by the prosecuting authorities on the basis of an accused's admission of a fraud of a lesser amount than alleged by victims, the police can only seek and order for recovery of that lesser amount.

5. The figures on asset recovery attributed to the City of London Police do not take into account cases where the City Police have acted as the investigative and enforcement arm for a partner organisation, such as the SFO. In such cases, recovery of assets are credited to the partner organisation's figures and not those of the City of London Police. Accordingly the £168 million does not include any sums recovered from them. Of the sums referred to in the written submission and paragragh 3 above, around £1.6 billion is estimated to be attributable to such cases and no credit will therefore be given to amounts recovered from them in the City of London Police's statistics.

Identity Crime

6. The City of London Police do not have a national lead role for identity crime. The City Police are, however, actively working with the NFIB, NFA and SOCA to address identity crime where it is an enabler for fraud. The threat from identity crime demands a strategic response across government—there is no one agency or sector that can pursue an effective response on its own. It requires a coordinated and multi-agency approach and the involvement of the private sector. The City Police via the NFIB have actively supported the creation of the newly established Identity Crime Strategic Implementation Board, under the Home Office and they along with the other Strategic members of this board are now proactively taking this work forward in partnership.

Cybercrime

7. Members of the Committee asked questions about the prevalence of various forms of internet related crime. In many cases, 'cybercrime' is a reference to conventional crime which is technology enabled rather than a description of a new category of criminality. The commission of very many crimes now frequently involves some element of 'new technology'. This means that standard statistical data does not necessarily reveal the extent of internet involvement. Crimes are primarily categorised by type and, therefore, the particular method by which the crimes have been committed is not routinely documented in the statistics. Nevertheless, the following paragraphs attempt to offer some commentary on the prevalence of online frauds and may be of help to the Committee.

Online Banking Fraud

8. One of the most common types of cybercrime involving an ecomomic element is 'account takeover'. As reflected in research (notably the Garlik crime survey),[62] fraudsters are increasingly taking over existing accounts, as opposed to creating new ones.

9. The City of London Police, in its capacity as National Lead Force (NLF), has drawn on figures indicating that by the end of 2010, close to 2.5 million people will be banking online. Online banking fraud was estimated to total £59.7 million in 2009, an increase of 14% on 2008. However, in the first six months of 2010 there was a 36% fall in fraud losses, totalling £24.9 million. A number of factors have contributed to this sharp decrease. These have included operational successes, but also significantly include the NFIB and the NLF working more proactively with the Banking Industry to raise customer awareness of the need to protect their own computers with up-to-date anti-virus software. This joint approach is enhanced by the banks' own use of sophisticated fraud detection software.

10. Organised crime groups are now identified by the NLF as the main threat to a secure online banking system. Crime prevention initiatives rely on a collaborative approach from numerous agencies both in the public and private sector. The City Police will continue to work closely with high street banks to identify patterns which indicate accounts which may be subject to fraud.

Online Card Fraud

11. According to the Home Office Counting rules,[63] online card fraud is not recognised as a fraud type, therefore there are no specific official statistics covering this form of criminality. The City of London Police do, nevertheless, regard the use of the internet as a. distinctive methodology in the commission of fraud and statistics published by UK Cards Association on 'CNP' (card not present) fraud -which involves the theft of genuine card details which are then used to make purchases over the internet and telephone-indicates fraud to account for 58% of all card not present losses (2009 figures).

[62] Fafinski, S and Minassian (2009) UK Cybercrime Report 2009. Published by 'Garlik' Online.

[63] The Home Office Counting Rules provide a national standard for the recording and counting of notifiable offences recorded by police forces in England and Wales (known as 'recorded crime'). The Rules were revised to take account of the National Crime Recording Standard (NCRS) which was adopted on 1 April 2002 with the aim of recording crime in a more victim-focused way and maintaining greater consistency between police forces in the recording of crime.

