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Treasury Committee

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

Seventh Report of Session 2010–11

Volume III

Additional written evidence

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Written evidence

Written evidence submitted by the Office of the Complaints Commissioner

1. Current Position Regarding Accountability

1.1 Under the Paragraph 7(1) of Schedule 1 of the Financial Services and Markets Act (2000) (FSMA), the FSA must make arrangements for the investigation of complaints arising in connection with the exercise of, or failure to exercise, any of (the FSA's) functions (other than its legislative functions) made by eligible complainants. The rules of the complaints scheme are set out in the document entitled Complaints against the Financial Services Authority (also known as COAF). Specifically, paragraph 1.4.1 of COAF provides:

COAF 1.4 Coverage and scope of the scheme

1. allegations of misconduct by the FSA arising from the way in which it has carried out or failed to carry out its functions. The complaints scheme covers complaints about the way in which the FSA has acted or omitted to act, including complaints alleging:

(a) mistakes and lack of care;

(b) unreasonable delay;

(c) unprofessional behaviour;

(d) bias; and

(e) lack of integrity.

2. [deleted]

3. To be eligible to make a complaint under the complaints scheme, a person (see COAF 1.2.1 G) must be seeking a remedy (which for this purpose may include an apology, see COAF 1.5.5 G) in respect of some inconvenience, distress or loss which the person has suffered as a result of being directly affected by the FSA's actions or inaction.

1.2 The FSA must appoint a Complaints Commissioner, subject to the approval of HM Treasury, in order to carry out the functions conferred upon it by the Complaints Scheme.

1.3 The FSA is by the scheme implemented under Paragraph 7 of Schedule 1 of FSMA subject to independent accountability and oversight by a Complaints Commissioner.

1.4 *What are the possible outcomes for any complainant?*

1.4.1 If the FSA concludes that a complaint is well founded, it will tell the complainant what it proposes to do to remedy the matters complained of.

1.4.2 Remedying a well founded complaint may include offering the complainant an apology, taking steps to rectify an error or, if appropriate, the offer of a compensatory payment on an ex gratia basis. If the FSA decides not to uphold a complaint, it will give its reasons for doing so to the complainant, and will inform the complainant of his right to ask the Complaints Commissioner to review the FSA's decision.

1.4.3 Complainants who are dissatisfied with the outcome of an investigation, or who are dissatisfied with the FSA's progress in investigating a complaint, may refer the matter to the Complaints Commissioner, who will consider whether or not to carry out his own investigation.

1.5 When the FSA writes to a complainant with its final report of its investigation, or explaining that it will not investigate a complaint under the complaints scheme, the FSA will inform the complainant that, if he is dissatisfied, he must refer the FSA's decision to the Complaints Commissioner within three months of the date of that letter.

1.6 The current complaints scheme is widely considered to have worked well. It was set up in order to give the Industry a feeling that its interests would not be ignored by an over-zealous FSA bearing in mind that any Regulator must always have due regard to its statutory responsibilities.

1.7 It is recognised that the Industry has expressed concerns about the modus operandi of the Financial Ombudsman Scheme (FOS) and to a lesser extent the Financial Services Compensation Scheme (FSCS) but these concerns and these bodies do not come within the jurisdiction of the Complaints Commissioner.

1.8 Consumers also have access to the Commissioner's jurisdiction but are less successful in that access when compared to the Industry. This is because any dispute will generally revolve around a particular advisor or product as opposed to the FSA exercising its statutory responsibilities.

1.9 The most common complaint currently relates to the issue of plea discussions in the context of the Enforcement Department of the FSA. The Enforcement Department of the FSA is the department responsible for investigations of misconduct and prosecuting the result of the investigation if that is merited. Sanctions are determined by a quasi judicial process carried out by the Regulatory Decisions Committee (RDC) with a right of appeal to the Financial Services and Markets Tribunal. On many occasions an alleged offender will enter into a discussion to see if he can "strike a deal" as to his sanction without going through

the RDC process. Misunderstandings can, and do, then arise. To prevent this the Commissioner continues to recommend that any such discussions should not be conducted under a hectoring or threatening note but remain cognisant of the importance of the principle of equality of arms to ensure that the lack of representation of the alleged offender is not ignored to his detriment. The best way of achieving certainty in that area and to avoid challenges thereafter is to make a detailed note of all discussions and that that note is agreed by both parties.

1.10 Other areas that arise relate to fees and their calculation and to authorisations but do not merit individual comment in this response.

2. What are the relevant proposals in the context of the current position of the Complaints Commissioner?

2.1 Paragraph 3.38 of the Consultation Paper states:

> Given the quasi-legislative rule-making function of the Prudential Regulatory Authority (PRA), including the power to raise levies from firms, the Government will give particular consideration to which, if any, of the accountability mechanisms currently established with respect to the FSA should be put in place for the PRA. These mechanisms are described in more detail in paragraph 4.36.

2.2 Paragraph 4.36 of the Consultation Paper states:

> The Consumer Protection and Markets Authority (CPMA) will be subject to the following accountability mechanisms set out in statute and provides (inter alia):
>
> — a duty to maintain a complaints mechanism similar to that required of the FSA by schedule 1 of FSMA.

3. The Proposals Under Consultation

3.1 The Prudential Regulatory Authority (PRA).

3.1.1 The PRA has been given the role of promoting stable and prudent conduct of the financial service industry. It will also be given operational responsibility for the regulation and supervision of firms and will take over responsibility for regulatory decision making including the authorisation, supervision and the enforcement of its rules upon firms and take the lead in imposing sanctions (taking action) against firms. From this it appears that the PRA will inherit the FSA's regulation and supervision roles.

3.1.2 It is noted that the PRA will move from "a tick box approach" to regulation to a "judgement led" approach. Adopting this type of approach, whilst to be encouraged, requires different skills and improved documentation of the rationale for decisions. The Complaints Commissioner on occasions has commented that the FSA does not maintain adequate records and should improve its record keeping. This is referred to in his annual reports. The question therefore arises whether the staff, which will no doubt transfer from the FSA to PRA to undertake these roles, will have sufficient skills to adapt to this new, quite different, style of regulation. Failing to maintain adequate records, explaining the rationale behind decisions will leave the PRA open to claims of bias, lack of integrity and negligence. It is therefore important that the decisions made by the PRA staff are subject to review and oversight by an independent body and where complaints are made, particularly by the Industry, an independent review can be conducted.

3.1.3 Presumably the new regulators will have a statutory immunity from claims for negligence, albeit that complaints of this nature can be considered under the rules of any complaints scheme.

3.1.4 Much criticism has been made of the FSA by both the Industry and consumers, but not always justified, that the FSA is an entity which operates as its sees fit and is not accountable to anyone. Whilst much of the criticism relates to the failures of the Tripartite arrangement which led to the events of 2008/09, it is important that the PRA, as the lead regulator is seen to be open and to have accountability both to Parliament and to an independent body which is easily accessible both to the public and the Industry as the FSA is currently.

3.2 *Consumer Protection and Markets Authority (CPMA).*

3.2.1 The CPMA has been given the role of promoting confidence in the financial services industry and financial markets. It is envisaged that it will achieve this by undertaking arms length oversight of the operation of firms and markets conducting financial services.

3.2.2 The Consultation Paper indicates that the PRA will be the lead regulator and will have overall responsibility for the supervision of the industry. However, it goes on to say that the CPMA will have responsibility for ensuring that authorised firms comply with its Conduct of Business (COB) rules. Currently the COB rules form part of the FSA's handbook and are monitored, amongst other things, by a firm's Supervision Team. It is unclear how the PRA will be able to fulfil its role and supervise the Industry without considering the COB rules and/or the firms conduct. Having the PRA and the CMPA effectively both supervising a firm is introducing an "overlap" situation which could cause confusion as well as imposing further regulatory burden on the Industry which is something which the proposals intended to avoid.

3.2.3 Having two regulators effectively conducting, to some extent, the same functions albeit overlapping in some areas, introduces the possibility of inconsistent interpretation of the rules and/or requirements, particularly where judgement based regulation is being implemented. It also again raises the question of accountability and inappropriate comments or instructions on requirements during supervisory visits. This in turn leads to the necessity of the requirement of accountability (through a complaints process) on both bodies.

3.2.4 It is clear that the Government intends to have a degree of independent oversight of both the PRA and the CPMA. However, whilst the Government is consulting on this it is unclear whether it intends to adopt the same procedures for both bodies. This point is raised as, from the above, it does appear that there will be a considerable 'overlap' between the roles of both the PRA and the CPMA even though the PRA will be regarded as the lead regulator.

3.2.5 There needs to be a clear demarcation of the boundaries between the roles and operational process adopted by the CPMA and PRA. From the Consultation Paper, it does not appear, or is at least unclear, whether there is to be a clear demarcation between these regulators. This is particularly relevant if mistakes are made by one or both of the regulators when considering the actions of the firm.

3.2.6 The Complaints Commissioner does not have the jurisdiction currently to entertain complaints about a particular product provider and a consumer of that product. That jurisdiction is fulfilled by the existence of the FOS and should be replicated at the end of the current process of change.

3.2.7 The issue of clarity in this area is important however and it is essential that there continues to exist a clear dividing line between the jurisdiction of any Complaints Commissioner and any new or enlarged FOS. The Complaints Commissioner must not become a second port of call for a consumer who fails at the hands of the FOS.

4. The issue of Compensation and the meaning of ex gratia

4.1 The last time this matter arose was during the passage through Parliament of the Financial Services and Markets Act 2000. The report in Hansard (27 January 2000 Column 617) is worthy of consideration at this juncture as the difficulties that were canvassed then remain live today.

4.2 The Industry funds what is put in place in terms of the overall regulation of the Industry but would no doubt be seriously concerned if that funding could be open ended in terms of compensatory payments and the consequential legal costs if recourse was had to the Courts.

4.3 The current wording within the current scheme has not led to large awards by the Complaints Commissioner for a number of reasons:

4.3.1 the issue of direct causation of loss caused by the FSA is not necessarily easy to establish;

4.3.2 the complainants often were primarily to blame because of the actions that they themselves took;

4.3.3 it is clear that it is the case that other third parties bear some degree of responsibility;

4.3.4 the loss suffered could not have been in the contemplation of the FSA—it is simply too remote;

4.3.5 sufficient degree of culpability cannot be laid at the door of the FSA;

4.3.6 what is called a novus actus interveniens (an intervening act) breaks the chain of causation.

4.4 This list is not exhaustive but gives some indications of the hurdles that have to be surmounted. That is in addition to the fact that the scheme in question does not involve hearings or representation at hearings and a consequential forensic examination of the relevant evidence. Quite apart from the fact the scheme refers specifically to "compensatory payments" and not damages and whatever the figure awarded is to be ex gratia. That is, it is a discretionary award.

4.5 The FSA is well aware of the problems posed by this whole issue and the position that it arrived at after extensive consultation (see CP73 (November 2000) and CP93 (May 2001) seemed to result in a compromise acceptable to all.

4.6 However The Law Commission has also looked at the problem of Administrative Redress between Public Bodies and the Citizen and has issued a Consultation Paper No 187 to which the FSA responded on 30 October 2008.

4.7 The view could be taken, viewed objectively, that the current position despite some uncertainties represents a reasonable compromise having regard to the existence of the FOS and the FSCS as well as this office that ensures accountability of the Regulator as set out in 1.1 hereof.

4.8 Whilst the current complaints scheme does not give a right to financial awards called damages to successful complainants, and is only under the obligation to offer compensatory payments, where a complainant can demonstrate a financial loss (which they would not have incurred had it not been for the FSA making a decision which upon review of the information available to it at the time was incorrect) the FSA can then make an award on an ex gratia basis. Any complaints scheme which the Government puts in place as a result of the Consultation Papers may feel obliged to address the issue of Compensatory Payments possibly on the same basis and taking account of both the requirements of EU law and the Human Rights Act (which FSMA does).

5. Answers to Specific Questions Posed by the Treasury Select Committee (where Relevant to the OCC)

5.1 *Do the Government's proposals appropriately assign roles and responsibilities between the different regulatory institutions?*

5.1.1 This report shows that the "overlap" of functions does not clearly and appropriately assign roles and responsibilities between the PRA and the CPMA in the context of accountability. If the approach is to be adopted exceedingly clear boundaries will be needed and a demarcation of responsibilities set out. There also needs to be clear guidelines and timescales for referrals and co-operation between regulators. If this is not the case there will be constant litigation in the Courts.

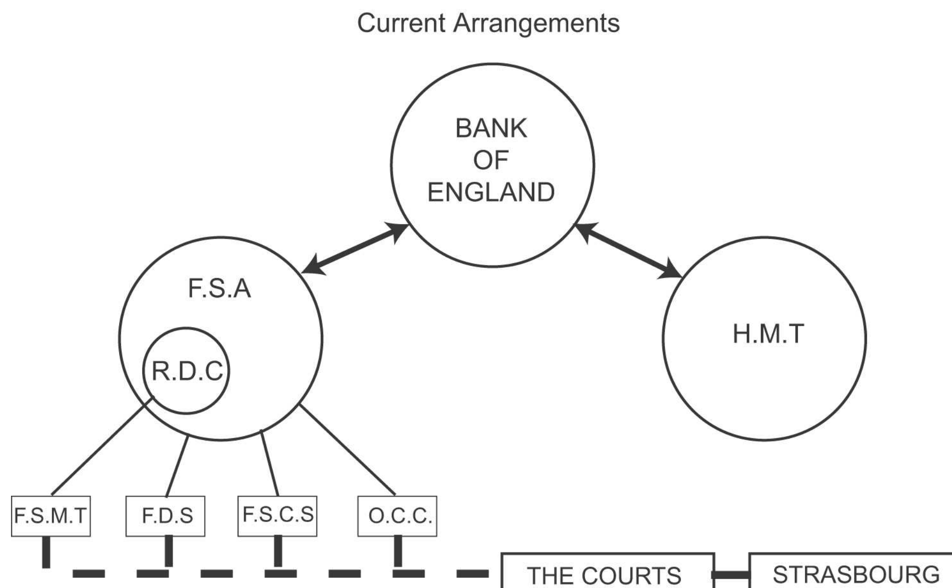
5.2 *Is it appropriate for the PRA and the CPMA to adopt judgements-based approach to financial regulation and supervision?*

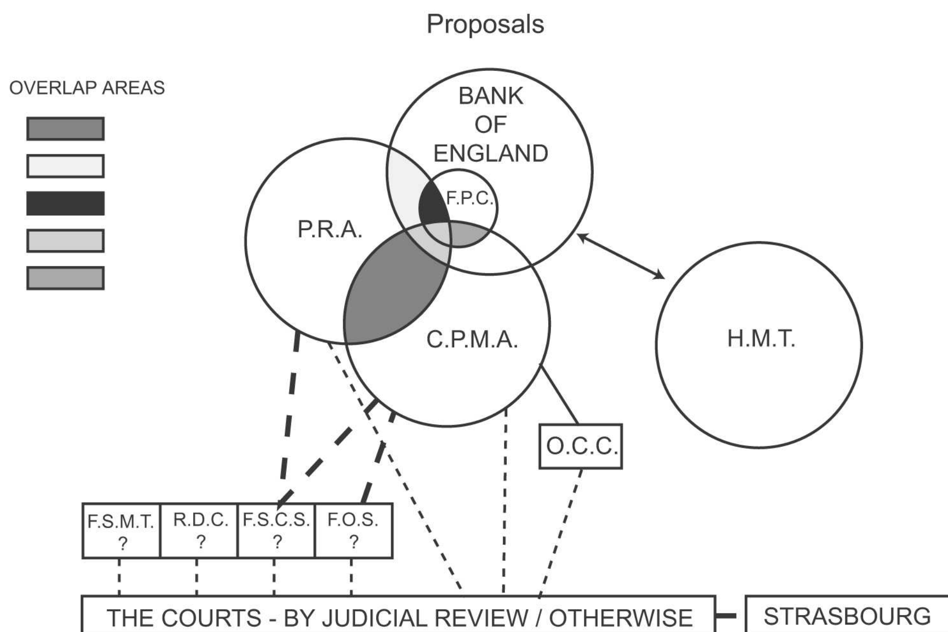
5.2.1 It is questionable whether the staff transferring to the PRA and CPMA from the FSA currently have sufficient skills to undertake this type of regulation. Whilst judgement led regulation will reduce the size of any rulebook firms must operate within, it opens regulation to interpretation (and therefore challenge). Whilst adopting this approach could make regulation simpler, it equally could (and is likely to) introduce inconsistencies between regulators (and even employees of a regulator) over what is acceptable and what is expected. The regulators (and in particular individual supervisors) need to adopt a common or standard approach, with clear and full documented rationale for any judgements they make and advice/instructions which are given to firms.

5.2.2 There are also considerable issues to the manner in which the FSA retains records of the rationale giving rise to the decisions made. Considerable improvement to the new regulators' record keeping (including the rationale behind/supporting its decision making) needs to be made to ensure that the reasons for their decisions can be justified so that any claims that the relevant regulator made mistakes, acted inappropriately or acted with bias can be defended. Failure to do so, particularly if Enforcement action is taken could leave the regulators open to a successful challenge at the equivalent of the RDC and/or the Tribunal with ultimate recourse to Strasbourg.

5.3 *To what extent will the regulatory and administrative burden increase for those firms who now have to deal with two regulators?*

5.3.1 From the Consultation Paper it is clear that there is a considerable overlap in the roles that the PRA and CPMA will undertake, particularly in relation to rule making, supervision and reporting. Those firms having to deal with two regulators will have to comply with two sets of rules (which will overlap and may be inconsistent), be subject to two supervisory regimes (and presumably visits) and also submit reports to two bodies. From this (and the above) it is clear that the regulatory and administrative burden will increase considerably for the affected firms.





15 September 2010

Written evidence submitted by the Association of British Credit Unions Ltd

EXECUTIVE SUMMARY

1.1 As the main trade association for credit unions in Britain, we welcome the opportunity to respond to this inquiry on behalf of our members who serve around 85% of credit union members in the country.

1.2 Credit unions provide services to over 850,000 people in Britain and look after over £600 million in savings.

1.3 As financial co-operatives, credit unions only exist to meet the needs of their members, who own and control the credit union on a one member one vote basis. Credit unions provide inclusive financial services and work with local, regional and national governments to tackle financial exclusion in communities around the country.

1.4 As financial mutuals, credit unions have a key role to play in Government plans to foster diversity in financial services and promote mutuals.

1.5 Many credit unions employ staff and of those that do, the vast majority employ less than five. The size of credit unions, coupled with their simple business model means that a proportionate approach to regulation is essential if they are not to be adversely affected by burdensome red tape.