ONLINE FRAUD PREVENTION WORK

12. The National Fraud Intelligence Bureau (NFIB)—fully operational since June—is a key component of efforts to combat online banking fraud, online card fraud and chip and pin fraud. As one of the most advanced police intelligence systems in the world it is exposing the activities of serial offenders including those responsible for online fraud. The software isolates and matches people, places, events and behaviours associated with fraud across industry sectors. As well as directing enhanced operational activity this data is also being used to produce fraud alerts that are distributed to police forces, Action Fraud, banks and financial institutions to help warn businesses and individuals about emerging frauds and scams.

13. As a result of the NFIB, records of offences which would not have been seen by police previously—because details of them were held by financial institutions or separately by different forces—are now available for analysis. The enables the NFIB's intelligence systems comprehensively to establish patterns of fraudulent activity.

14. Additionally, the NFIB for first time is establishing the scale of repeat fraud abuse across industry sectors. A recent data-run compared fraudsters who were known to public bodies against those associated with fraud in financial institutions. It showed a 50% match rate. This information is helping shape a more robust national fraud intelligence picture.

15. Building on the success of the original Project Griffin,[64] in November the City of London Police launched Project Griffin Fraud to encourage members of the community to work in partnership with the police to deter and detect fraudulent activity and crime. One of the main aims of the project is to allow partners the chance to feedback ideas to ensure NFIB fraud alerts are as effective as possible. Members are updated by email and invited to take part in regular conference calls.

CHIP AND PIN SECURITY FEATURES

16. The City Police is not aware of any significant compromise of chip and PIN security measures. A potential compromise was identified by the card schemes and a technical upgrade was applied and has been substantially deployed over the last 2 years. Since chip and PIN was introduced, card fraud losses in the UK high street have declined by 67% since peaking at £218 million in 2004. As a result fraudsters are now targeting those environments that do not use chip and PIN, such as the internet and other jurisdiction where chip and PIN technology is not commonly used.

17. The City Police Economic Crime Directorate also have line management of the Dedicated Cheque and Plastic Crime Unit (DCPCU) which was set up in 2002 to tackle the organised criminal groups that commit cheque and plastic card fraud. The Unit comprises officers drawn from the City of London Police and Metropolitan Police Forces, supported by bank investigators and case support staff. Over the past eight years DCPCU has prevented an estimated £340 million of card and cheque fraud losses, which means on average they have prevented over £3.5 million of losses per month.

INSIDER FRAUD

18. The Financial Services Authority (FSA) takes the lead on tackling insider fraud, with the City of London Police providing expertise in the delivery of case strategies through the provision of expert investigative capability. Support from the City Police also often includes providing forensic capability, arrest and search teams and providing custody areas and interview rooms. As a recent example of the FSA-City of London Police partnership working in practice came in last month at Southwark Crown Court a man pleaded guilty to 13 counts of breaching the general prohibition to s19 of the Financial Services and Markets Act 2000,[65] in relation to the sale of shares by unauthorised overseas share brokers. The FSA wrote to the Detective Chief Supt Steve Head, Director of the Economic Crime Division, to express thanks for the City of London Police's role in this successful investigation.

December 2010

Written evidence submitted by Consumer Focus, Age UK, Citizens Advice, and Which?

We are aware members of the Committee have asked questions in evidence sessions about requiring consumer contributions prior to the Financial Ombudsman Service (FOS) taking on a case in an effort to deter speculative complaints. This issue was not raised in the session held with consumer groups so we wanted to put our views on the record.

We are very supportive of the current arrangements which allow free access for all consumers to the FOS. We strongly believe any charge for access is likely to deter many consumers with legitimate complaints from seeking redress as they would have to weigh up the potential risk of increasing any financial loss. This view

[64] Project Griffin is a City Police initiative formally introduced in London in April 2004 as a joint venture between the City and Metropolitan police forces with a remit to advise and familiarise managers, security officers and employees of large public and private sector organisations across the capital on security, counter-terrorism and crime prevention issues.