1.6 Our submission to this inquiry represents the early thoughts of our members. Credit unions are keen to be able to access focussed communication and guidance in the run up to any changes. Credit unions have concerns about the following points:

— that the regulatory compliance burden may not be proportionate to the size of the sector and institutions;

— that regulation by two bodies may cost more to deal with and may require significantly more time from credit union volunteers and staff;

— that staff and directors of the new organisations, if new to the regulation of the sector, may not have sufficient understanding of the unique features of credit unions and that briefing these people becomes a further burden for credit unions and the trade body;

— that consultation with practitioner panels and public consultation should continue to be a key part of the policy making process; and

— that costs may be increased due to an overcomplicated structure for raising levies for the FSCS.

1.7 In the work of both the PRA and the CPMA, consideration should be given to promoting financial inclusion and recognising the value of financial mutuals.

1.8 The key regulatory needs for the credit union sector are for proportionality, a recognition of and understanding of credit unions' unique features and a simple structure which will not place undue burdens on credit unions in terms of time and money.

Introduction

2.1 We welcome the opportunity to respond to this inquiry. ABCUL is the main trade association for credit unions in Britain. The Association represents approximately 70% of credit unions in England, Scotland and Wales who in turn represent about 85% of credit union membership. Credit unions are not-for-profit, financial co-operatives owned and controlled by their members. They provide safe-savings and affordable loans facilities. Increasingly credit unions offer more sophisticated products such as current accounts, ISAs, Child Trust Funds and mortgages.

2.2 At the end of March 2010, credit unions in Great Britain were providing financial services to 761,708 adult members and held £599 million in deposits with £474 million out on loan to members. There were also 107,077 young people saving with credit unions.[1]

2.3 At 30 September 2009, the 325 credit unions belonging to ABCUL were managing around £568 million of members' savings on behalf of over 470,000 adult members.

2.4 The Credit Unions Act 1979 sets down in statute the objects of a credit union; these are four-fold:

- the promotion of thrift among members;
- the creation of sources of credit for the benefit of members at a fair and reasonable rate of interest;
- the use and control of their members' savings for their mutual benefit; and
- the training and education of members' in the wise use of money and in the management of their financial affairs.

2.5 The Coalition Government, since coming to office, has committed to bring forward detailed proposals to foster diversity in financial services, promote mutuals and create a more competitive banking industry.[2] At a meeting of the All-Party Parliamentary Group on Credit Unions on 30 June 2010, the Financial Secretary to the Treasury, Mark Hoban MP, explicitly identified credit unions as part of this drive to support mutuals in financial services saying:

> "This Government believes that strong credit unions will greatly enrich British society, so it is in our interest to do whatever we can to help the credit union movement to prosper."[3]

2.6 Over the past decade or more credit unions in Britain have developed significantly towards emulating the successes of their international counterparts. According to the World Council of Credit Unions (WOCCU) there are 49,330 credit unions operating in 97 countries and with $1.4 trillion dollars in assets—in Ireland more than 50% of people belong to their credit union whilst in the US and Canada it is around 45%.[4]

2.7 The credit union business model is a simple one. With limited exceptions—notably the DWP Growth Fund with which over 100 credit unions have delivered 300,000 affordable loans in low income communities using money from the Financial Inclusion Fund—the money that credit unions lend out to members comes from members' savings.

2.8 The latest information available to us (from 2007) shows that 150 credit unions that are ABCUL members (out of 330) did not employ any staff. Only 25 credit unions employed 5 or more full time staff. This demonstrates the small size of credit unions and the need to ensure that regulation does not result in a disproportionate burden on their operations.

2.9 ABCUL recognises the need for good governance and management in credit unions and works with its members in a number of ways to raise standards of governance and ensure that credit unions are well run, sustainable and effective financial co-operatives. As well as a range of training and information services, we have launched a Code of Governance for Credit Unions and introduced the PEARLS financial monitoring system. We have always been supportive of FSA regulation and the raising of standards for credit unions, but given the size and development stage of the sector, have always stressed the need for proportionate regulation which does not place undue burdens on credit unions.

2.10 We have concentrated in our response on some early thoughts from our sector on how credit unions could be affected by this proposal, informed by a survey of our members. We have also included some views informed by the last transition for credit union regulation—the move to FSA regulation in 2002.

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1 Figures from unaudited quarterly returns provided to the Financial Services Authority.
2 The Coalition: our programme for Government: http://www.cabinetoffice.gov.uk/media/409088/pfg_coalition.pdf
3 See: http://www.hm-treasury.gov.uk/speech_fst_300610.htm for full speech.
4 See: www.woccu.org

3. The move to FSA Regulation—2002

3.1 Credit unions have been regulated by the Financial Services Authority since 2002. A specialist sourcebook within the FSA Handbook sets out prudential rules and guidance for credit unions.

3.2 Prior to the FSA regime, credit unions were regulated by the Registry of Friendly Societies. This was largely a light touch regime and the move to FSA regulation therefore represented a challenge for the sector, especially for smaller credit unions.

3.3 In recognition of this, staff at the FSA worked closely with the sector and trade associations to ensure that credit unions were prepared for the new regime. A series of road shows took place at which credit union staff and volunteers were able to find out more about the new regime. FSA staff helped ABCUL to prepare a range of information and training.

3.4 Comments received from our survey of members shows that these efforts were appreciated and helped credit unions to make the transition to the new regime.

3.5 Credit unions were, on the whole, appreciative of the efforts that the FSA took to communicate the changes to credit unions, and the time that was taken to allow credit unions to familiarise themselves with the new regime. But the view that FSA staff did not, at the beginning of the regime, have enough knowledge and experience of credit unions was also raised.

3.6 We believe that it is important that the communication and education efforts that the FSA put in place to prepare credit unions for transition in 2002 are repeated when these proposed changes take place. Efforts should also be taken to ensure that experienced and knowledgeable staff are in place at the new regulatory authorities to ensure the smoothest possible transition.

4. The current Regulatory regime and proposed changes

4.1 Credit unions are currently subject to rules and guidance in the Credit Union Sourcebook (CRED) as well as being required to conform with Banking Conduct of Business Rules (COBS).

4.2 Credit unions are required to keep a basic level of solvency, maintain a minimum liquidity ratio, and key staff and volunteers are subject to the FSA's approved persons standards. Credit unions are also part of the Financial Ombudsman Service and must comply with rules on complaint handling and they must comply with reporting requirements as part of their membership of the Financial Services Compensation Scheme.

4.3 Credit unions operate either with a Version 1 or Version 2 permission. Along with some variation because of a credit union's size, this determines the powers credit unions have and the regulatory regime they are subject to.

4.4 This regime reflects the risk based approach to credit union regulation that the FSA has taken. Smaller credit unions are mainly supervised using a desk based approach using regulatory returns—credit unions will be visited and more attention will be paid to their business planning and operations.

4.5 As the FSA has to cover the costs of regulation through fees paid to firms, it is essential that the regulation is efficient, proportionate and does not impose a financial or resource burden on credit unions.

4.6 The FSA has taken the opportunity of forthcoming legislative reform for credit unions to review the prudential standards for the sector. We have worked closely with our members and the FSA during the consultation period for these changes and broadly welcome the near final rules which will increase the minimum capital–assets ratio for credit unions, so that the majority of credit unions will not just have to meet bare solvency to be compliant. We also welcome the commitment of the FSA to review their use of regulatory returns to ensure that problems are picked up in credit unions in a speedier manner.

4.7 Credit unions have a simple business model which is not affected by the vagaries of international financial markets. Credit unions have not been responsible for risky and short term business practices which have severely damaged the economy in recent years. As financial mutuals, credit unions have democratic internal checks and balances built in to their business models. Proportionate and effective regulation, which recognises the volunteer led nature of credit unions and effectively uses financial information to spot early signs of trouble, need not place a financial or resources burden on credit unions. The FSA has been reasonably successful in reaching this balance and this should continue under a new regime.

5. The Proposed new Structure for Regulation

5.1 In order to ascertain the views of our members, varying in size from 200 to over 20,000 members, we carried out an online and postal survey during August 2010. 64 credit unions responded to the survey, representing over 20% of our membership. The survey attracted responses from a broad cross section of credit unions.

5.2 *The proposed new structure*—The majority (53%) of credit union respondents did not know at this stage whether these proposals overall were a good idea. Only 22% thought that the proposals were a good idea.

5.2.1 Major changes in regulation can be extremely disruptive for small firms which operate with few or no staff. Communication and explanation about how the changes will affect credit unions and assistance to prepare is essential if understanding is to be raised and if credit unions are to be able to confidently comply with a new regime.

5.3 Dealing with two regulators—A large majority (73%) had concerns about dealing with 2 regulators instead of one.

5.3.1 Reasons to be concerned focussed around cost, time and level of understanding:

Costs of dealing with regulation may increase	87%
Fees for dealing with regulation may increase	91%
Time taken to deal with regulation may increase	83%
Regulators may not understand credit unions as well	72%

5.3.2 A number of credit unions were also concerned about the potential for conflicts that could arise because of more than one regulatory body, and potential problems that could be caused by lack of communication between different regulators. This could possibly lead to duplication of work and/or credit unions being pulled in two different directions.

5.3.3 It is essential to ensure that in building a new system any duplication is avoided and efficiency as well as effectiveness are the main considerations in its design. Credit unions only exist to meet the needs of their members and operate on very tight margins. They have limited resources and unnecessary regulatory burdens can place the operations of smaller credit unions at risk. It is essential that care is taken to ensure that these reforms do not impact unduly upon the compliance burden for credit unions.

5.4 Cost Benefit Analysis and consultation requirements— Of those who had made up their mind, a large majority of respondents (88%) thought that the PRA should be required to carry out a Cost Benefit Analysis and consult with practitioner panels and the general public before making rules.

5.4.1 The consultation process is a vital part of the FSA rules making process, and will continue to be so under the new regime. As a small part of the financial service sector, credit unions have no representation on the FSA board.

5.4.2 Credit union inclusion in practitioner panels and ABCUL's engagement with consultations in the past few years has been an essential way of demonstrating the needs of the sector and ensuring that unnecessary burdens are not placed (whether inadvertently or not) on credit unions. It is essential that the consultation process should continue under a new regime.

5.5 Compensation and Levies

5.5.1 A large proportion of our members who expressed a view (82%) believe that a single scheme for funding the Financial Services Compensation Scheme should continue, as should cross-subsidy across the classes. This is likely to be a simpler and more cost effective system and is more likely to be able to cope with any future crisis and ensure that consumers receive compensation in the most efficient way possible. We would be concerned about proposals which would place a higher financial burden on credit unions.

5.5.2 A single levy raising system for the FSCS should continue, as should cross subsidy between different classes of firms under the Financial Services Compensation Scheme. It would make sense for the CPMA, as the responsible body for the FSCS to have responsibility for the levy raising function.

5.6 *Considerations under which the CPMA should operate*: Establishing considerations or "have regards" under which the CPMA should operate represents a great opportunity to ensure that social goals and Government commitments are at the core of the operations of the CPMA.

5.6.1 The Coalition Agreement commits the Government to "foster diversity in financial services, promote mutuals and create a more competitive banking industry". Having a built in requirement to promote diversity in the financial services industry and require the CPMA to ensure that rules do not disadvantage mutually owned financial services providers will be of benefit to the aims of the Government as well as to consumers.

5.6.2 Ensuring that the needs of all consumers and not just those on higher incomes are met should also be a key consideration for the CPMA. Commercial financial services providers tend either to not provide the services that people on lower incomes need, as they are not profitable, or, in the case of so called 'sub-prime' lenders, charge much higher rates than customers of mainstream financial services providers enjoy. Promoting financial inclusion by encouraging access to suitable products and services should therefore also be a key consideration within the work of the CPMA.

5.6.3 We agree with considerations proposed and believe that the suggested public interest considerations will be an important factor in the effectiveness of the CPMA and its ability to meet the needs of all consumers. Promoting diversity by ensuring that the unique needs of financial mutuals are taken into account in the work of the CPMA, and promoting financial inclusion are essential in ensuring that all consumers can benefit from the work of the new agency. Other agencies in the new regulatory structure should also have regard to these considerations, and that of promoting competition in the financial services

industry in their work. One way in which this could happen will be ensuring that the make up of the boards of the agencies have representation from mutual and consumer experts, not just individuals from the commercial financial services sector.

6. Conclusion

6.1 This submission represents the early thoughts of the sector and we will be preparing a full response to the FSA consultation on the proposals. We would be very happy to submit further information that the committee requests.

There is often a risk in the design of new systems that the needs of smaller sectors are not fully considered or considered last, often leading to unnecessary burdens. It is essential that the new regime recognises the unique position of credit unions as not-for-profit, volunteer led organisations providing inclusive financial services to a wide range of people, including those on low incomes.

September 2010

Written evidence submitted by the Chartered Institute of Bankers in Scotland

On behalf of the Chartered Institute of Bankers in Scotland, I am delighted to respond to the Committee's Call for Evidence on the Government's proposals to change the system of UK financial regulation, as set out in the July 2010 consultation paper. I hope you will find our comments helpful.

1. General Comments on Proposals

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?

1.1 In our view, the proposals are helpful in improving the regulatory architecture. They should help improve both "early warning" of potential problems and more effective crisis resolution through better communication between the regulatory bodies. We believe these are necessary but not sufficient steps, however, in preventing future financial crises, as the regulatory changes alone will do little to improve the public confidence and trust in banks and bankers on which a sustainable banking industry must be built.

1.2 Rebuilding confidence and trust in banks requires, in our view, rebuilding confidence and trust in the integrity and competence of individual bankers, from Customer Service Officers to Chief Executive Officers. We need to bear in mind that not all the problems affecting the UK banking industry were imported from the US—poor lending decisions, poor risk management and poor liquidity management lay at the heart of the difficulties faced by institutions including Bradford & Bingley, HBOS and Northern Rock. "Better bankers" play as important a role in ensuring financial stability as an improved regulatory framework.

1.3 We would like to see, therefore, the new regulatory framework supported by further work to develop and embed a culture of professional integrity, founded on a common commitment across the industry to high ethical, professional and technical standards. This will require encouragement and support from government and regulators in the form of:

- working with the banking industry and stakeholders to develop and agree set(s) of professional standards and monitor compliance with these—this could be supported by a Professional Standards Board or similar, along the lines of that suggested by the Future of Banking Commission;
- introducing and monitoring requirements for some form of initial and ongoing ethical and professional training for those employed in the banking industry;
- introducing a requirement for senior staff and supervisors to positively encourage the development of higher ethical, professional and technical standards within their firm; and
- working with professional bodies and others to raise professional standards across the industry.

1.5 We are unsure that the totality of risk in the financial system is being fully measured or understood by regulators and institutions. Identifying potential, systemic risks and taking timely action to avoid these is, in our view, the key to ensuring the success of the proposed framework. This will require financial institutions and regulatory bodies to recruit and train greater numbers of more highly qualified banking and risk professionals than now.

2. Financial Policy Committee (FPC)

Should the FPC have a statutory remit? If so, what should that remit be?

2.1 The main structural weakness in financial regulation was the division of responsibilities between the Bank of England and the FSA, and we believe the creation of the FPC would address this defect.

2.2 The FPC should have ensuring financial stability as its sole objective. Whilst factors such as the effects of the FPC's actions on business and consumer lending, UK competitiveness and bank profitability are important, we believe these are secondary, political concerns that should not deflect the FPC from a clear remit to ensure stability.

2.3 We are concerned, however, as to whether the proposed Financial Policy Committee (FPC)—or any such body—will, in practice, be able to "identify imbalances, risks and vulnerabilities … and take decisive action" (ie be able to predict the next crisis); the majority of economists and regulators seemed unable to predict this one.

2.4 We propose that financial institutions' Chief Risk Officers are included in the new regulatory framework, perhaps as an Advisory Panel to the proposed Prudential Regulation Authority (PRA), to ensure the early capture of potential systemic risks. This could help the PRA and FPC better predict, prepare for and prevent future crises.

3. The Prudential Regulation Authority (PRA)

Should the PRA be the lead authority over the Consumer Protection and Markets Authority (CPMA)?

Is it appropriate for the PRA (and CPMA) to adopt a judgments–based approach to financial regulation and supervision?

3.1 We believe it is appropriate for the PRA to be the lead authority over the CPMA. Furthermore, we believe that the conduct of business by firms and individuals should be the responsibility of the PRA rather than the proposed CPMA, or that there should at least be some form of joint responsibility. "Unsafe" business practices such as lending without proper controls are not simply consumer protection issues but rather issues that—as we have seen—can threaten the stability of institutions and the system as a whole.

3.2 We strongly support the adoption of a judgments-based approach to regulation and supervision and believe this should prove effective provided:

— institutions and regulators can recruit and train the requisite numbers of qualified, experienced banking and risk management professionals able to exercise professional judgement—this will require major changes in the way financial institutions and regulatory bodies recruit and develop their staff;

— general principles of prudent banking underpin the judgments-based approach, rather than prescriptive formulae such as, for example, a maximum loan-to-value (LTV) ratio—bad lending decisions can as easily occur at 60% LTV or 90% LTV; and

— regulators take steps to embed the culture of professionalism required to support a judgments-based approach to regulation, without which institutions may try to game the system and push principles too far.

4. Consumer Protection and Markets Authority (CPMA)

Do the reforms provide adequate protection for the consumer?

4.1 Ensuring adequate consumer protection requires more than regulatory reform and the creation of new agencies. Only the development of "better bankers" at all levels, committed to high ethical, professional and technical standards will embed the culture of integrity and trust that is needed to demonstrate that the industry is truly "treating customers fairly."

4.2 The FSA's "Retail Distribution Review" (RDR) offers a good example of how the financial services industry can work with regulators to improve professional standards and ensure better outcomes for consumers. The RDR applies only to the relatively small, retail investment advice sector, however. In our view, similar professional standards need to be applied across the whole financial services industry.

4.3 There is strong public support for this view. 88% of the public believe that all bankers should be required to take professional banking exams to demonstrate their competence and their commitment to professionalism.[5] Introducing new requirements for greater numbers of financial services personnel to hold a relevant qualification and to demonstrate an ongoing commitment to high ethical, professional and technical standards through continued education would do more, in our view, to improve outcomes for consumers than a change in the regulatory architecture.

4.4 We do not believe it would be helpful or practicable to require all individuals employed in the financial services industry to hold a specific financial services qualification, however. Many individuals employed in the industry perform non-financial services related roles and would not find such qualifications relevant.

[5] Survey carried out online by YouGov plc among 2011 GB residents aged 18+. Data is weighted to be representative of UK population. Fieldwork carried out 6–9 November 2009.

4.5 Even if there is little appetite from regulators to impose professional qualification requirements, more could be done to encourage financial institutions themselves to embed higher ethical, professional and technical standards. This could include, for instance, a requirement for institutions to report to the regulator the numbers of staff (particularly those in Significant Influence and Approved Persons functions) holding recognized qualifications.