[65] Under s19 of The Financial Services and Markets Act, no person may carry on a regulated activity in the UK unless he is an authorised or exempt person under FSMA.

was supported by Lord Hunt of Wirral when he conducted his independent review: "I think it far more probable that many complainants—including the most vulnerable—would be deterred from advancing even cases that have obvious merit, particularly in claims of comparatively low value. From the perspective of accessibility, this cannot be the right solution".[66]

Universal free access is one of the criteria for membership of the British and Irish Ombudsman Association.[67] It would be deeply damaging to the wider ombudsman movement, which has benefited consumers, if the country's biggest ombudsman scheme failed to live up to the accepted standard.

Furthermore, by increasing the hurdles consumers face in seeking redress there is less incentive for the industry both to get things right the first time, and to resolve complaints quickly, effectively and fairly. The financial services industry has an extremely poor track record of adequately resolving customer complaints. The FSA's recent review of complaints handling in banks[68] found evidence of poor complaints handling standards within most of the banks they assessed. Meanwhile the FOS has seen uphold rates increase in favour of consumers across their work and is currently upholding in favour of the consumer in over half of all the disputes they resolve. Consequently, it is vital consumers have the Ombudsman as a free fallback option when the banks fail them. They should not have to pay to gain access for redress resulting from poor treatment.

We also wish to counter the claim that speculative complaints are an extensive problem causing excessive costs and delays. The FOS already makes stringent efforts to limit its costs and to ensure cases that it charges are neither speculative nor vexatious. In 2009–10, only 702 cases out of the 166,232 settled during the year (0.4%) were categorised as frivolous and vexatious and firms are not charged a case fee in these cases. Furthermore, fewer than one in six initial enquiries become chargeable cases and the FOS makes pro-active efforts to settle cases very early on thereby avoiding a fee. Each firm receives 3 "free cases" under its levy and that means only 1% of all businesses covered pay any case fees.[69]

It has been suggested that financial firms are concerned by the significant number of cases and delays generated by claims management companies (CMCs) on payment protection insurance (PPI). We would point out that the uphold rate for PPI cases is higher than the average at 89%.[70] Therefore, there is no evidence to suggest the cases CMCs generate are not legitimate.

We would be interested to see what evidence the industry has presented supporting their case that speculative complaints are a problem, and on the cost burdens they believe these impose. The highly unsatisfactory delays involved in complaining to FOS we believe are the result of banks failing to settle cases earlier when they know they will lose. The solution is to get banks to settle cases earlier when they know they will lose, rather than making the FOS less accessible to consumers.

We very much hope the Committee takes on board our views and rejects the idea of introducing a charge for access to the FOS.

21 December 2010

Supplementary written evidence submitted by the Association for Financial Markets in Europe (AFME)

COMPLIANCE COST OF REGULATION FOR CONSUMERS

Thank you for your letter to me of 14 December, following our attendance at the Committee's Hearing on 12 October.

AFME's brief is to focus on Capital Markets issues on behalf of our Members, so that we have little information about the compliance cost of regulation for consumers (and, indeed, we recall that the questions on this aspect that were raised at the Hearing were put to the representatives of the building societies and high street banks). However, we have drawn our Members' attention to the Committee's interest in the compliance costs issue and have suggested that they should contact you if they feel able to help; also, anecdotally, we can report that some Members in reviewing the costs of their Compliance teams (so excluding other compliance costs and FSA levies/fees) have referred to headcount increases of more than 50% since 2005, contributing to an increase in departmental budgets of over 90%—and this at a time when business headcount overall over the same period has fallen.

We are also aware of some helpful studies that have been undertaken in the past which maybe of assistance to the Committee's work.