5. Other Issues

Should any of the proposed bodies be given responsibility for promoting competition in the banking and financial services sector?

Should any of the proposed bodies have a role in promoting the City of London?

5.1 We believe it might be helpful for all the proposed bodies to be given a general (secondary) objective to promote competition in financial services, but that financial stability considerations must always override this where there is any conflict. In particular, the CPMA could play an important role in encouraging new entrants to the retail financial services sector, and in fostering competition.

5.2 We do not believe that any of the proposed bodies should have a role in promoting the City of London (as national bodies they would in any case presumably promote UK financial services, rather than the City alone). There are already a plethora of government, industry and other bodies promoting UK financial services and encouraging inward investment, and there is no need for the regulators' integrity to be compromised by encouraging them to act as a form of marketing agency for the UK financial services sector.

5.3 In a similar vein, the new Consumer Financial Education Body (CFEB) already exists to promote public understanding of financial services (many other bodies also undertake work in this area) and there is no need for the CPMA also to work in this area, as proposed.

September 2010

Written evidence submitted by PanaceaIFA

Introduction

PanaceaIFA.com is an online community representing 3,000 smaller, directly regulated Independent Financial Advisers (IFAs). Our members' annual premium income from sales represents £639.9 million. PanaceaIFA.com aims to give a voice to smaller, directly regulated IFAs and help ensure their concerns are not overlooked by policy makers.

PanaceaIFA.com welcomes the opportunity to contribute written evidence to the Treasury Select Committee's inquiry.

Key Points

- The formation of the CPMA should take into account the five key principles of the Better Regulation Executive.
- Legislators should consider the unintended consequences of regulation on smaller businesses in the financial services sector, while addressing the failures which lead to the financial crisis.
- The CPMA should take a risk-based, transparent, consistent and proportionate approach in its dealings with IFAs, something the Financial Services Authority (FSA) has often failed to do.

Submission and Recommendations

1. When constituting upon the formation of the CPMA, and with the smaller IFA firm in mind, HM Treasury should build on the principles of the Regulators' Compliance Code.

2. The Regulators' Compliance Code is a central part of the Government's better regulation agenda. Its aim is to embed a risk-based, proportionate and targeted approach to regulatory inspection and enforcement among the regulators it applies to.

3. PanaceaIFA.com's members see the government's review of Financial Services Regulation as a much needed opportunity to ensure these principles are applied to the CPMA.

4. While protecting the consumer, such an approach would deliver significant benefits to low risk and compliant businesses within the IFA sector through better-focused inspection activity, better advice for businesses and lower compliance costs.

5. *Transparency*—The FSA has often failed to be transparent. Rules are often unclear, change frequently and are applied retrospectively. This makes compliance extremely difficult for smaller IFA firms.

6. *Accountable*—The CPMA should be accountable for its actions. Currently the FSA cannot be sued for any failures and has a record of being neither fair nor reasonable to the small businesses it has regulatory authority over.

7. *Proportionate*—The regulatory costs of resources, reporting, disciplinary action and qualification levels should reflect fairly and proportionately on small IFA firms, by giving consideration to the size of the regulated firm and the nature of its activities.

8. *Consistent*—the CPMA should ensure that the nature and direction of regulation is clear for all to see, by way of rules not principles, and not subject to knee jerk reaction and changes of direction or policy on a whim.

9. *Targeted*—the CPMA should only direct its attention towards cases where action is needed. The FSA has a history of embarking on "fishing expeditions" seeking out, even creating problems without thinking through the impact of its actions. It is therefore important that the CPMA builds confidence and trust with the consumer and the IFA community in its ability as a regulator to carry out its role correctly and in a fair and reasonable way.

10. Key staff in the CPMA should be required to gain financial services qualifications to better understand the markets in which they are operating.

22 September 2010

Written evidence submitted by BlackRock

1. BlackRock is one of the world's largest publicly traded investment management firms. As at 31st March 2010, the assets under management of BlackRock were USD 3.36 trillion. BlackRock is a premier provider of global investment management, risk management and advisory services to institutional and retail clients around the world. The firm manages assets on behalf of institutions and individuals worldwide through a variety of equity, fixed income, cash management and alternative investment products, as well as the industry leading exchange-traded fund platform, iShares.

2. BlackRock welcomes the opportunity to comment on the proposals made in this consultation paper. In providing our responses we are mindful of the fact that the Government's paper does not deal with the proposals in great detail pending further consultation. Our response is therefore also in general terms given the lack of clarity which currently exists.

A *Do the Government's proposals appropriately assign roles and responsibilities between the different regulatory institutions?*

1. As currently drafted the proposals are unclear as to whether asset managers doing business in the UK would be prudentially regulated in the United Kingdom by the Prudential Regulation Authority ("PRA") or by the Consumer Protection and Markets Authority ("CPMA"). Our response below highlights the concerns for asset managers of: (i) being dual-regulated by the PRA in respect of prudential issues and by the CPMA in respect of conduct issues; and (ii) being regulated by CPMA at the prudential and conduct level.

2. Under the current proposals deposit-takers, insurers and broker-dealers (or investment banks) are considered to be carrying on prudential regulated activities and will therefore be prudentially regulated and supervised by the PRA and supervised by CPMA in respect of conduct-related issues. Whereas those firms carrying on non-prudential regulated activities will be exclusively supervised and regulated by the CPMA for both prudential and conduct issues. Some asset managers may have entities within their group in the United Kingdom which have permissions as a deposit-taker for insurance business only (for example, life insurance entities providing unit-linked policies without any mortality guarantees to UK pension funds and other UK insurance companies which are in the most material aspects similar to asset management businesses) and/or entities which have permission to deal as principal for limited purposes (for example, for purposes of managing corporate cash or making seed capital investments in sponsored product). It is unclear from the consultation whether these permissions will bring some or all of asset management group entities in the United Kingdom within the scope of prudential regulation by the PRA and conduct regulation by the CPMA or whether it is intended that these activities would be excluded from the scope of the PRA.

3. The proposals indicate that the Financial Policy Committee ("FPC") will be empowered to give directions to the PRA (and the CPMA, if relevant) on the regulatory tools that should be deployed in pursuit of macro-prudential policy, and how they should be formulated or calculated. It seems most likely that such directions would be relevant to the PRA and the types of firms it regulates. Should asset managers be regulated by the PRA, the concern is that such directions would be applied to asset managers in the same way as they would be applied to banks, insurers and broker-dealers, which would likely not be appropriate given that asset managers do not engage in proprietary trading and therefore have significantly different risk profiles than these institutions. It will be important to ensure that, if asset managers are to fall under PRA regulation, the implications of the exercise of the PRA's prudential oversight is considered in the context of the very different business model and risk profile that asset managers pose and not with a "one-size fits all" mindset with issues posed by the major banks and broker dealers.

4. If asset managers doing business in the UK are to be regulated by a single regulator, the CPMA, it is important that the CPMA is equipped with staff who have appropriate expertise and skills to regulate and supervise asset management businesses with both a retail and wholesale/institutional business, not only at

a conduct level, but also prudentially. A potential solution to this issue is for the CPMA to have a "college of expertise" to supervise asset managers at both a conduct and prudential level separately from, for example, high street independent financial advisers. The consultation itself acknowledges that prudential regulation and conduct of business regulation require different approaches and cultures and combining them in the same organisation is difficult. The challenge will therefore be to ensure that the CPMA can appropriately supervise and regulate asset managers at a prudential level, given its remit of also supervising and regulating institutions such as high street independent financial advisers which have a significantly different prudential profile.

B *Will there be unintended consequences of the Government's proposals for regulation on the prospects for non-bank financial institutions?*

1. Our concerns regarding the split between the PRA and the CPMA for asset managers are set out above.

C *To what extent will the regulatory and administrative burden increase for those firms who now have to deal with two regulators?*

1. In our view, if asset managers are to be subject to dual-regulation by both the PRA and the CPMA, the regulatory and administrative burden and lack of clarity will increase. The implications include:

- increased resource requirements in order to deal with two regulators;
- the potential for both underlap or overlap of regulatory oversight;
- lack of clarity around how supervisory initiatives such as ARROW will operate. It will be important for both regulators to have a joined up approach and efficiencies for ARROW supervisory visits suggest that they should be conducted together; and
- lack of clarity around which regulator is responsible for supervision and enforcement of specific issues, eg transaction reporting. On the basis of the current proposals, it would seem that responsibility for enforcing systems and controls failings will lie with the PRA (in respect of dual-regulated firms) and therefore, a firm would have enforcement action from both regulators to manage at the same time.

BlackRock intends responding more specifically to HM Treasury's consultation paper concerning this current proposal.

September 2010

Written evidence submitted by Aviva Plc

1. Aviva is supportive of reforms to the UK system of financial supervision and regulation, in the light of the recent financial crisis.

2. Much of the success of the Government's proposals will depend on getting the detailed implementation right. As such, I believe it is important to focus on how effective the new financial architecture will be, rather than its structure.

3. In terms of how the new regulatory architecture will work in practice, there are a number of issues raised by the proposals that are of some concern to Aviva, and where we feel further discussion and thinking is warranted.

4. As the UK's largest insurer, as an owner of a large asset management business, and as a leading pan-European player, we have a keen interest not only in the UK system of supervision and regulation, but also in how it interacts with the emerging EU architecture. We are, therefore, uniquely positioned to highlight certain perspectives around what may work, and what may not, for diverse groups in the proposals.

5. I would highlight the six areas overleaf as ones where the Committee can helpfully investigate and review the Government's proposals to ensure we get it right as we move effectively from the existing regulatory structure to the new one.

Remaining Active and Focused in Key European Negotiations

6. The planned new EU supervisory architecture—and its interactions with the UK regulatory framework—is very important for large businesses like Aviva.

7. The new European Supervisory Authorities (ESAs) are due to come into operation from 1 January 2011. There is a risk that at this most critical phase, the UK will be preoccupied by internal reorganisation.

8. EU level discussions on insurance and asset management must remain focused, and receive appropriate attention by senior officials, throughout the transitional period, so that a strong UK voice continues to be heard.

9. For example, Solvency II is the most important piece of modernising insurance legislation in a generation, and the final Implementing Measures are still under discussion. Full and active engagement in such crucial EU negotiations is going to be critical to get the best outcome for our millions of customers.

10. *Proposal*: During the transitional period, we would urge the FSA to prioritise active engagement in those European negotiations of vital importance to both the insurance and asset management industry. We further recommend that a dedicated team is put in place to oversee this engagement.

Achieving Appropriate Prudential Supervision for Insurers within the PRA

11. Historically, the purpose of the prudential regulation of insurance companies has been the protection of customers. This reflects the role of insurers as providers of retail consumer products, and the fact they are participants in the financial system—rather than drivers of it.

12. Under the new proposals, insurers will be prudentially regulated within the PRA alongside banks and investment banks. These are fundamentally very different businesses.

13. It is important that careful consideration is given to "getting it right" when it comes to the prudential supervision of insurance firms.

14. *Proposals*: (1) The primary objective of the Prudential Regulatory Authority should incorporate a requirement that the PRA pays adequate attention to the fundamentally different rationale for the prudential regulation of insurance companies. (2) The prudential supervision of banking and insurance within the PRA should both be separately recognised within the internal management structures, to ensure that they are of equal prominence.

Achieving Oversight and a Holistic View of Large, Diverse Non-banking Firms

15. As a large insurance group that includes an asset management business, we do have a concern that under the Government's proposals, no single body will be charged with taking a holistic view of the whole Aviva group.

16. Under the proposed new structure, supervisors would have to gain such an overview despite the fact that substantial businesses within the Aviva group would be subject to prudential supervision by different regulatory bodies: the insurance business by the Prudential Regulatory Authority (PRA), and Aviva Investors (our asset management business) by the Consumer Protection & Markets Authority (CPMA).

17. *Proposal*: Group supervision should be recognised within the proposed reforms so that a lead supervisor can take a balanced view of groups.

Ensuring the FPC, PRA and CPMA Work Effectively Together

18. As a large, diverse financial organisation, we are used to dealing with multiple regulators. As such we are more interested in the effectiveness of the proposed new financial architecture, rather than its structure.

19. It is clear though, that there will need to be considerable cross-consultation and co-ordination between the PRA, CPMA and the FPC in the effective discharge of their responsibilities. Much of the success of the Government's proposals will depend on getting the detailed implementation right, including how liaison will happen in practice between these three bodies.

20. It is important that regulation continues to strike the right balance between:

- — delivering against the regulator's objectives;
- — supporting important access to products and services that consumers need;
- — promoting a culture of saving and personal provision; and
- — attracting capital from investors into the sector.

21. There are significant differences between retail and wholesale markets and it will be important that the priorities of the CPMA are not dominated by thinking rooted in consumer protection.

22. The existing FSMA principles for better regulation should be maintained and there will need to be appropriate checks and balances to allow for transparent scrutiny of the performance of the different regulatory bodies in the delivery of their objectives. This should include formal external reporting to industry representatives, as well as appropriate consultation on policy development.

23. *Proposals*: (1) The CPMA should be led by someone of equivalent standing to the CEO of the PRA, and who should be publicly recognised as such. This will avoid the CPMA being perceived as a junior regulator in the new UK regulatory system. (2) In order to create the right balance, we would recommend a broader primary objective for the CPMA of not only ensuring the financial system protects its consumers, but also of promoting saving. (3) The existing Better Regulation principles, statutory consultative Panels and consultation processes should be maintained for both PRA and CPMA.

Ensuring Appropriate Representation on the Financial Policy Committee (FPC)

24. The UK financial services market is one of the most competitive and diverse in the world, including a number of global banking, insurance and asset management businesses.

25. Financial stability mechanisms, whilst naturally banking-focused, nonetheless need to properly take into account the fundamental differences in business models of these diverse firms, their relationships with consumers, and their varying roles in the real economy.

26. *Proposal*: The membership of the FPC needs to ensure there is appropriate and authoritative representation covering buy side market participants (insurers and asset managers) in addition to sell side.

Managing Risks in the Transitional Period between Now and the Implementation of the New Structure in the UK

27. The transitional period between the current and proposed new structure of financial regulation in the UK must be very carefully managed, to ensure there continues to be consistently high standards in the way the UK financial services industry is regulated.

28. *Proposal*: We recommend a transitional plan is developed by the FSA, in conjunction with stakeholders, to demonstrate how key regulatory proposals and legislative requirements will be managed over the transitional period, and approved as soon as possible. This should include how controls over the quality of supervisory decisions and policy formulation will be maintained.

Aviva looks forward to working with policymakers on legislative proposals as they develop.

22 September 2010

Written evidence submitted by Plus Markets Group Plc

1. I am the Director of Regulation of Plus Markets plc, a Recognised Investment Exchange based in the City of London operating both primary and secondary market infrastructure. In addition to operating a Regulated Market for listings, PLUS maintains the PLUS-quoted market a primary market for unlisted securities which is the second largest growth market within Europe, and competes in trading services against traditional Exchanges and MTFs with 7,500 UK and European securities on its platform. We operate in a space characterised by rapid evolution of market regulation, technology and user preferences. As an operator of market infrastructure with a core franchise of helping companies raise funds and providing trading and investor services, PLUS has an understandable interest in the proposals set out in HM Treasury's consultation "A new approach to financial regulation: judgement, focus and stability" and are grateful for the opportunity to make known our views.

Executive Summary

2. We are supportive of the need for reform albeit reform which should go further and not merely be limited to structural change. The revised regulatory architecture must be well placed to identify and mitigate prudential and systematic threats to the integrity of the system. With this in mind, we concur in that the perspective of a central bank is needed and the Bank of England should given a more operational role with both responsibility for financial stability and a full array of macro-prudential supervisory tools. It is our view that responsibility for stability and macro-prudential supervision must go hand in hand with the micro-prudential supervision of individual firms to enable the Bank to enable deliver on the overarching objective of financial stability: this aspect of the proposed regulatory architecture is likely to be well received at an EU level. These proposed reforms are justified in our estimation on the basis that the supervision of prudential risk must benefit from better comprehension and understanding of developments and cyclical imbalances within the financial system. That said, whilst the Bank of England is more likely to be in a position to make use of a judgement-focused supervisory approach, it remains to be seen how well the Bank will operate in a heavy duty operational and rules based environment. As an RIE we do not have a sufficiently direct interest in prudential regulation and will therefore refrain from substantial comment on the range of macro-prudential tools proposed to be made available to the Bank of England. However there is a danger that the impact of the prerogatives afforded the Bank of England may become overbearing unless its supervision benefits from a robust and workable mechanism whereby the Bank of England is accountable. At the same time there are tensions inherent in the proposed regulatory framework not least when it comes to accountability and cooperation between respective regulatory authorities.

3. Our chief concern is to ensure that the significance of market infrastructure is correctly appreciated and we have identified characteristics of the proposed regulatory architecture which merit further consideration by HM Treasury. Future initiatives relating to Exchanges and market operators are likely to recognise that their proper role in promoting confidence, transparency, price formation, equal access and liquidity and in the mitigation of idiosyncratic risks posed by innovated exchange-traded products are likely to be greater in the scheme of things than the need to protect consumers. The protection of consumers is important but it is by no means the dominant factor in play when it comes to the supervision and regulation of financial markets and stock exchange activity. At the same time, the UK needs to understand that the

needs of wholesale and retail markets are different and need to be approached in different ways and whilst financial stability and the integrity of financial markets ought to be the sole objective, supervision needs to keep pace with and not stifle innovation. We have particular concerns over the proposed future of the UK Listing Authority and also proposed reforms concerning Recognised Bodies and seek for these proposals to be withdrawn.

Cooperation between Regulaotry Authorities versus In-Built Tensions, Supervisory Overlap and Relations with EU Regulators

4. We take comfort from the proposals outlined in the consultation paper relating to the FPC's role in supervising and monitoring the performance of the PRA and the CPMA. Significant cooperation between both will prove necessary and to ensure that their respective agendas are harmonised and calibrated towards ensuring financial stability. In particular the FPC's power to give directions may prove particularly useful when it comes to ensuring that the PRA and CPMA are correctly aligned and that their respective agendas benefit from the perspective of the central bank and its monetary policy. The proposals with respect to CEOs of the PRA and CPMA being members of the FPC and being appointed to each other's respective Board may go some way to achieving this and to fostering a culture of cooperation but the two bodies. However, the PRA and CPMA are likely to have very different cultures with the likelihood that a number of tensions inherent in this architecture may exist. The potential for competing agendas is acute given the different cultures but added to the tensions inherent in the proposed regulatory architecture on a national level, there also exists the possibility for competition in agenda and remit as between the domestic regulatory authorities and the new supra-European regulators due to be brought into being next year. Duplication of output and dialogue are likely to be troubling features requiring a lot of regulatory engagement as between regulatory bodies and participants in the financial services system on a number of levels. It could be that HM Treasury's proposed regulatory architecture is influenced by considerations of European oversight and in particular the demarcation of responsibility between the European Banking Authority and the European Securities and Markets Authority. Whilst there is evidently a well perceived need for national regulatory authorities to engage and cooperate with these supra-European supervisors, a replication of this divide on a national level poses potentially very serious difficulties surrounding the engagement of individual firms with the PRA and the CPMA.

5. The impact will be felt by Exchanges and market operators, leading to a position where Exchanges and market operators providing both trading and clearing services will be supervised by both the PRA and the CPMA (dual supervision). This concern is especially pertinent at the present time given that the London Stock Exchange is believed to be in discussions with a number of banks with a view to establishing and operating a clearing house.[6] There is an increasing trend within the EU of Exchanges moving into the provision of clearing services (Euronext and NYSE LIFFE for example). The EU is proposing to develop regulatory initiatives designed to mitigate risk with the involvement of both Exchanges and clearing facilities as it perceives both as useful mechanisms to dampen the risk within the financial system associated with the trading of derivative securities OTC.[7] Although the considered response to these initiatives appears to have dissuaded the EU from making use of exchange infrastructure in this way,[8] there are obvious synergies and approaches involving both Exchanges and clearing facilities. Nevertheless, central counterparties providing clearing services will be supervised by the PRA whilst Exchanges and market operators will be supervised by the CPMA in the new regulatory landscape. The effect of HM Treasury's proposals are far reaching though and it should be recognised that even CCPs solely providing clearing services may be supervised by the CPMA as regards conduct of business. Dual supervision involves additional burden, cost and resource for a broad range of different business models and there exists the possibility of intrusive conflicting supervisory agendas impacting a single firm.

Supervision of Exchanges and Market Operators by the CPMA and Regulatory Agenda for Equity Markets

6. It remains to be seen how the PRA will be resourced to discharge its micro-prudential supervisory responsibility and ensure that its front line supervisory functions are equipped to undertake a judgements-focused supervisory approach as opposed to utilising a "check-box" approach. This danger is of particular concern when it comes to the CPMA based on our experience of the FSA. The make-up of the CPMA needs to be adequate to take responsibility for supervision of firms' conduct of business and for policy concerning the conduct of business and markets infrastructure, as operationally distinct from its consumer protection function. That poor standards of behaviour and risks to consumer protection often involve securities traded on Exchanges and other market infrastructure is not sufficient justification in our view for the CPMA supervising market infrastructure in addition to those firms that are in the business of trading securities. In order to justify the CPMA supervising Exchanges and market operators, the CPMA will need to be

[6] Reported by City AM on 20 September 2010.
[7] Committee of European Securities Regulators ("CESR") consultation paper, *Standardisation and exchange trading of OTC derivatives* July 2010.
[8] See the Proposal for a Regulation of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories COM (2010) 484/5.

resourced and well positioned to formulate and progress key policy initiatives relating to markets that recognise their proper role in promoting access to markets, confidence, transparency, price formation and liquidity.

7. In terms of firms' conduct of business and the relationship between the regulation of conduct of business and financial markets, retail activity and investment are significant both in terms of maintaining markets as viable venues for capital raising and in terms of facilitating secondary market liquidity. CESR has quite rightly perceived that volumes of trading in equities and wholesale bargain sizes are diminishing since the introduction of MiFID in late 2007.[9] In this environment and in the context of reduced appetite for investment, retail activity and retail trades become of greater significance as do their interaction and combination with wholesale activity and investment. This needs to be recognised by the CPMA whose agenda and approach should appreciate the significance of retail activity rather than being skewed towards acting in a fashion that tends against it for consumer protection reasons. This is especially true with regard to the regulation of retail client advisory business in that whilst the CPMA should be an incisive tool to hold to account and prevent unethical behaviour on the part of financial services professions it should not pursue an overbearing approach when it comes to regulating the conduct of advisory business. The significance of markets as mechanisms for raising capital and for fuelling economic growth and recovery needs to be borne in mind. The proposed removal of the UK Listing Authority from the CPMA to reside with the Department for Business, Innovation and Skills rather runs the risk of the regulation of firm's conduct of business not benefiting from this awareness and perspective.

8. Foreseeable regulatory initiatives for Exchanges and market operators in the medium term (predominantly originating from the EU) include the CESR Review of MiFID and the likely impending EU directive amending MiFID,[10] the extension of the pre- and post- transparency obligation, the implementation of proposals to counter the adverse effects of fragmentation of liquidity, micro-structural issues concerning high frequency trading, sponsored and unsponsored Direct Market Access, trading platform stability, also pricing, best execution, the trading of OTC derivatives on-exchange, short selling, the review of the Prospectus Directive[11] and listing and disclosure requirements for UCITS, and the recognition of foreign non-IFRS issuer financial reporting. The CPMA needs to be sufficiently dexterous to be able to take into account the evolution of markets infrastructure, trading practices and user need in the formulation of regulatory policy and approach to EU representation, and legislation. The CPMA must additionally have regard to the distinct needs of the wholesale and retail markets in addition to those of consumers.

The UK Listing Authority

9. It is our view that the CPMA's credibility may be hampered *ab initio* by the removal of the UK Listing Authority from the CPMA to reside under the Department for Business, Innovation and Skills. We foresee particular difficulties when it comes to UK representation and engagement with the new European Securities and Markets Authority because the CPMA will not have responsibility for the Listing function. Most of the central plans underpinning the UK's Listing framework have their origin in European legislation and the UK is exposed to the possibility of regulatory intervention from the EU that undermines the pedigree of listing on the UK's Official List and threaten the UK's competitiveness—witness the evolution of the recently introduced Standard Segment. The Listing function is of considerable importance in maintaining the UK as a credible and competitive destination for listings and therefore needs to be ensconced within the CPMA and benefit from the CPMA's accountability and its norms for interacting with the financial services industry, the EU and the European Securities and Markets Authority. It also should be recognised that there is also cross-over with the consumer protection brief given that within the Listing Rules there are specific rules legislating for consumer protection such as those relating to closed ended investment companies, investment trusts, REITs and UCITS. The interests of consumers and investors are paramount when it comes to framing rules and policy relating to prospectuses, class transactions, circulars, disclosure, transparency and financial reporting: seen in this way, there is more of a synergy between primary markets and the CPMA's remit for the regulation of conduct of business and consumer protection as compared to the CPMA's role in the regulation and development of secondary market infrastructure. Why then separate the UK Listing Authority from the CPMA? Deprived of the listing function, it becomes harder in our view to justify responsibility for the supervision of Exchanges and market operators falling within the CPMA's purview. If the proposals in the consultation are to be legislated into being without substantial alteration, our recommendation would nevertheless be that the UK Listing Authority should remain with the CPMA.

10. With regard to the proposed merger of the UK Listing Authority with the Financial Reporting Council (FRC), the FRC has a role in promoting confidence in capital markets. The FRC plays a part in monitoring and ensuring that that corporate governance is sound, that financial reporting is of sufficient quality and more particularly, that the narrative of directors' reports properly reflects and accounts for the risks and uncertainties specific to a particular business. Of particular concern in relation to smaller companies is the appropriateness of sensitivity analysis and the impact of certain sensitivities on working

[9] Committee of European Securities Regulators ("CESR") consultation paper, *Technical Advice for the European Commission in the Context of the MiFID Review—Equity Markets* April 2010.

[10] Markets in Financial Instruments Directive 2004/39/EC.

[11] EU Prospectus Directive 2003/71/EC.

capital and the FRC's role in these areas is supportive of improving the quality of behaviour on capital markets. There is some overlap here with the remit of the UK Listing Authority, however such a merger if carried into effect would greatly expand the function of the Listing Authority and take it into other areas. The Listing Authority's present remit expands beyond issuers applying for inclusion or included in the Official List (given the effect of the Prospectus Directive) however there is significant doubt in our mind as to reason for the merger proposal which needs to be carefully examined and the rationale for the changes made out. In particular, there is a danger that to merge the UK Listing Authority with the new companies regulator will prove too burdensome to issuers listed or seeking to list on the Official List and will undermine London's competitiveness. There is little to suggest that merging the FRC and the UK Listing Authority would enhance their respective functions.

Rationalisation of Authorisation under Part 4 FSMA 2000 and Recognition under Part 18

11. The EU has discerned increasing unease with Multilateral Trading Facilities ("MTFs") which are subject to less stringent regulatory requirements than Regulated Markets at the present time. With this in mind, CESR is proposing changes to ensure that the requirements for MTFs are made more stringent to align the requirements more closely to those to which operators of Regulated Markets are subject.[12] As the operator of a Regulated Market subject to more burdensome requirements PLUS is supportive of the arrangements with respect to firms authorised by the UK as operators of MTFs being looked at and made more robust. Regulatory requirements to which a Recognised Body or authorised firm are subject should be determined by reference to the activities carried out rather than the regulatory status of the operator. That said, we would resist an attempt to remove or erode the status accorded Recognised Bodies in the regulatory system, not least because this would be out of step with the European Union which recognises the distinction between operators of Regulated Markets and MTFs. The distinction and status of a Recognised Investment Exchange remains valid given that as operators of Regulated Markets, they bear responsibility for primary markets and compete as listing destinations against their counterparts within the EU. The organisational and regulatory requirements and resources are different compared to those required to maintain pure secondary market infrastructure. This is the case to a greater extent in that both of the UK's RIE equity markets, the London Stock Exchange plc and PLUS Markets plc also operate exchange-regulated primary markets (AIM and the PLUS-quoted market), therefore the regulatory requirements and risks associated with these market infrastructures are wholly different compared to those authorised firms operating as MTFs which are pure trading facilities for trading securities listed on EU exchanges. Looked at in this way, there is every reason to maintain separate regimes. RIEs bear a unique position within the regulatory landscape because of their role in the price formation process as operators of primary markets. RIEs are quasi-regulatory bodies and benefit from this status in superintending the activities of exchange member firms and from the statutory information sharing gateways and prerogatives afforded them. To seek to remove or erode the status of a Recognised Body would be counterproductive and HM Treasury needs to make out a case for conflating the two regimes as there is little evidence to suggest that the different requirements are problematic. As the operator of a Regulated Market we fully concur with the need to accept a higher degree of regulatory burden and the requirements in Part 18 as a Recognised Investment Exchange.

21 September 2010

Written evidence submitted by Peter Bonisch, Managing Director, Paradigm Risk, and PJ Di Giammarino, CEO, JWG

Executive Summary

1. We have recently completed a major, independent review of systemic risk. Our comments are informed by that review activity.

2. Although not addressed by our recent review, we believe Treasury Committee can and should play a vital role by ensuring the relevant agencies, principally HM Treasury, the Bank of England and the Financial Services Authority, identify appropriately their respective functions and objectives for supervisory control of systemic risk and that any preconceptions are identified and, if necessary, challenged.

3. The focus of the Treasury Committee on this area in the domestic policy agenda is also critical to ensure it receives, at official level, the attention it needs and deserves. While European oversight of systemic risk is under development, each European Member State must translate European law and Level 2 guidance to domestic law. Also, as Europe's largest financial centre, London's contribution, officially and from its financial firms, will be vital to ensuring Europe adopts a robust, effective and internationally compatible framework for systemic risk supervision.

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[12] Committee of European Securities Regulators ("CESR") consultation paper, *Technical Advice for the European Commission in the Context of the MiFID Review—Equity Markets* April 2010.

4. In its consultation paper, HM Treasury does not distinguish systemic risk from other macroprudential issues. However, we believe there are substantial issues that pertain uniquely to systemic risk (as opposed to macroprudential issues more broadly) that makes its separate and active consideration vital for effective policy formulation.

5. Whilst we have not had the opportunity to discuss these matters with HM Treasury (despite repeated attempts to do so), we are confident that the issues we raise in this submission—and the distinction between systemic risk and other macroprudential issues—are understood in some functions at the Bank of England and Financial Services Authority.

6. Without active and separate attention to systemic risk issues by Parliament (through the Treasury Select Committee) and HM Treasury, it is possible that the Bank of England will not be afforded the latitude, priority or resources to put in place the range of activities, modelling approaches and other solutions it will require to supervise and attempt to control systemic risk.

7. A roadmap for development of a global or globally compatible approach to systemic risk supervision is urgently required at international, regional and national level. In the UK, the regulator should, after consultation and collaboration with financial firms, develop and promulgate a regulatory data architecture to improve firms' regulatory data management and its own use of supervisory data. This should include mandating the development of a standard regulatory data taxonomy for the UK; we also advocate this for other jurisdictions.

8. Considerable and potentially divergent research is required on the problems of systemic risk. This will need to be inter-disciplinary and involve an unprecedented level of cooperation and collaboration between financial firms, regulators, supervisors and academics of different 'stripes'.

9. At present, firms and representative trade bodies have not been engaged in the debate on systemic risk issues. Their understanding and engagement will be essential. Unlike monetary policy interventions, systemic risk interventions will not treat all firms equally and evidential standards for intervention will be considerably greater. If the regulatory logic on systemic risk is not sound and communicated effectively, firms are likely actively to challenge supervisory action.

10. Structural solutions, which are at the heart of the HM Treasury's consultation paper, are less important than conceiving and describing realistically the challenges of systemic risk supervision and developing suitable information sources to inform supervisory decision-making (whoever undertakes the role). It is more important that this be done well than quickly.

Background

11. In May 2010, Paradigm Risk and JWG began a project to research the practical issues of systemic risk. The research, part-funded by an award from the Technology Strategy Board, was undertaken in collaboration with the Financial Services Knowledge Transfer Network who commissioned the project at our suggestion.

12. In this submission, we are representing only the views of the authors of the report: Peter Bonisch of Paradigm Risk and PJ Di Giammarino of JWG only. We do not represent, nor do we wish to appear to represent, the views of any other party.

13. Our research, which will be published this week, has involved dozens of interviews with officials from the UK, Europe, the US and some other jurisdictions, international regulators, academics, trade bodies and financial sector firms. We have reviewed hundreds of official and academic papers and validated our findings with officials and firms.

14. The focus of our work was initially purely practical: what "pipes and plumbing" would be required to develop and implement a robust and effective platform (ie system, infrastructure and capabilities) for supervisory control of systemic risk. However, as we have gone through the exercise of our review, we have found that there are more fundamental issues that are yet to be resolved, or in some cases even to be properly identified and addressed, before an effective supervisory solution can be described.

15. Our work has borne extensively on the issues discussed by the July 2010 Consultation Paper by HM Treasury titled A New Approach to Financial Regulation: judgement, focus and stability. Accordingly, and in the interests of promoting effective public discourse on these vital issues, we have sought to present our ideas to your Committee.

16. Our views are not without contention or controversy. Many of the issues we raise are well accepted by academics and officials alike. However, by no means all of our views have been accepted universally. One of the more noteworthy aspects of our review has been that, in the interviews and extensive review we have conducted, we have found very little alignment of views on any of the key issues of systemic risk other than the necessity of addressing it.

17. A significant part of our representation to your Committee is that, in the field of systemic risk, the notion of a single, accepted solution is both illusory and dangerous; we will be better off allowing and accepting both disagreement and debate about systemic risk and creating supervisory structures which allow and encourage such debate to be open, transparent and participatory. We are not convinced that the proposals of HM Treasury achieve these objectives. But nor do they preclude achieving them.

18. While we have views on the aspects on the HM Treasury's consultation outside financial stability, it is on those that our recent, extensive research has been undertaken. In our submission, we will limit ourselves to comments on that area (largely in chapter 2 of the HM Treasury Consultation Paper).

A Series of Questions

19. We have structured this submission as a series of questions to assist the Committee to understand the challenges we are raising.

What is systemic risk and why is its definition important?

20. It is clear that the focus of government agencies prior to the financial crisis was in the wrong place. The consultation paper by HM Treasury (hereafter HMT) concedes that:

> " . . . one important lesson from the financial crisis has been that insufficient attention was paid to the systemic or aggregate risks that built up in the financial sector. Regulation was excessively focused on individual institutions, and recent experience has exposed the limits of this approach—because of the intricate linkages within the financial sector, even institutions that seemed to be in good health came close to collapse." (HMT, para 2.5)

21. This draws a clear distinction between supervising financial sector firms and supervising the financial system. The problem created by financial institutions, and the logic of intensive and invasive regulation of the financial sector (ignoring consumer protection), is the externality caused by the potential contagion effect of the failure of a highly levered financial firm. The focus on reducing the probability of individual firms' failure was misplaced, as the only valid concern to regulators (other than consumer protection) was the broader impact of the failure on the financial system. It is apparent that the regulator and supervisor—the Financial Services Authority (FSA)—substantially lost sight of this key objective.

22. There is an extensive definition of systemic risk in our report, and we will not cover it in detail here. However, in considered systemic risk, we consider it essential to differentiate the following:

- Microprudential focus;
- Macroprudential focus;
- Systemic focus relating to the financial network and interconnectedness of financial firms; and
- Resolution focus (at firm level).

We reproduce the distinction in an Attachment to this submission, for your reference.

23. The key insight is the distinction between macroprudential focus, which includes counter-cyclical capital buffers, lending limits, collateral requirements and other tools indicated by HMT in Box 2.C, and systemic focus which considers the interconnectedness of the financial network and behaviours of firms in that network. Importantly, firms' behaviours may give rise to properties which emerge unpredictably from their interaction and create supervisory challenges entirely separate from those which may be considered macroprudential issues (using our narrower definition thereof).

What has HM Treasury proposed?

24. The HMT proposal advocates a Financial Policy Committee (FPC) as a committee of the Court of Directors of the Bank of England, with representation from the CEO of the Prudential Regulatory Agency (PRA) and HM Treasury. The FPC will four have external representatives.

25. The HMT proposal assigns the following objective to the Financial Policy Committee:

- 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 damping the credit cycle (HMT para 2.24).

26. The HMT paper advocates a range of policy tools that are macroprudential in focus (relating to the latter objective). However, the HMT paper is silent on interconnectedness and does not discuss systemic or network characteristics of financial firms. This is a surprising and unhelpful omission.

27. The key difficulty with the omission is that much of the uncertainty in the official and academic communities over the future direction of financial system regulation relates to interconnectedness rather than macroprudential elements. By failing to address interconnectedness, the HMT paper:

- fails to address a critical area of the debate on financial sector regulation;
- represents the state of that debate as far more settled than, in reality, it is or should be; and
- fails to address, and thus to prioritise, the essential building blocks of any viable solution to the supervisory control of systemic risk as distinct from other macroprudential challenges.