A Deloitte report—The cost of regulation study—commissioned jointly by the FSA and the Financial Services Practitioner Panel is particularly relevant. While the report's conclusions relate to three financial services sectors (hence no general conclusions can be drawn about the total cost of regulation across the UK financial services industry), the report was considered to be "ground-breaking in its nature and scope" whilst also illustrating the challenges and limitations inherent in trying to measure the costs of regulation. In particular, the report confirmed that:

66 http://www.thehuntreview.org.uk/updates/FOS_Report.pdf
67 http://www.bioa.org.uk/criteria.php
68 http://www.fsa.gov.uk/pages/Library/Other_publications/complaint_handling/index.shtml
69 http://www.financial-ombudsman.org.uk/publications/technical_notes/QG1.pdf
70 http://www.financial-ombudsman.org.uk/publications/ar10/ar10.pdf

"Firms do not generally seek to measure and monitor their costs in terms of regulatory activity—the costs of complying with the FSMA [Financial Services and Markets Act] requirements are now largely embedded into firm's operating infrastructure". *[Executive summary, section 1.6]*

"Some large films, due to their global presence, will primarily monitor and manage financial performance, including their cost base, by division rather than legal entity. This makes it difficult to distinguish between costs incurred in undertaking business in the UK and overseas. Firms with global operations may also apply a global approach to regulation in which they apply a common set of standards which incorporate all necessary local regulatory requirements. Consequently, this has reduced the amount of incremental regulatory costs reported by those medium and large firms where an overseas regulatory imposes equivalent or super-equivalent regulatory standards to those required under the FSMA". *[Executive summary, section 1.2]*

At a more subjective level, the Committee may well be aware that the Practitioner Panel's periodic surveys of the FSA's regulatory performance examine firms' views on the costs of compliance—so these too should be a helpful source.

We would also highlight, finally, two reports on the FSA itself that consider, respectively, the economy, efficiency and effectiveness with which the FSA has used its resources in five key areas of its operations and its progress towards implementing the Hampton and Macrory reports (which were concerned with achieving regulatory outcomes in a way that minimises the burdens imposed on business): namely—

— The Financial Services Authority, A review under section 12 of the Financial Services and Markets Act 2000: The National Audit Office, April 2007; and

— Effective inspection and enforcement: implementing the Hampton vision in the Financial Services Authority: the National Audit Office and the Better Regulation Executive.

We hope this information is helpful and we stand ready, of course, to help further on any specific questions that are pertinent to AFME's role with which we might be able to assist the Committee.

Mark Austen
Chief Operating Officer

7 January 2011

Supplementary written evidence submitted by Nomura

Thank you for inviting me to give evidence before the Committee last Thursday.

The session raised several important issues about European Union financial regulation and its impact on the UK's financial services sector.

I would underscore particularly the importance of ensuring that UK and EU policymakers address the causes rather than the symptoms of the crisis, namely barriers to entry in the banking sector and the impact of government guarantees on creditors' expectations and the appetite for risk. I would also emphasise the need for coordination at a global level to ensure a consistent approach to financial regulation and to reduce opportunities for regulatory arbitrage.

The Committee asked Nomura to submit supplementary written evidence regarding the increase in resourcing to manage regulation in the aftermath of the crisis. I now enclose this information (see annex).

I hope this assists the Committee in its inquiry. Please do not hesitate to contact me if you have further questions about the enclosed material.

David Benson
Global Chief Risk Officer

Annex

The Treasury Committee requested supplementary evidence regarding the increase in resourcing required to deal with new regulation in the aftermath of the financial crisis.

The table below shows headcount in the key departments in Nomura's operations in Europe, the Middle East and Africa (EMEA) responsible for managing financial regulation. Figures are given at the end of the financial year for 2009 and 2010, with a forecast of the headcount for March 2011.

This equates to an expected increase in headcount of 77 percent from March 2009 to March 2011.

Figure 1

HEADCOUNT IN DEPARTMENTS RESPONSIBLE FOR MANAGING FINANCIAL REGULATION IN NOMURA'S EMEA OPERATIONS, 2009–11

Department	*March 2009*	*March 2010*	*March 2011 (forecast)*	*(%) Increase*
Risk	79	104	173	119%
Risk IT	25	33	44	76%
Compliance	52	57	59	13%
Total	**156**	**194**	**276**	**77%**

10 December 2010

Supplementary written evidence submitted by the Building Societies Association

Thank you for your letter of 14 December 2010 which poses a series of difficult questions. I have distributed your letter to the Council (ie Board) of The Building Societies Association and have a little information to give you. (The Council comprises the chief executives of the three largest building societies, and Co-operative Financial Services, along with the chief executives of nine medium-sized and smaller building societies broadly representative of the sector.) However, the answers that have been provided to me are by no means definitive and I don't think will take you very far along the path you are quite rightly are seeking to travel.