28. There remain significant areas of uncertainty at all levels of the debate over systemic risk—at official, academic and regional and international regulatory levels. Key to these are:

- the appropriate approach to understanding the risks posed by the interconnectedness of financial institutions and their behaviour—the methodological question;
- how the various international supervisors can or will collaborate—the governance question; and
- how to create an environment in which information required to be consolidated analytically can be brought together comparably—the data standards question.

29. None of these issues is addressed, or even raised, by the HMT paper, except to refer to the need for international collaboration at para 1.12. All (and many more) must be resolved before a satisfactory supervisory solution to the systemic risk problem will be possible.

How do the HM Treasury proposals differ from what was there before? What has changed?

30. The proposed structure differs very little from its ineffective predecessor, the Tripartite Agreement. The same institutions will be represented, often by the same people. While there will be a lead responsibility assigned to the Bank of England, the machinery will be fed by the same information sources.

31. However, the more important message:

> the Government believes a regulatory structure is needed in which both aspects of regulation—monitoring firms on a collective and an individual basis—are brought together (HMT para 2.16) . . .
>
> . . . is undeniably true. Also, the salience of the issue of system failure suggests that the individuals and institutions that were not properly attentive to the issue previously (by their own admission) are unlikely to make the same mistake again, at least for some years. However, the approach applied must be robust and also adapt over time to changing conditions and knowledge.

Will the HM Treasury proposals be effective? If not, why not?

32. In its paper, HM Treasury states:

> The Government believes that abolishing the tripartite system, and placing a single authority, the Bank, at the centre of the framework for preserving financial stability is the single most important reform needed to the UK financial regulatory system. (HMT para 2.25)

If that is the case, "the Government" is emphasising organisational arrangements ahead of the substantive conceptual and analytical challenges of financial stability and systemic risk; our emphasis would differ. For the reasons suggested, this organisational reform, while valuable, is far from being the most important that can, or should, be made. Far more important substantive reforms are needed, as noted above, around methodology, international governance and data standards. The substantial commitment in the US Dodd-Frank Act of the funding and development of an Office of Financial Research to address systemic risk indicates that international approaches are already diverging. Once established, divergent supervisory data structures and data compiled with different underlying standards will be difficult to reconcile.

33. In terms of what the FPC can and will do, the HMT paper acknowledges:

> These macroprudential tools will be relatively untested, and there will inevitably need to be an initial learning process to adapt and fine-tune them.

It then continues:

> Setting out the tools in secondary legislation will allow the Treasury, in consultation with the FPC, to easily adapt the tools to any lessons learnt in this initial period, as well as periodically assess the suitability of the macroprudential toolkit, and to incorporate any international developments in macroprudential regulation. (HMT para 2.36)

34. The lack of concession of the uncertainty of efficacy of systemic risk supervision specifically and macroprudential supervision more generally is unsurprising but disquieting. The reality is that, especially in the area of systemic risk supervision and control, there is no certainty that a solution can or will be found that will be operable. Certainly, without considerable, focused and explicit attention to the issues, limited progress is likely. The HMT paper does not offer such attention nor does it explain how it will arise. While officials of HM Treasury may have determined a suitable course of action, that is not evident from their consultation paper.

35. The HMT paper states:

> The majority of the macroprudential tools that are being considered involve the use of classic microprudential levers (such as capital requirements and leverage limits) for a macroprudential purpose. Therefore the legislation will stipulate that the PRA will be required to implement the FPC's decisions on the use of its macroprudential tools by applying them across all relevant firms. (HMT para 2.37)

36. While this may be true of macroprudential tools (as we have narrowly defined them), the HMT paper is silent on systemic risk tools. As yet, it is far from clear that precluding supervisory direction at individual firm level to reduce systemic interconnectedness is wise.

37. The HMT paper states:

> The transparency and accountability mechanisms for the MPC are considered a critical part of its success and credibility. The Government intends to recreate, as far as possible, these mechanisms for the FPC. (HMT para 2.52)

There is a clear need for the FPC to deliberate behind closed doors. However, by publishing the Financial Stability Review (as it has, under one title or another, for more than a decade), the Bank of England already acknowledges the need to discuss openly and frankly issues of financial stability and systemic risk openly and frankly. In terms of methodology, there is a need for considerably greater transparency than is afforded under the current MPC arrangements. Indeed, there is unlikely to be one model or a single set of interoperable models that will afford the official deliberative and decision body (we continue to refer to it as the "FPC" for convenience) sufficient insight—there will be no one "right answer" or, as we refer to it, no single-point solution.

38. We believe there is a need to design model plurality into the systemic risk supervisory framework through the FPC—recognition that multiple, contending models will be required and that there will need to be a basis for selecting potential models (or modelling exercises driven by empirical data), sourcing and accessing relevant data, validating results, assessing their utility, and comparing their results. The HMT paper is silent on all these issues, which our research suggests are essential for an effective systemic risk supervisory solution.

39. By itself that is not a concern. The Bank of England officials to whom these tasks will be assigned are all, as far as we have been able to ascertain, capable and diligent and would probably approach the task in the way we advocate. However, unless these considerations are "baked in" to their mandate, they may not be given the latitude, priority or resources to pursue them.

40. More concerningly, unless Parliament, through your Committee, understands these challenges, the Bank of England officials will not have the resources or encouragement to pursue actively, with financial sector firms and relevant academics, potentially divergent solutions to the challenge of systemic risk. Without an appreciation by your Committee and HM Treasury of the methodological difficulties involved, they will not enjoy the patience of your Committee and HM Treasury to debate these complexities openly with policy makers, academics and sector firms.

What would we propose that differs from HM Treasury's proposal?

41. In our report, we propose actions for all parts of the puzzle:

- — for politicians, regulators and supervisors, which are shown below;
- — for investment firms, their suppliers, trade bodies and technical associations; and
- — for the research community, academics and funding agencies.

We attach the summary of the report from our recent review for your reference.

42. However, there are five themes we would like to bring out that deserve the attention of the Committee:

- — Multi-disciplinary solutions are needed.
- — Supervisory collaboration with firms is essential.
- — Focus of funding of research must reflect the need for sector engagement and multi-disciplinary research efforts.
- — Attention to international standards for reference data is an essential building-block of effective systemic risk control.
- — Resources need urgently to be applied to development of a regulatory data architecture and a blueprint for systemic risk control.

We address each of these briefly.

Multi-disciplinary solutions

43. At present, many economic commentators, including leading members of the international academic economics "orthodoxy", contend or acknowledge that orthodox economics has not provided a satisfactory path for policy-making or supervision in systemic risk. Her Majesty, The Queen, received partial acknowledgement of this in response to a visit to one of the UK homes of economic orthodoxy, the London School of Economics. There is a need for extension of economic models and disciplines to acknowledge variously complexity, model agent behaviour and feedback systems in financial markets—the model pluralism we advocate, and to place data (observed reality) before models (which greatly simplify that reality). As a UK statistician, George Box, once observed: "all models are wrong but some are useful". Far greater emphasis, from a range of disciplines, needs to be paid to conditions of model utility and to the data which is needed to define and test those models.

Sector engagement

44. To date, financial sector firms have been left out of the debate on systemic risk. While there is no usual organisational home for systemic risk (ie no clear function responsible for it—it is the result of an externality), engagement of firms is not a luxury but a necessity. First, any additional data will be required to be sourced from either from sector firms, data aggregators or market operators. Secondly, an entirely conceivable approach to systemic risk—one under active consideration by international regulators—is the application of an additional capital charge or "add-on" relating to a firm's contribution to systemic risk. The standards of evidence for this will be—or should be, anyway—far higher than for economy-wide measures (this same evidential point holds true for macroprudential intervention also). Firms will be impacted differentially by such measures and their collaboration and co-operation will be essential to avoid dissent, conflict and the possibility of litigation.

The focus of funding

45. Much funding for academic research focuses on ranking of research based on venue of publication. We have heard considerable criticism of this approach both from with the academic economics and from the financial services sector. Although we have not reviewed funding formulae, we believe that there is insufficient engagement between firms and academics, academic and regulators, and regulators and firms. Also, where such engagement occurs, multi-disciplinary or inter-disciplinary research is rare. All sector participants have impressed upon us the need for incentives for research and for participation in research initiatives to be refocused towards greater interaction between sectors and disciplines.

International data standards

46. At present, there are no uniform international standards for reference data. As a result, a counterparty (say, Vodafone plc, just as an example) may mean different things to Barclays Bank (Sao Paolo) Limited and Mitsubishi UFJ Financial Group's Singapore subsidiary. Furthermore, even within financial groups, one of our firms, JWG, has found in a recent survey of data standards that there are considerable discrepancies in reference data standards among major financial sector firms. For data to be comparable between regulated entities and internationally—an essential component of any internationally integrated systemic risk supervisory regime—these data standards must be aligned.

Regulatory data architecture and systemic risk blueprint

47. Despite the enormous information and reporting loads placed on UK firms (and firms in all comparable jurisdictions), the regulator and supervisors have developed no coherent model of its data requirements or its data uses. This results in fragmented and often repetitious data requirements from firms and increases the cost of data provision to the sector. It also reduces the analytical efficiency of supervisors. While this lack of data coherence has persisted and been tolerated to date by politicians, policy-makers, regulators, central bankers, supervisors and sector firms, it adds costs and impedes (and may inhibit) the development of a robust international financial supervisory capability for systemic risk. Technologies (such as XBRL—a data tagging taxonomy or framework) that are in development elsewhere have been overlooked in the UK.

48. The UK supervisor should, we believe, as a matter of priority, define a robust and comprehensive data architecture that it can communicate to and validate with the financial services sector. It must be adaptable, extensible and support unified data standards. Once this has been achieved, it will be practicable to develop a blueprint for data to support more meaningful analysis of interconnectedness, feedback systems in financial markets and systemic risk. Without such a blueprint, these ambitions appear unachievable.

Recommendations for Action

49. In our report, we recommend a series of actions for all relevant participants in the sector. Those findings relating to politicians, regulators and supervisors are shown here:

Key problems:

- understanding systemic risk is a complex, multi-faceted problem. There are no single-point solutions;
- there is presently considerable political will to address the problem, but objectives of the national and supranational control organisations are not sufficiently aligned;
- given the volume of market, technology and regulatory innovation, the requirements for a control infrastructure are getting more difficult quickly and will continue to change;
- the practical implications of the quantum of regulatory change is impossible for any one body to interpret for the whole industry;
- SR control is not a problem solved by edict from the "centre". A collaborative approach inclusive of all facets of the industry is required;
- there is a "guilty knowledge" dilemma that disincentivises supervisors from collecting data that they are not able to process and draw conclusions from;

— an efficient systemic risk supervisory structure requires global supraordination but approaches have already begun fragmenting in 2010;

— incentives for collaboration with the firms who have the expertise, and the resources to help, have not been established;

— vendor profit incentives are leading to the generation of multiple fragmented "quick fixes" that will not address the holistic problem—which is yet to be understood;

— costs can be in tens or hundreds of billions without certainty of benefit; and

— milestones which are currently in the G20's action plan are unlikely to be met.

What the problems mean to you:

— the problem will continue to distract supervisors from attending to the risks they are meant to be controlling;

— consequences of moving too slowly, or in the wrong direction, are high as an incorrect analytical approach may do more damage than good;

— whatever solutions do get developed are likely to be costly, late and inefficient as mandates for decision-making are not clearly articulated;

— more resources will be required at supranational, regional and member State levels;

— a clear roadmap of "what good SR oversight looks like" as described in Chapter 6 is required now; and

— if you want to return to "crisis as usual" stop reading now.

Your action checklist:

— articulate clear mandates at international, regional and national levels;

— increase resourcing levels to do the job properly;

— set a date by which a roadmap is required in order to catalyse new, ongoing requirements, design and standards discussions;

— understand control requirements though practical, multidisciplinary and focused research;

— make a realistic statement about the information capabilities that are truly required;

— establish the incentives for the appropriate participation of the firms and their suppliers; and

— mandate the development of standard regulatory data taxonomy in each jurisdiction now, or accept the risks, costs and consequences of building a regulatory tower of Babel.

Attachments

1. Framework for the regulatory toolkit defining and differentiating systemic risk focus from macroprudential focus (see paras 12 and 13 of this submission).

2. Response to questions posed by the Treasury Committee.

3. Summary material from our research: Achieving Supervisory Control of Systemic Risk.

ATTACHMENT 1

FRAMEWORK OF THE REGULATORY TOOLKIT

Focus	*Terminology*	*Additional coverage required*	*Development state*
Firm-level aspects	Microprudential	— Adding to existing firm-level prudential and control rules — Enhancements to governance of risk—per Walker — Liquidity enhancement — Prudential capital requirements	Under development or implemented at local and BIS level
	Micro and macroprudential	— Stress testing — Reverse stress testing — Firm and sector liquidity exercises	Under development or implemented at local and ECB level
	Macroprudential	— Counter-cyclical buffers — Instrument or counterparty class risk weights for capital requirements — Collateral requirements — Prospective cyclical loss provisioning — Lending limits / credit controls — Reserve policy	Under development or development under consideration

Focus	Terminology	Additional coverage required	Development state
	Resolution measures	— Living wills and data requirements of the special resolution regime — Contingent capital measures	Under development
Network aspects	Systemic	— Interconnectedness — Capital adjustments for highly interconnected firms — Transmission mechanisms — Amplification mechanisms — Emergence mechanisms	Under discussion at academic level

Economy aspects	Macroeconomic	— Linkage of macroeconomic variables to financial system risk
		  — Fiscal policy
		  — Monetary policy settings
			Extensive commentary emerging academically and at policy level

ATTACHMENT 2

RESPONSE TO QUESTIONS POSED BY THE TREASURY COMMITTEE

50. In this section, we answer briefly the questions posed by the Treasury Committee in its press release dated 28 July 2010 announcing the consultation on the HM Treasury Consultation Paper.

Overall

Will the Government's financial regulation proposals improve the framework for financial stability in the UK? Will they work in a crisis?

All sophisticated analyses of the financial crisis, including many offered by the Bank of England, have emphasised financial system interconnectedness, "network effects" or "systemic risk" as a contributory factor. HM Treasury analysis is silent on this point; its policy prescription is similarly silent. Without a clearer picture of the proposed approaches to systemic risk, it is not possible to know whether the approach described in the HMT paper will be effective. There can be no certainty that any framework that allows leverage by financial firms and interconnectedness between them will avoid crises in future.

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?

We do not believe so, for reasons we explain in the body of our submission.

How do the Government's proposals dovetail with initiatives currently being undertaken at European and the global level?

In relation to systemic risk, they are largely compatible but offer no leadership. As the major financial centre in Europe, we believe this represents a lost opportunity to steer the debate on and suggest solutions for systemic risk. If the UK official sector does not improve its coherence and co-ordination on the topic of systemic risk and represent this effectively to ESRB / ECB and decision-makers at European Commission and EU Parliament level, any opportunity for such leadership or recovering such leadership may be squandered. We do not believe that is necessary or in the UK's interest.

What costs will the regulatory structure place on consumers?

We have not reviewed this issue in relation to systemic risk.

Power, Roles and Responsibilities

Do the Government's proposals appropriately assign roles and responsibilities between the different regulatory institutions?

We consider this issue less important than defining the appropriate requirements for systemic risk, which we have attempted to address in our report, a summary of which is attached. Without defining requirements or even objectives in relation to systemic risk, assignment of proposed roles and responsibilities appears premature.

Will there be unintended consequences of the Government's proposals for regulation on the prospects for non–bank financial institutions?

Inevitably. We have not attempted a robust analysis of this issue, but have highlighted several such "unintended consequences" in our substantive submission.

The Financial Policy Committee (FPC)

— Should the FPC have a statutory remit? If so, what should that remit be?

We have not reviewed this issue robustly.

How should the success of the FPC, both in and out of crisis, be measured?

It is not possible to measure the success of something the purpose of which is to avoid an event, except by experiencing the event and finding it a failure. This is a key epistemological dilemma of supervisory control of systemic risk. We discuss this issue further in our report at section 3.3.

— Given the international regulatory framework, what macro–prudential tools should be granted to the FPC?

We have not reviewed robustly the alternatives for macroprudential tools for the FPC. Our chief concern is that those indicated in the HMT paper do not cover detecting, measuring or responding to interconnectedness in financial markets.

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?*

— *the size of the Committee?*

Although we have not reviewed this matter closely, we have made some comments on it substantive submission (see paras 19 and 20, above)

What characteristics, experience and qualities should the Government look for when appointing external members of the FPC?

We did not review the requirements or capabilities of members of the FPC as it is currently proposed. However, based on our review of the requirements for supervisory control of systemic risk, we believe:

— First, they should be experienced bankers.

— Secondly, they should be experienced policy makers.

— Thirdly, they should have regulatory and/or supervisory experience.

— Fourthly, they should have experience as economists, econometricians or social scientists.

— Fifthly, they should have extensive experience at data mining, "statistical physics", complex systems analysis and/or agent-based modelling.

— Finally, they should not want the job.

That seems an unlikely combination of attributes.

ATTACHMENT 3

SUMMARY INFORMATION FROM ACHIEVING SUPERVISORY CONTROL OF SYSTEMIC RISK

The summary information from our report Achieving Supervisory Control of Systemic Risk is attached separately.

The full report is available at www.jwg-it.eu/library.php?typeId = 11 and www.paradigmrisk.com

22 September 2010

Written evidence submitted by the Investment and Life Assurance Group

1. Executive Summary

1.1 Whilst we welcome the opportunity to comment on the proposed new system in response to the specific questions posed by the Committee, our remarks are necessarily coloured by our belief that institutional reform on the scale envisaged is not justified by the events of the recent financial crisis. As such, it will inevitably impose considerable, additional financial costs and burdens on:

— the financial services industry in meeting the costs of the new structure, and

— a significant number of individual firms—large, medium and small—in being supervised by two domestic regulators.

1.2 That said, we acknowledge the need for a more purposeful approach to national financial stability entailed by the creation of a new body (Financial Policy Committee or FPC) within the Bank of England (BoE).

1.3 However, we are less convinced of the arguments surrounding the proposed abolition of the Financial Services Authority (FSA) and the imposition of a system of dual regulation and supervision over many firms in the UK industry. Whilst we recognise a case for ceding back responsibility for prudential regulation and supervision of the banks to the BoE, other reforms should have been targeted at the internal workings of the FSA to achieve a more focused and sharper organisation rather than dividing up responsibilities between two brand new institutions.

1.4 In particular, we are aware that EU initiatives such as the Capital Requirements Directives (affecting banks and investment firms) and Solvency II legislation (insurers) will govern firms' prudential reporting and capital reserves—as well as the whole business of financial risk management—and be implemented broadly at the same time as the new regulatory structure formally takes effect. It has to be said that not only is the FSA well advanced in developing these measures in a UK context but is also working closely with the industry in preparing firms for their implementation. To have this important process interrupted by upheaval and dismantlement of the FSA would be a very retrograde step.

2. Overall

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?
How do the Government's proposals dovetail with initiatives currently being undertaken at European and the global level?
What costs will the regulatory structure place on consumers?

2.1 In theory, the proposed establishment of new institutions, and particularly the FPC, should improve financial stability in the UK but the "acid test" will only come when the next crisis occurs and how effectively these new arrangements then operate in practice. It is vital that there is full and proper co-ordination of activities and a clear decision-making path. On that level, we harbour concerns especially given the number of bodies involved.

2.2 Some critics have argued that the new framework only responds to the last financial crisis and that all crises are, by their very nature, unpredictable. Whilst we accept that some regulatory changes should be made it is more about having the right people, processes and culture in place to manage the next crisis than the make-up of the institutions themselves.

2.3 Equally, the origins of the crisis will have a major bearing on the effectiveness of UK action. Where the crisis is of a global or European nature the scope for unilateral measures—and their ultimate success—may be limited. It is therefore essential that, at least on a European level, machinery to give early warnings and take remedial action is fully integrated as between EU and UK institutions. In particular, the proposed FPC and PRA must have a close and continuing rapport with the embryonic European Systemic Risk Board (ESRB) and European Supervisory Authorities (ESAs), respectively, involving inter-linking systems and processes.

2.4 Inevitably, setting up this new regulatory structure will involve additional establishment and on-going costs and mean that, in having to bear the funding itself, the industry will be forced to pass on much of this cost to consumers if it is to remain competitive in the global marketplace. In particular, the insurance sector regrets that subsequent higher premiums and product prices, and possibly even complete withdrawal of some product lines, will only excacerbate the existing savings and protection gaps in this country—especially when it played no part in causing the recent crisis.

2.5 We enlarge on these issues in later comments.

3. Power, Roles and Responsibilities

Do the Government's proposals appropriately assign roles and responsibilities between the different regulatory institutions?
Will there be unintended consequences of the Government's proposals for regulation on the prospects for non-bank financial institutions?

3.1 As far as can be gauged, the split of roles and responsibilities appears logical if one accepts the premise that regulation is best divided between two bodies—three if the FPC is included.

3.2 As to "unintended consequences" these only really become apparent after the event but based on the last financial crisis there are reasons to fear that they might re-occur and that the whole financial services sector may have to pay again for the sins committed by one particular sector. We would hope that none of the bodies would be so fixated on the need to take either pre-emptive or remedial action at short notice that they did not, at the same time, give some consideration to the impact of such measures on different sectors.

4. The Financial Policy Committee (FPC)

Should the FPC have a statutory remit? If so, what should that remit be?
How should the success of the FPC, both in and out of crisis, be measured?
Given the international regulatory framework, what macro–prudential tools should be granted to the FPC?
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?*

What characteristics, experience and qualities should the Government look for when appointing external members of the FPC?

4.1 We do believe that the FPC should have a statutory remit in order that, at all times, it acts within its recognised boundaries and is accountable for all its actions. As proposed, its primary remit is focused on preserving financial stability and we feel that its terms of reference should be extended to include secondary factors to take account of wider socio-economic considerations in much the same way as the MPC does.

4.2 In a business sense any measurement of success must be linked to its objectives but, in reality, the FPC will be judged by the actions it takes in either responding to or preventing the next crisis in the UK. If such decisions prove effective then it will be deemed a success but anything less may call into question its fitness for purpose. That apart, it is difficult to quantify how success should be measured on a formulaic basis as crises will vary in type, origin and impact. Certainly in its day-to-day operations, the FPC should adopt the procedures of the MPC and publish minutes and reports on a regular basis to aid transparency and public scrutiny.

4.3 In managing the exercise of its macro-prudential functions upwards, it should have the means and authority to communicate swiftly with corresponding international bodies ie. G20 Financial Stability Board (FSB) and ESRB, and be able to take unilateral measures consistent with any action taken on an international level. In managing downwards, it should, in emergency situations, have the power to direct both the PRA and CPMA to take action without due consultation although in an operational sense some prior notice will need to be given.

4.4 It is difficult at the drawing board stage to visualise how direct conflicts could arise between the MPC and FPC in the exercise of their duties as within the BoE their objectives are linked in relation to the workings of the whole economy. Both bodies should have secondary responsibilities to take into account these wider considerations though in practice it is difficult to predict the resultant effects elsewhere eg. actions by the MPC to raise or lower interest rates and its immediate or measurable effect on financial stability, and equally any actions by the FPC in closing financial markets in triggering sudden changes in price stability.

4.5 It is important, however, that where actions have direct or indirect consequences the relationships between the two committees are underpinned by a "memorandum of understanding"-type document to ensure a formal process of engagement and co-ordination. Additionally, within the Bank of England, a similar document should be prepared to define the relationships between the Court of Directors and the FPC (presumably on similar lines to the MPC).

4.6 On the size, composition and character of the FPC, we agree that the numbers proposed are of the right order and fully endorse the need for balance of membership to reflect a cross-spread of interests and abilities in financial sevices. As proposed, and against the background of the recent crisis, there is a danger that the FPC Board will be bank-issue orientated and it is important that the non-Bank appointees provide the necessary breadth of knowledge in other areas. These appointees should have a sound understanding of strategic and systemic risk and also occupy positions of prominence within their own financial sectors to be able to draw on vital, practical experience. Thus the ideal remit in terms of appointing external members is to ensure that other sectors, particularly the insurance and securities markets, are adequately represented, rather than filling the extra places with regulatory and academic-based persons.

4.7 Above all, we believe that the external appointees should be of senior NED–type quality bringing independence, diversity and challenge to all the FPC's activities.

5. The Prudential Regulation Authority (PRA)

Should the PRA be the lead authority over the Consumer Protection and Markets Authority (CPMA)?
Is it appropriate for the PRA (and CPMA) to adopt a judgements–based approach to financial regulation and supervision?

5.1 We believe that the PRA should be the principal regulator of financial firms and have authority over the CPMA. Otherwise, firms will suffer from uncertainty and confusion as to which body is in charge and potentially be faced with having to carry out different edicts that may be in apparent conflict with each other eg having to increase capital reserves at the same time as being instructed to allocate more resources to monitoring financial promotions. It is vital that the two bodies operate as closely as possible in order to ensure that the whole regulatory regime is seamless and runs as smoothly and cost-effectively as possible.

5.2 The notion that both regulatory bodies should move to a judgement-based approach is both complex and far from straightforward. For example, in applying new rules based on EU regulations and directives, the scope for a judgements-based approach will be severely limited as in most cases adoption of such measures will be governed by prescription. Indeed, there are many smaller and medium-sized firms that prefer to abide by the (FSA) rulebook rather than having to operate under a principles-based regime which may provide less certainty and consistency.

5.3 We appreciate that appointing an executive committee under the auspices of the PRA Board, to include non-executives, may help to instil a more judgements-based culture, but doubts will remain as to how this approach percolates down to actual officials responsible for day-to-day supervision of firms. From recent experience within the industry, there is an impression that supervisors are uneasy in dealing with firms that interpret and discharge the same rules in different fashions. If this is to be perpetuated, there is a continuing risk that firms may suffer from lack of consistency on the part of supervisors, either being too cautious or cavalier in what they allow firms to do. How one solves this conundrum can only be achieved by ensuring that all supervisors are sufficiently skilled and experienced in making such judgements and in giving the necessary confidence to firms.

5.4 Thus in an ideal regulatory world, there should be room for both rules and judgements but whatever the final mix there must be a level of clarity and certainty that gives no grounds for dual or misinterpretation.

6. The Consumer Protection and Markets Authority (CPMA)

Do the reforms provide adequate protection for the consumer?
To what extent will the regulatory and administrative burden increase for those firms who now have to deal with two regulators?

6.1 Setting up a dedicated body with the words "consumer protection" in its title would appear to confer the status of a consumer champion with an over-arching role to provide adequate safeguards. However, it is essential that such a body operates on an even-handed basis in discharging its functions taking into account the legitimate needs and interests of firms as well as consumers. A careful balance has to be struck between consumer protection and ensuring that the financial services sector is not unduly constrained in facilitating access to suitable products and services. Otherwise, there lies the danger of a cumbersome and costly conduct of business regime for firms that will then have unintended consequences for consumers in pushing up prices and involving layers of detailed and largely un-read documentation; thus leading to a widening of the already large savings and protection gaps.

6.2 More fundamentally, the whole concept of firms having to report to two regulators takes the industry back over 10 years, before the FSA was formed, and which even at that time proved costly and burdensome to firms even though the rule book was at most half the current size. Returning to split regulation will be a real and significant issue for an estimated 1,500–2,000 firms, requiring new relationships to be established and imposing extra costs and resources both during transition and thereafter. If it is to work effectively, then the systems, processes and controls of the two organisations must be streamlined and inter-linked and the respective officials must communicate with each other on a regular, on-going basis.

6.3. Moreover, the Government's preliminary cost-benefit analysis, set out at the back of its consultation paper is threadbare in the extreme, based on only two options—"do nothing" or "proceed"—with nothing in between. It contains only a broad approximation of transitional costs for the new institutions and makes vague assumptions that firms will notice only minimal cost increases of a transitional and on-going nature. We firmly believe this will not prove to be the case and that further and more detailed assessments are required.

7. Other Issues

Should any of the proposed bodies be given responsibility for promoting competition in the banking and financial services sector?
Should any of the proposed bodies have a role in promoting the City of London?

7.1 In neither case, do we see such an overt role for any of the proposed bodies in the new regulatory environment. Certainly, they should take care to avoid any measures that may have a direct, serious and adverse impact on competition and innovation in the industry but their prime responsibilities have to be to ensure efficient regulation and supervision and clean, fair and orderly markets.

7.2 In any case in the City of London, a new purpose-made body—TheCityUK—has recently been created to undertake the task of actively promoting the City and UK financial services at home and abroad and duplication of effort should be avoided.

22 September 2010

Written evidence submitted by Shelter

Summary

1. Shelter welcomes the committee's decision to hold an inquiry into the government's plans to change the system of UK financial regulation. As a housing, welfare and debt advice provider, Shelter's expertise in this area lies in the regulation of mortgage lending and mortgage arrears management, in the context of consumer protection. Therefore this submission will set out Shelter's position on the principles for reform in this area.

2. Though levels of repossessions and mortgage arrears have dropped since last year, the number of homeowners in difficulty is still worryingly high and the risk of another rise in repossessions is acute. For this reason, and for the sake of long term economic and social sustainability, it is crucial that a strong and effective regulatory system is put in place to address the historical flaws in the existing consumer protection regime.

3. The new regime must:

— Be based on clear, rules-based regulation that does not allow too much flexibility for interpretation.

— Be tough on lenders, with enforcement action and public naming and shaming.

— Promote responsible lending.

— Incorporate a strong consumer voice and a system of consumer redress.

— Be transparent so that consumers and lenders fully understand their rights and responsibilities.

— Have systems in place to ensure that the new agencies work together effectively.

— Bring second-charge and buy-to-let lending under the remit of the CPMA.

Evidence

4. Shelter has considerable experience and expertise in the area of mortgage arrears and repossessions, both from a services and a policy perspective. Shelter staff provide practical advice, support and innovative services to over 170,000 people a year, helping people with housing, debt and welfare issues through face-to-face, online and telephone provision. Our services have seen a large increase in queries from clients in mortgage arrears since 2008. Between April 2009 and May 2010 Shelter provided mortgage debt advice to over 7,000 households, of which more than 4,700 households were helped under Shelter's Homeowner Mortgage Support (HMS) contract, funded by the Department of Communities and Local Government (CLG).

5. Though low interest rates and government safety nets such as Support for Mortgage Interest (SMI) have ensured that the rate of repossessions has not been as high as was initially feared, for many households the threat of repossession has not passed. At the end of June 2010, there were over 245,000 mortgages more than three months in arrears in the UK.[13] Shelter is concerned that a rise in interest rates, the effects of unemployment and the announced cuts to SMI will mean that arrears remain unusually high well into 2011. A YouGov survey commissioned by Shelter in May found that 29% of mortgage holders were unprepared for the increase in mortgage payments when interest rates inevitably rise.[14]

6. Even once the economy has fully recovered there will still be some households who find themselves in mortgage arrears and at risk of repossession, but it is in the UK's economic and social interest that the number of repossessions is minimised. In addition to the costs of re-housing families there are also many social costs associated with repossession, including poor educational attainment and poor health outcomes of children made homeless and living in temporary accommodation. NEF Consulting, in a report for the Law Centres Federation, calculated that preventing the eviction of a family of four can result in a saving to government (national and local) of £34,000.[15]

7. The importance of having a strong and effective regulatory regime cannot be underestimated. There remain a number of long-term regulatory issues that need to be addressed to ensure that the repossessions crisis does not deepen now, or reoccur later. Shelter welcomes the fact that the government is attempting to address these issues and that it appears to be taking a fundamental and long-term view. Broadly speaking, Shelter is not necessarily concerned about where exactly consumer protection sits within the regulatory regime, as long as there is tough regulation, proper enforcement of that regulation, and a strong consumer voice.

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[13] Council of Mortgage Lenders.

[14] Shelter commissioned YouGov to conduct an online survey of 4,405 adults in Great Britain. Fieldwork was undertaken between 7–10 May 2010. The survey was carried out online. The figures have been weighted and are representative of all adults (aged 18+).

[15] *NEF Consulting/Law Centres Federation*, The socio-economic value of law centres, 2008.
Based on the cost of providing accommodation in London, as well as the cost of providing treatment for depression, the cost of school support for children and the loss of tax receipts resulting from loss of employment.

8. However, with three new agencies being introduced to replace the FSA, there are risks that the new regime could fail to operate as a coherent whole, and systems must be put in place to ensure that the new agencies work together effectively. Mortgage regulation is already too fragmented, with second charge lending being the responsibility of the Office of Fair Trading rather than the Financial Services Authority (FSA). Our recommendation is that all mortgage regulation should sit in the same place, to promote clarity and consistency of practice across the mortgage market, and minimise confusion for consumers. Having only one regulator would ultimately make compliance and associated costs more straightforward for lenders, which could result in lower costs to borrowers. Currently there is no regulation at all of buy-to-let lending or securitised mortgages, and these need to be brought into the new regulatory framework.

9. It is crucial that the new regime addresses the problems with consumer protection that have existed under the old system, though it must be emphasised that the FSA is now vastly improved, with a much better arrears management and enforcement regime. Shelter largely supports the measures proposed by the FSA in its recent consultation paper *Mortgage Market Review: Irresponsible lending*, and we urge the government to press ahead with these reforms alongside the proposed structural changes. The new system must build on the process of improvement that has already been initiated, rather than set it back.

10. In addition to this, Shelter calls on the government to ensure that the new regulatory regime incorporates:

— Principles rather than rules-based regulation. The old MCOB (Mortgage Conduct of Business) left far too much flexibility for interpretation (for example in the use of terms such as "fairly" and "reasonably" without definition). More prescriptive, binding rules can promote consistent standards across the lending industry and give borrowers a much clearer idea of what to expect.

— A rigorous approach towards lenders. In the past, the FSA has failed to take enforcement action against specific lenders, even when they have been found guilty of bad practice.

— The willingness to name and shame. The FSA has in the past refused to publicly name firms that have been found guilty of bad practice, and therefore borrowers have not been sufficiently empowered with the knowledge to challenge their lenders directly.

— Provisions for consumer redress. There must be appropriate systems in place to provide consumer redress for borrowers who have been mistreated by lenders and who may have suffered significant financial loss as a result.

22 September 2010

Written evidence submitted by the Futures and Options Association

1. Introduction

1.1 The Futures and Options Association ("the FOA") is the principal European industry association for over 170 firms and organisations engaged in the carrying on of business in futures, options and other derivatives. Its international membership includes banks, financial institutions, brokers, commodity trade houses, energy and power market participants, exchanges, clearing houses, IT providers, lawyers, accountants and consultants (see Appendix 1).

1.2 The FOA supports the overarching objectives, including the establishment of a Financial Policy Committee (FPC), a Prudential Regulation Authority (PRA) and a Consumer Protection and Markets Authority (CPMA), set out in the Government paper *A new approach to financial regulation: judgement, focus and stability* (CM7874), but does have a number of observations and concerns, namely:

(a) The scope provisions of the PRA are unclear and described in different terms in various sections of CM7874.

(b) It is not clear how, in the proposed structure of the CPMA, wholesale and specialist broker-dealers, which are not systemically important or "retail" or "market infrastructure providers", will be accommodated and the FOA would suggest therefore that there should be three separate divisions within the CPMA, namely "retail", "wholesale" and "markets".

(c) The FOA supports the broad-based industry view that the UK Listing Authority should remain within the Markets division of the CPMA rather than be transferred to the FRC.

(d) The FPC, the PRA and the CPMA should be required to take into "full account" the secondary factors referred to in CM7874 as largely reflected in the Financial Services and Markets Act 2000 (described by the FSA as "Principles of Good Regulation"), including the need for regulated institutions to be competitive and innovative. Where possible and appropriate, the factors should be the same for each authority because, as factors, they will be subordinated to each of their primary objectives.

(e) Retail investor protection and fair dealings should be at the heart of the CPMA, but its description as a "strong consumer champion" seriously undermines its independence as a statutory-based authority, particularly in the area of handling customer complaints and consumer-related disciplinary proceedings, and it suggests that other CPMA divisions will be subordinated to its consumerist responsibilities.

(f) The proposed restructuring of financial services regulation into separate bodies carries the risk of inter-institutional rivalries and tensions as well as rules and supervisory duplication. It is important therefore that there are "bright lines" in terms of scope, responsibilities and decision-making and in the areas of information-sharing and cooperation.

(g) The rule-making functions of the PRA and the CPMA should be subject to scrutiny and oversight by the competition authorities and to duties to consult publicly, issue feedback statements and carry out market impact analysis.

(h) The PRA and the CPMA should each have a high-level, statutory-based practitioner panel of sufficient seniority and expertise to perform the role currently provided by the FSA's existing high level Practitioner Panel.

(i) The right of the FPC, the CPMA and the PRA to set their own fees should be overseen by the National Audit Office or HM Treasury to ensure that that process is subject to effective cost-benefit analysis, does not involve fees based on unnecessary duplication and does not result in a severe and disproportionate impact on the economics of financial services business.

(j) The Preliminary Impact Assessment in CM7874 appears flawed because, firstly, it covered only the options of "do nothing" (which is not really an option) or "proceed" and did not analyse such other options as "do less" or even "do differently"; secondly, it did not assess the core elements of the proposed changes; and, thirdly, it assumed no substantive rules change as a result of structural change—an assumption the assessment conceded specifically as "unrealistic".