Before I give you the Council's responses it is helpful to refer to the joint FSA/Financial Services Practitioner Panel 2005 report *(The cost of regulation study)*, which I think is the best attempt in recent years to look at the cost of regulation. This can be found at http://www.fspp.org.uk/documents/Deloitte%20Costs%20final%20report%2028%20June%2006.pdf. The report, prepared by Deloitte, covers only three areas—corporate finance, institutional fund management, and investment and pension advice, all fairly remote from building societies' mainstream business, and was, of course, prepared well before the recent very significant market events and regulatory changes. The report, which I think took around a year to prepare, discusses the very difficult issues that need to be addressed in preparing estimates of regulatory costs, the significant input required of firms taking part in the study, and the risks of inconsistent responses even where terms were tightly defined. The research highlighted the variety of experiences and views among firms including very different levels of compliance efficiency, different estimates of the incremental costs of regulation (and therefore of what would have been done anyway), and different levels of appetite to take compliance risks.

These issues were reflected in the reactions I received from BSA Council members (although I suspect few recall the report mentioned above) when I circulated your letter. The most common response from members of the Council was the likely inconsistency between institutions in making regulatory cost estimates. Also none felt that any realistic work could be undertaken in the time scale suggested by your letter. Difficulties were highlighted in determining what items were within the "costs of regulation" and what were outside. Separating out what element of that cost is considered to be excessive or disproportionate—that is the level which would be thought to be over and above the reasonable cost of the risk management and compliance costs that managements would expect to incur in running a well controlled entity in any case—was seen as especially problematic.

Having said this, one small member told me that it found it hard to support the ratio of indirect to direct costs quoted in your letter.

Another smaller contributor to this response has indicated that it recently recruited three additional people out of a total full-time equivalent employment of 115 to ensure that the business of compliance was well documented and understood across the business. Responsibilities were reordered for a range of other staff with the same objective in mind. For this society, however, the biggest indirect cost is the opportunity cost of not embarking on new areas due to the constraints of simply absorbing new and increasing regulation for the current business—this would be measured in terms of lost asset growth, and lost opportunities to introduce new products that might have helped members to meet their financial needs.

Another small member of the BSA Council suggests that "off the top of my head" the additional cost beyond that of usual management information of compliance is about 8% of the cost base.

Finally, one large member of the Association put forward the following analysis of their interaction with the FSA during the fourth quarter of 2010. They received six visits from the FSA. All the visits involved a degree of discovery work in advance, which meant that staff were involved in gathering on occasions, significant volumes of management information for the FSA. That organisation conducted 85 meetings with 86 members of staff. The vast majority of the meetings were shadowed and roughly a third of meetings were

with directors and directors' direct reports. Further update meetings took place with typically five or six colleagues attending. Taking into account preparation for FSA meetings and debriefs, a typical hour and a half for each meeting with the regulator is likely to consume a man day for the interviewee.

The final piece of information I can offer arises from a survey which the Association undertook of Chairmen of BSA members at the end of 2010. This survey revealed regulatory compliance and oversight was reported to be one of the areas that occupied most time at board meetings over the previous year. Five out of 29 respondents to the survey said that compliance was the most time consuming topic in 2010 and another four said that it was the second most time consuming. This puts regulatory compliance on a par with current market conditions and setting strategic direction as the most commonly reported topic that occupied the most board time.

As I said at the beginning of this letter I don't feel that this information answers the points raised by your letter very well. It is clear that a robust, albeit time consuming and properly resourced, survey of firms is necessary to provide the necessary output. The Treasury Committee might like to consider recommending that the FSA, and the Financial Services Practitioner Forum, repeat and extend their earlier study, although the planned reform of the UK financial services regulatory system makes it difficult to determine when such work should be undertaken.

Adrian Coles
Director General

11 January 2011

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