2. Response to Specific Questions

Q1. *Will the Government's financial regulation proposals improve the framework of for financial stability in the UK? Will they work in a crisis?*

2.1 The FOA supports the establishment of a new FPC and the need for a close interface with the PRA and believes that these proposals will improve the framework of financial stability within the UK, providing responsibilities and decision-making processes are clearly defined and the traditional weaknesses of multipartite arrangements are addressed.

Q2. *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?*

2.2 Since it is difficult to predict the cause of the next crisis, it is not possible to determine whether the current proposals do, in fact, "get the balance right" but, subject to the observations in para 2.1 above, the FOA believes that they should have a better chance of catching a growing crisis on the "orange light" rather than the "red light".

Q3. *How do the Government's proposals dovetail with initiatives currently being undertaken at European and the global level?*

2.3 Matched responsibilities between the new European Supervisory Authorities and the CPMA and PRA are unlikely, so the PRA and the CPMA will, in certain respects, probably have to represent each other's interests in their relations with the new European Supervisory Authorities.

2.4 CM7874 does not address how the UK, where it has the competence, will be represented on the international standard-setting bodies.

Q4. *What costs will the regulatory structure place on consumers?*

2.5 The CPMA, insofar as it replicates existing parts of the FSA, should not have any significant cost implication for consumers, although that is unlikely to be the case for the customers of PRA regulated firms, where there will be dual regulation. Such additional costs are likely to be passed on to customers in commissions and charges.

Power, Roles and Responsibilities

Q5. *Do the Government's proposals appropriately assign roles and responsibilities between the different regulatory institutions?*

2.6 In general terms, the FOA thinks the proposed split between prudential regulation of systemically-important institutions and business conduct regulation is appropriate, but the scope of the firms to be regulated by the PRA (assessed to be in the order of 1500-2000 firms) is unclear (eg broker-dealers are equated with investment banks, which is manifestly incorrect) and the supervisory responsibilities of the PRA are described differently in various sections of CM7874.

2.7 It is not clear how, within the proposed CPMA structure, the regulation of wholesale firms and the more specialist broker-dealers, which are not systemically important or "retail" or "market infrastructure providers", will be accommodated. It would seem appropriate to establish within the CPMA three separate "retail", "wholesale" and "market" divisions, each of which should have its own sub-board.

Q6. *Will there be unintended consequences of the Government's proposals for regulation on the prospects for non-bank financial institutions?*

2.8 Further to para 2.7 above, the FOA believes that there is a real risk that the CPMA will not be able to differentiate proportionately between wholesale and retail business (which is not an argument for "light touch" regulation), because of the intense consumerist overlay imported into the CPMA by its role being described in CM7874 as a "strong consumer champion" (see also para 2.19 below).

2.9 The FOA, for all the reasons given by the London Stock Exchange, believes that the UK Listing Authority should remain within the markets division of the CPMA.

2.10 While the FOA does not seek to speak for insurance and asset managers, the "on the ground" supervisory consequences for non-bank financial institutions which fall within the remit of the FOA are, subject to paras 2.7and 2.8 above, unlikely to generate any significant changes.

The Financial Policy Committee (FPC)

Q7. *Should the FPC have a statutory remit? If so, what should that remit be?*

2.11 The FOA is content with the broad remit (which should be statutory) assigned to it in CM7874, but believes strongly that:

- the FPC (like the CPMA and the PRA) should be subject to those Principles of Good Regulation that are relevant to its work (including taking into full account not just the monetary and economic consequences of its actions, but also the social consequences); and
- the authority of the FPA to set its fees should (as is the case with the PRA and the CPMA) be the subject of independent oversight (see further para 2.22).

Q8. *How should the success of the FPC, both in and out of crisis, be measured?*

2.12 The FOA supports the external (as opposed to just internal) accountability of the FPC, but believes:

- there should be more external members on its Board if they are to effectively, as it is put in CM7874 "challenge" its deliberations; and
- the degree of independence of the FPC, its operational processes and its responsibilities and duties as regards co-operation and information-sharing should all be set out in a separate code of governance.

Q9. *Given the international regulatory framework, what macro-prudential tools should be granted to the FPC?*

2.13 Other respondents will be more focussed on replying to this question, but in general terms, the powers and capabilities set out in CM7874 appear adequate,

2.14 The powers of the FPC are not entirely clear. For example, it can give directions to the PRA on the regulatory tools that should be deployed in pursuit of macro-prudential policy and to make recommendations where specific regulatory actions are required in order to protect financial stability (para 2.32), but it may not exercise "any formal power of direction in relation to firm-specific decisions or other operational matters" (para 3.29). The FOA would note, firstly, that the former could require the latter and that, secondly, that this undermines the objective of integrating macro-oversight with micro-prudential regulation.

Q10. *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?*

2.15 It is outside the remit of the FOA to comment on the functioning of the MPC.

Q11. *What characteristics, experience and qualities should the Government look for when appointing external members of the FPC?*

2.16 The FOA believes that the role and responsibilities of external members are comparable to those of a non-executive director, ie they should be sufficiently informed and expert to ensure that the Committee lives up to its responsibilities, including in terms of decision-making and accountability, and to "challenge" the assumptions and decisions of the Committee members could include, for example, a chief economist of one of the major banks, a senior prudential regulation expert from one of the major accountancy firms and a senior, well-respected independent economist.

The Prudential Regulation Authority (PRA)

Q12. *Should the PRA be the lead authority over the Consumer Protection and Markets Authority (CPMA)?*

2.17 Outside the area of prudential regulation, it is difficult to see why the PRA should be the "lead authority" over the CPMA because the CPMA will be responsible for the prudential and business conduct regulation of the vast majority of financial services firms in the UK, ranging from asset managers to specialist broker-dealers, exchanges and international oil and energy corporates, which are far removed from the competence and experience of the PRA. Further, it is difficult to see how the CPMA could play an authoritative role representing the UK on ESMA if it is seen to be sub-ordinated to the PRA.

Q13. *Is it appropriate for the PRA (and CPMA) to adopt a judgements-based approach to financial regulation and supervision?*

2.18 Yes, providing their staff:

- have the training and competence to do so;
- exercise their judgements in accordance with pre-set transparent criteria and they are "cleared" internally to ensure consistency;
- subject to the principal objective of the PRA/CPMA, take into full account the secondary factors; and
- exercise any discretions in the area of investigation fairly, consistently and in line with accepted notions of natural justice.

The Consumer Protection and Markets Authority (CPMA)

Q14. *Do the reforms provide adequate protection for the consumer?*

2.19 The FOA believes strongly that retail investor protection and fair and honest dealings with all consumers should be at the heart of the CPMA, but the description of the CPMA as a "strong consumer champion" is deeply misconceived and materially undermines the CPMA as a detached and balanced regulatory authority, particularly with regard to the handling of customer complaints and consumer-related disciplinary proceedings, free of bias. Further, this poses the question, in respect of what and against whom is it supposed to act as a "champion"?

2.20 Government policy is clearly confused in this area, insofar as, by way of direct contrast, CM7874 states that the Financial Ombudsman Service should remain independent of the CPMA to avoid impugning "its claim to impartiality, and hence its legitimacy on making rulings which are binding on firms" and that it can only retain credibility "if it does not favour, or appear to favour, consumers". Surely, this is equally true of an independent statutory-based regulatory authority such as the proposed CPMA!

Q15. *To what extent will the regulatory and administrative burden increase for those firms who now have to deal with two regulators?*

2.21 CPMA-regulated firms are unlikely to face any significant increase in the regulatory and administrative burden and the style and nature of CPMA supervision is likely to be similar to that of the FSA in its current revised form. However, dual-regulated PRA firms face potential duplication in reporting obligations and supervisory visits and overlap in areas where business conduct and prudential regulation are closely interwoven. This could be exacerbated if cooperation and consensus-building processes became overly bureaucratic or time-consuming. It was concerns of this nature that led to the abandonment of the SRO system and the establishment of the FSA in the first place.

For this reason, the FOA believes there is real merit in one authority undertaking the provision of common services, including authorisation, the removal of permissions, organising supervisory visits and collecting data, albeit working in cooperation with any other relevant authorities.

2.22 Regulatory cost could be exacerbated significantly if the FPC, the PRA and the CPMA are able to set their own fees without any independent oversight to ensure that they are the subject of effective cost-benefit analysis; do not involve duplicative functions; and do not result in a severe and disproportionate cumulative impact on the economics of financial services business. This role could be undertaken by, for example, the National Audit Office or HM Treasury.

Other Issues

Q16. *Should any of the proposed bodies be given responsibility for promoting competition in the banking and financial services sector?*

2.23 No. This is an inappropriate role for a regulatory authority and is already being addressed by a number of organisations, such as TheCityUK, LondonFirst and UK Trade & Investment.

On the other hand, the FOA is strongly supportive of maintaining competitiveness as a factor that should be taken into account by the PRA and the CPMA when carrying out their regulatory responsibilities. It is impossible to see how they can perform a more judgemental and interventionist role—which will involve taking decisions on commercial matters, reviewing business models and judging growth strategies—without being required to take into full account the need for institutions to sustain not just their international, but also their domestic, competitiveness.

2.24 If, as stated in para 3.9 of CM7874, one of the reasons for regulatory failure was "excessive concern for competitiveness", that level of attention was not, and never has been, a requirement of the existing legislation, ie facilitating competitiveness was a factor and not an objective; and "promotion" of competitiveness was specifically rejected by the Joint Committee at the time of the passage of the Financial Services and Market Act (see further Appendix 2).

2.25 Government policy towards competitiveness was clearly expressed in the opening lines to the Executive Summary of the HM Treasury paper "Risk, Reward and Responsibility: The Financial Sector and Society" (December 2009), which stated that

> "a strong and competitive financial sector is essential to a productive modern economy, and financial services make a significant contribution to the UK economy in particular".

It seems to the FOA that it is entirely right that the PRA and the CPMA should be required to take into full account this expression of Government policy, albeit as a factor sub-ordinated to the principal objectives of each authority.

2.26 With regard to innovation, Sir David Walker in the Preface to his Report "A review of corporate governance in UK banks and other financial industry entities" (July 2009) noted that

> ". . . any undue hampering of the ability of bank boards to be innovative and to take risks would itself bring material costs. It would check the contribution of the banks to wider economic recovery and delay restoration of investor confidence in banking as a sector capable of generating reasonable returns for shareholders".

2.27 The FOA agrees with the Government view that financial innovation should not be facilitated "at all costs", but, once again, that level of priority was never required under the existing legislation. The need to facilitate innovation should therefore continue to be a factor to be taken into account by the PRA and the CPMA.

2.28 Since all the "factors" will be sub-ordinated to the delivery of the primary objective, the FOA believes that the obligation should not just be "having regard to" or "being mindful of" but "taking into full account". This will ensure that meaningful and not just superficial consideration is given to them.

Q17. *Should any of the proposed bodies have a role in promoting the City of London?*

2.29 See the response to Q16 above (and Appendix 2).

3. Additional Observations

3.1 The FOA recognises that the core proposals in CM7874 reflect government policy and the primary purpose of this submission has been directed towards making observations that go with the grain of that political reality.

3.2 However, the intention of the Government to establish a "shadow" construct of the proposals for a new CMPA and PRA within the FSA, while necessary as a first step in implementation, will constrain the scope of the comprehensive consultation promised by the Government "early in 2011".

3.3 More positively, this internal restructuring within the FSA will have the advantage of "test driving" the proposed construct and would provide an ideal opportunity for making a preliminary assessment in terms of lessons learned and "fitness for purpose". It would also enable the Government to assess whether or not the objectives and mechanisms for cooperation and coordination, particularly as between the PRA and the FPC, could be achieved without necessarily taking the next step of "externalising" those divisions. Such an interim review would seem pragmatic and sensible and could be incorporated within the proposed 2011 consultation exercise (see Appendix 3).

APPENDIX 1

LIST OF FOA MEMBERS

Financial Institutions

ABN AMRO Clearing

ADM Investor Services International Ltd

AMT Futures Limited

Bache Commodities Limited
Bank of America Merrill Lynch
Banca IMI SpA
Barclays Capital
Berkeley Futures Ltd
BGC International
BHF Aktiengesellschaft
BNP Paribas Commodity Futures Limited
Capital Spreads
Citadel Derivatives Group (Europe) Limited
Citigroup
City Index Limited
CMC Group Plc
Commerzbank AG
Crédit Agricole CIB
Credit Suisse Securities (Europe) Limited
Deutsche Bank AG
GDI Markets Limited
GFI Securities Limited
GFT Global Markets UK Ltd
Goldman Sachs International
HSBC Bank Plc
ICAP Securities Limited
IG Group Holdings Plc
Investec Bank (UK) Limited
JB Drax Honoré
JP Morgan Securities Ltd
Liquid Capital Securities Ltd
LMAX Limited
Louis Capital Markets UK, LLP
M & G Investment Management Ltd
Macquarie Bank Limited
Mako Global Derivatives Limited
MF Global
Marex Financial Limited
Mitsubishi UFJ Securities International Plc
Mizuho Securities USA, Inc London
Monecor (London) Ltd
Monument Securities Limited
Morgan Stanley & Co International Limited
Newedge Group (UK Branch)
Nomura International Plc
ODL Securities Limited
Rabobank International
RBS Greenwich Futures
Royal Bank of Canada

S E B Futures
Schneider Trading Associates Limited
S G London
Standard Bank Plc
Standard Chartered Bank (SCB)
Starmark Trading Limited
The Bank of Nova Scotia
The Kyte Group Limited
Tullett Prebon (Securities) Ltd
UBS Limited
Wells Fargo Securities International Limited
WorldSpreads Limited

Exchange/Clearing Houses
APX Group
Bahrain Financial Exchange
CME Group, Inc.
Dalian Commodity Exchange
Dubai Mercantile Exchange
ECX
EDX London
European Energy Exchange AG
Global Board of Trade Ltd
ICE Futures Europe
LCH.Clearnet Group
MEFF RV
NYSE Liffe
Powernext SA
RTS Stock Exchange
Shanghai Futures Exchange
Singapore Exchange Limited
Singapore Mercantile Exchange
The London Metal Exchange
The South African Futures Exchange
The Tokyo Grain Exchange

Specialist Commodity Houses
Amalgamated Metal Trading Ltd
ED & F Man Commodity Advisers Limited
Engelhard International Limited
Glencore Commodities Ltd
Koch Metals Trading Ltd
Metdist Trading Limited
Mitsui Bussan Commodities Limited
Natixis Commodity Markets Limited
Noble Clean Fuels Limited
Phibro GMBH
RBS Sempra Metals

Sucden Financial Limited
Toyota Tsusho Metals Ltd
Trafigura Derivatives Ltd
Triland Metals Ltd
TRX Futures Ltd
Vitol SA

Energy Companies
Accord Energy Ltd
Atel Trading AG
BP Oil International Limited
ChevronTexaco
ConocoPhillips Limited
E.ON EnergyTrading SE
EDF Energy
EDF Energy Merchants Ltd
Gaselys
International Power plc
National Grid Electricity Transmission Plc
RWE Trading GMBH
Scottish Power Energy Trading Ltd
Scottish & Southern Energy Plc
Shell International Trading & Shipping Co Ltd
SmartestEnergy Limited

Professional Service Companies
Ashurst LLP
Baker & McKenzie
Barlow Lyde & Gilbert
Berwin Leighton Paisner LLP
BDO Stoy Hayward
Clifford Chance
Clyde & Co
CMS Cameron McKenna
Complinet
Deloitte
Denton Wilde Sapte
Eukleia Training Limited
Exchange Consulting Group Ltd
FfastFill
Fidessa Plc
Financial Technologies India
FOW Ltd
Freshfields Bruckhaus Deringer
Herbert Smith LLP
Hunton & Williams LLP
International Capital Market Association
ION Trading Group

JLT Risk Solutions Ltd

Katten Muchin Rosenman Cornish LLP

KPMG

Mpac Consultancy LLP

Norton Rose LLP

Options Industry Council

PA Consulting Group

Patsystems (UK) Ltd

Pekin & Pekin

Pinsent Masons

R3D Systems Ltd

Rostron Parry Ltd

RTS Realtime Systems Ltd

APPENDIX 2

THE "COMPETITIVENESS" PRINCIPLE OF GOOD REGULATION

1. Section s2(3) of the Financial and Services Markets Act (2000) ("FSMA") sets out a number of factors (otherwise known as Principles of Good Regulation) to which the FSA must have regard in making its rules and guidance and determining the policy and principles by which it exercises its other functions. These include a factor described as "the international character of financial services and markets and the desirability of maintaining the competitive position of the United Kingdom". In commenting on this criterion to the Future of Banking Commission, the Chairman of the FSA described this factor as imposing a "secondary objective" on the FSA, challenging the FSA's target of "good regulation" by infecting it with "industry promotion" and risking a "sort of race to the bottom".

2. With regard to imposing a "secondary objective" on the FSA, the legal position is that, while the FSA must, so far as is reasonably possible, act in a way "which is compatible with the regulatory objectives", ie, maintaining market confidence, promoting public awareness, protecting consumers and reducing financial crime, it is required only to "have regard" to the factors set out in s2(3) of FSMA. In the circumstances, and bearing in mind also that competitiveness was specifically rejected as a statutory objective by the Joint Committee of the House of Commons and House of Lords on the Financial Services and Markets Bill and subsequently by the then Government, it is difficult to see how this factor can operate as an "objective", either primary or secondary, of the FSA.

3. With regard to the observation over "industry promotion", the fact is that no such duty is imposed on the FSA under s2(3) of FSMA and, while some argued strongly at the time that the competitiveness criterion should use the word "promote", this was, once again, specifically rejected by the then Government. In the circumstances, it is difficult to see how the Principles of Good Regulation in s2(3) of FSMA can be construed as imposing any sort of obligation of "industry promotion" on the FSA.

4. Clearly, neither the PRA nor the CPMA should be inhibited from maximising regulatory effectiveness within the boundaries of proportionality, deliverability and affordability. This means, however, marrying up good and effective regulation with, in the case of London, good international business, which in turn would involve taking into account not just the need to sustain diversity, entrepreneurialism and (another s2(3) factor to consider) innovation, but also the international character and competitiveness of that business. It is particularly difficult to see how the PRA or the CPMA can fulfill a more business-intrusive approach to supervision (described by Hector Sants as "judging the future decisions of firms based on business models and other analyses . . ." and "taking a view on management action") without being required to take into full account the international character and competitiveness of firms regulated by them.

APPENDIX 3

THE CASE FOR A MID-TERM ASSESSMENT OF THE PROGRAMME FOR RESTRUCTURING FINANCIAL SERVICES REGULATION

1. The proposal in CM7874 to establish a "shadow" internal structure within the FSA which replicates and anticipates the creation of the CPMA and the PRA will provide a very real opportunity to "test drive" the proposals and for a mid-term "fitness for purpose" assessment before proceeding to the next substantive step of "externalising" the PRA and the CPMA as separate bodies.

2. The FOA recognises that the Government is committed to a restructuring of financial services regulation along the lines set out in CM7874, but believes such a mid-term assessment (which could also be the subject of the proposed early 2011 consultation) would also provide the Government with an opportunity to assess whether or not its objectives as set out in CM7874 can be achieved to full effect without losing the advantages and strengths of having a unified regulatory authority. Possible advantages include:

— solving the problems of a potential mismatch between the scope and responsibility of the European Supervisory Authorities and those of CPMA and the PRA;

— avoiding the major costs and upheaval involved in creating a bi-partite arrangement;

— sustaining the significant changes introduced by the FSA to correct shortcomings, many of which have relevance to both business conduct and prudential regulation; and

— reducing substantially the risk of duplication, conflict, complexity and dual regulation of PRA/regulated firms and the risk of inter-institutional rivalries.

3. Clearly, the underlying question is whether an independent PRA division operating within the FSA could be sufficiently detached to enable it to deliver on the Government's proposals for improving the framework for managing financial stability in the UK, particularly in the context of providing the FPC with sufficient convergence with and "reach" into the micro-supervisory responsibilities of an internalised PRA. The FOA recognises that any such mid-term review may determine that evolution to an external "twin peaks" approach as envisaged within CM7874 is necessary, but at least such a review will help to determine how best that next step can be achieved to the benefit of all the "stakeholders" in financial services regulation.

September 2010

Written evidence submitted by Berwin Leighton Paisner LLP

Executive Summary

1. This memorandum is submitted by Berwin Leighton Paisner LLP in response to the Treasury Select Committee's call for evidence in relation to the government's proposals for reform to financial regulation in the United Kingdom.[16]

2. We have consulted with our clients very widely within the financial services industry, spanning the banking, investment and insurance sectors. The views expressed to us may be summarised as follows:

— The industry strongly welcomes the proposed new powers and responsibilities of the Bank of England in relation to macro-prudential regulation. It was a failing of the previous regime that this responsibility was not clearly allocated. The Bank of England is the best body to fulfil this function, given its economic responsibilities and its stature both in the UK and internationally.

— The industry believes it is sensible to have a single body responsible for the investigation and prosecution of economic crime. Some concerns have been expressed about the fact that investigation and prosecution of civil market abuse may be split from the investigation and prosecution of criminal insider dealing and market manipulation. This is viewed as undesirable due to the duplication that it would create, and potential disagreement between the CPMA and the ECA as to whether a civil or criminal sanction is appropriate in a particular case. Further, concerns were expressed about whether the ECA would be able to attract sufficient calibre of staff if it were to be publicly funded rather than via an industry levy (as is the case for the FSA) and therefore unable to pay sufficiently attractive salaries. If the ECA is not able to pay at competitive rates, there is a concern that it will be destined to fail as an institution.

— Clients have universally expressed the view to us that abolishing the FSA and replacing it with two new regulatory bodies would result in a less effective and more costly system of regulation. The various reasons for this are discussed in detail below. Clients felt that the proposed changes were being made for purely political reasons and that the new system would be weaker than the current system. Moreover, there was a sense that making representations on the negative impact of the new structure would be pointless given the Conservative Party's pre-election pledge to abolish the FSA. It is therefore widely considered that making representations on the fundamentals of the new structure would be a waste of time.

3. The reasons why we and our clients view the new PRA/CPMA structure as a retrograde step include the following.

[16] HM Treasury's consultation paper entitled *A new approach to financial regulation: judgement, focus and stability*, July 2010.

RATIONALE FOR CHANGE IS MISCONCEIVED

4. The various reasons given by the government for abolishing the FSA and splitting its role between the PRA and CPMA are incorrect, as they are based on misconceptions about the current regulatory regime, or are illogical.

5. The Financial Secretary to the Treasury, Mark Hoban MP, set out the government's rationale for abolishing the FSA in a speech on 26 July 2010. The four principal reasons given are each addressed below.

(a) *Supervisors need greater discretion to direct firms*

6. The current system of supervision by the FSA was described as a tick-box approach. Mr Hoban explained that he wished to see the financial regulator have much greater discretion to require firms to take action that the regulator deems appropriate.[17] This statement suggests a lack of understanding of how the current regulatory system operates.

7. In fact, the FSA certainly does not operate a tick-box approach but rather exercises very wide discretion in its oversight of authorised firms. In view of the wide powers and broad discretion that the FSA has, it is, in practice, able to get firms to take virtually whatever action it deems appropriate.

8. These powers include:

— the ability to require firms to hold additional regulatory capital to reflect perceived additional operational risk if the firm does not take steps that the FSA wishes it to take;

— the power to require firms to commission costly "skilled person reports" on particular areas of a firm's business regarding which the FSA has concerns;

— the threat to remove a firm's regulatory permissions (ie its ability to continue some or all of its regulated activities) via its "Own initiative variation of permission" (OIVoP) powers;

— broad high-level obligations on firms (the breach of which results in unlimited fines for firms and members of senior management);

— the discretion to raise the firm's risk assessment level, resulting in more frequent (and, in some cases "close and continuous") regulatory attention;

— the power to object to individuals being appointed as members of senior management, on the basis that the FSA is not satisfied that they are fit and proper;

— the threat of negative publicity emanating from the FSA if a firm does not act in a way that the FSA wishes; and

— the wide discretion to commence formal disciplinary investigations into firms and/or members of senior management, if it appears to the FSA that there are grounds to believe that one or more of the FSA's very high-level Principles or other widely-drawn rules may have been breached—resulting in significant management time and legal costs being incurred, and (if a case is proven or a settlement secured) an unlimited fine against the firm and/or the relevant individuals.

9. These powers are discussed in more detail in Compliance Monthly.[18] In practice, we have seen the FSA use these powers to get firms to agree to take steps they were arguably under no obligation to take, such as to stop selling certain products entirely, to replace individuals on the Board of firms and requiring other individuals to be promoted to the Board, and blocking acquisitions of other regulated entities.

10. The FSA uses these powers as part of its new "intrusive approach" to supervision[19] and we have seen no evidence to suggest that the FSA currently has insufficient powers in order to pursue this more intrusive approach.

11. In summary, it is difficult to imagine a situation in which the regulator could have greater discretion in the way that it supervises firms than that currently exercised by the FSA.

[17] Mark Hoban MP's speech stated: "We want to create a new supervisory approach that takes into account the lessons of the past but that is also designed for the future—a future in which supervisors should have greater discretion to use their own judgement, and to take a more risk-based approach to their work." While recognising that significant improvements have been made by the FSA in its approach to prudential regulation, Mr Hoban nevertheless compared the proposed new regime with the FSA's approach before the improvements had been implemented: "These changes will enable supervisors to build on the changes the FSA has put in place and take a more risk-based and judgement-led approach to prudential regulation, freeing supervisors from the 'tick-box' approach that typified supervision prior to the financial crisis."

[18] An article by the authors, published in the October 2009 edition.

[19] The new approach of the FSA was outlined by chief executive Hector Sants in a speech on 9 November 2009: "The FSA has moved firmly into the realm of making 'judgements on judgements'. This is different from how we operated in the past . . . [Our new approach] focuses on the risks inherent in a firm's business model and enables us to be proactive and not reactive to the management of these risks. Our outcomes-focused philosophy requires supervisors to judge firms on the likely consequences of their decisions."

(b) *Prudential and conduct of business regulation result in irreconcilable conflicts*

12. Second, as a rationale for abolishing the FSA and replacing it with the PRA and CPMA, Mr Hoban stated that:

— prudential regulation of individual firms (ie ensuring that they are soundly and prudently managed, with adequate financial resources); and

— conduct of business regulation of individual firms (ie ensuring that the day-to-day conduct of their business, including customer and counterparty dealings, are conducted fairly),

were inherently in conflict and therefore needed to be split out to two separate regulators.[20]

13. We believe that this contention is misconceived for a number of reasons.

14. We consider that it is debatable whether there are in practice real conflicts of interest between prudential and conduct of business regulation of individual firms. However, regardless of the view taken on this issue, it would plainly be much more desirable for any such conflicts to be resolved by the regulatory body itself, rather than to place upon authorised firms the unfair burden of having to follow the wishes of two different regulators who may well be requiring the firm to take mutually inconsistent actions. This is of fundamental importance in assessing how the new regime is to be structured.

15. Furthermore, the very significant majority of authorised firms—namely all those who are not retail or investment banks or insurers—will under the new regime continue to be both prudential and conduct of business regulated by a single regulator, the CPMA. If the government genuinely believes that prudential and conduct of business regulation of individual firms presents irreconcilable conflicts, why does it propose to retain this approach for the vast majority of firms (including some very significant global businesses)?

16. Finally, one of the core lessons to be learnt from the various reviews of the regulation of Equitable Life Assurance Society prior to its closure to new business[21] was that it was undesirable for prudential and conduct of business regulation to be undertaken separately, and that the much better model was for prudential and conduct of business regulation to be fully integrated. It would be wrong for these important findings on how to improve regulation to be ignored.

(c) *Need for dedicated "consumer champion" regulatory body*

17. The third reason given by Mr Hoban for abolishing the FSA and replacing it with the PRA and the CPMA is that in recent years the FSA has focused far too much on prudential regulation of individual firms and not enough on consumer protection.[22] As a result, Mr Hoban suggests, it is necessary to have a dedicated "consumer champion" as regulator of retail financial services.

18. The statement that the FSA has historically focused far too much on prudential regulation and not enough on consumer protection is simply incorrect. In fact, as frequently stated publicly and as accepted by the FSA, the opposite is true. Since the onset of the financial crisis the FSA has been widely criticised for having devoted far too much resource to its "Treating Customers Fairly" initiative (designed to ensure that consumers were being properly protected) and accompanying enforcement actions in the retail sector, at the expense of resource it should have been devoting to identifying what events may cause authorised firms to fail (ie core micro prudential regulation).[23]

19. We believe there is sufficient evidence, as highlighted above, to support the proposition that the FSA's Supervision and Enforcement divisions have worked together very effectively to ensure that, in particular, ordinary customers of retail products have received far greater focus and protection over the past few years than ever before. We do not believe that a dedicated consumer protection and markers agency is necessary in order to achieve the desired outcomes of the present government and we have not seen any evidence to suggest that a separate consumer protection body will achieve better results than the FSA.

20. Furthermore, it should be noted that, under the government's proposals, the CPMA will not in fact be a dedicated "consumer champion" at all. Rather, contrary to the statement that the CPMA will be a "strong consumer champion in pursuit of a single objective", it will have a wide range of regulatory responsibilities, of which consumer protection will be just one. Other responsibilities of the CPMA will include:

— Micro-prudential regulation of thousands of financial services firms, including fund managers, corporate finance advisory houses and commercial insurance brokers;

— Conduct of business regulation of wholesale financial services, ranging from complex commodity derivatives and global insurance programmes to advisory work on takeovers and acquisitions; and

[20] Mr Hoban described these two areas as having "multiple conflicting objectives" leading to "in built tensions between different objectives". He further states that "effective conduct and prudential regulation require very different skills" and "different approaches and cultures".

[21] See the Baird Report *The Regulation of Equitable Life an independent report*.

[22] Mark Hoban MP stated that "The combined remit of the FSA meant that participants in financial services and markets, particularly ordinary consumers of retail products, did not always get the degree of regulatory focus or the protection they may have expected or required".

[23] This has been accepted at the highest levels within the FSA as stated by Hector Sants in his speech of 12 March 2010: "The TCF initiative has yielded some benefits, particularly with regard to raising management awareness of the outcomes the FSA seeks but it has not yet delivered substantial on-the-ground benefits to consumers . . ."

— Oversight of listed stock exchanges and regulation of listed companies.

21. As a consequence the CPMA would appear to be little better placed to be a "strong consumer champion" than the FSA is currently able to achieve.

22. Finally, it should be noted that the FSA has already adopted a change in approach to retail financial services products, with the intention of acting more proactively to review and assess new products to seek to ensure that risks are properly disclosed to consumers and problematic products are prevented from coming to market.[24]

23. Accordingly, the role that the government is seeking to create for the CPMA closely resembles the role that is already undertaken by the FSA under the current regulatory structure.

(d) *Alignment of UK and EU regulatory structures*

24. A further basis for reforming regulatory bodies in the UK put forward by Mark Hoban MP is the expressed desire to mirror in the UK the regulatory structures that are being implemented at EU level.[25]

25. However this statement appears to be based on a misunderstanding of the changes to EU regulation that are being implemented with effect from 1 January 2011. In particular, three new EU-wide regulatory bodies are being created, as follows:

— The European Banking Authority, to be based in London;

— The European Insurance and Occupational Pensions Authority, to be based in Frankfurt; and

— The European Securities and Markets Authority, to be based in Paris.

26. As their names indicate, these three bodies will each be focused on overseeing regulation of specific sectors. Their role will encompass both prudential and conduct of business regulation in each of those sectors.

27. As a result, the UK regime—which is not at all to be based on sector areas but rather which will split regulation of banking and insurance between the PRA and the CPMA—will operate very differently to the EU regime that the government believes it would be desirable to mirror.

28. A number of our clients, particularly those in the insurance sector, have expressed the view that a new regulatory structure with supervisory bodies focused on specific sector areas would be more effective than that proposed by the government. This would also have the benefit of directly mirroring the three new supervisory bodies at the EU level.

Other Weaknesses in the Proposed new Regulatory Structure

29. We believe that there are a number of further inherent weaknesses in the proposed new regulatory structure. These are summarised briefly below:

(a) The new structure will result in significantly higher compliance costs for banks and insurers (and therefore, indirectly, their customers), as they have to deal with two different regulators with potentially inconsistent objectives and which are unlikely to be closely integrated. Spending time with supervisors to ensure that they understand your business and the products that you sell can take a significant amount of time; this will now need to be duplicated. Overall the regulatory burden on firms will be much greater.

(b) The new structure will be more costly from the supervisors' perspective. The PRA and the CPMA will collectively require more staff than the FSA currently requires, due to the duplication of activities that will be unavoidable under the new regime. It is likely that each body will have its own authorisation process, its own supervision teams and its own enforcement functions, as well as other specialist groups necessary to enable each regulatory body to fulfil their statutory role. This will require a materially higher levy on the financial services industry, a cost which will ultimately be passed on to customers.

(c) We anticipate that the PRA will be housed within the Bank of England while the CPMA will be housed in the FSA's offices in Canary Wharf. The distance between the two offices will make it much more difficult for the two bodies to be properly integrated and share information and resource in an effective way.

(d) We have some concerns about the PRA being established as a subsidiary of the Bank of England. While there will be some Bank of England ex-officio representation on the Board of the PRA, and the PRA will have its own independent statutory duties, there is a risk that the PRA will feel compelled to consult the Bank of England each time that there is a difficult regulatory judgement call to make. This would severely hamper the PRA's ability to operate as an effective supervisor of banks and insurers.

[24] See Hector Sants' speeches of 12 March 2010 and 24 June 2010.

[25] Mark Hoban MP's speech explained that the new UK regulatory structure "needs to be a design that fits within the broader regulatory architecture of the regulatory reforms being drawn up at the European and international levels whilst recognising the particular interests of London as a global financial centre".

(e) The Chancellor of the Exchequer has been vocal in criticising the tripartite structure of HM Treasury, the Financial Services Authority and the Bank of England, observing that important responsibilities fell between the cracks and that "when the crunch came no one knew who was in charge".[26] This is also what the FSA's Chairman Adair Turner referred to as "underlap" in the regulatory architecture.[27] However, the prospect of issues falling between the cracks as a result of either uncertainty or division of responsibility is almost certain to increase under the proposed new structure, in which four bodies (HM Treasury, the Bank of England, the PRA and the CPMA), rather than three, will have supervisory responsibilities.

30. If the proposed new regulatory framework is implemented, we believe that much careful thought will need to be given to the coordination of the separate authorities with one another and streamlining processes to overcome the operational challenges highlighted above. We envisage several structures being established in order to facilitate an appropriate level of communication and collaboration between the authorities. In particular, consideration should be given to establishing a body to allow members to share information about emerging risks and mutual concerns and to discuss issues where responsibilities overlap.

Proposed Extension of OIVoP Powers

31. Our final point relates to concerns we have in relation to the government's proposals to extend OIVoP powers under the new regime, supposedly for the purposes of enhancing the CPMA's ability to provide effective consumer protection.

32. As a result of changes brought in by the Financial Services Act 2010, the FSA's OIVoP powers have already been significantly widened, removing some of the restrictions which were previously in place and allowing the FSA to use its powers if it appears that this would be "desirable" in support of any one of the FSA's statutory objectives.

33. We believe that this power is currently very wide and at risk of being used improperly by the FSA to get firms to take steps for which there may be no genuine regulatory obligation. We do not consider that there is any good reason to extend the power.

Conclusion

34. The government has stated that the aim of its proposed programme of reforms is to build the foundation of renewed trust and confidence in the financial system by creating transparency and accountability. Whilst we agree that the reasoning behind the reforms is important, we do not believe that the government has presented sufficient evidence to demonstrate that this cannot be achieved under the current regulatory system, or that there is a better chance of these objectives being realised under the proposed regime.

35. Whilst it is widely accepted that mistakes were made by the FSA in relation to the recent financial crisis, under the auspices of the previous government the FSA has been proactive in implementing a programme of improvements which has resulted in a radically different approach to supervising the largest financial services firms. It is our view that the new government has not given due consideration to improving the current system of regulation in the UK and has been too quick to conclude that the best, and only, way forward is to disband the FSA and to implement reforms which themselves have no proven track record.

36. In summary, we do not believe that the evidence put forward by the government to date supports Mark Hoban MP's statement that "reform of the UK's regulatory system would be insufficient and incomplete without thorough institutional reform".

22 September 2010

Written evidence submitted by the Council of Mortgage Lenders

The CML is the representative trade body for the UK residential mortgage lending industry. Its 109 members currently hold around 94% of the assets of the UK mortgage market. In addition to lending for home ownership, the CML members have also lent over £138 billion for buy-to-let mortgages to support a private rental market, and over £60 billion UK-wide for new-build, repair and improvement to social housing.

We are writing to offer our support to the evidence submitted today by the British Bankers' Association. We have similar concerns about the new regulatory structure proposed by the Treasury and will be submitting a response to their consultation paper in due course.

In particular, we are concerned about the CPMA being described as a consumer "champion" and the potential imbalance between the primary objective of the CPMA (to ensure confidence in financial services and markets, with a particular focus on protecting consumers and protecting market integrity) and its secondary considerations around the principles of good regulation, the potential impact of policies or

[26] Mansion House speech, 16 June 2010.
[27] Speech to the FSA Annual General Meeting, 24 June 2010.

regulatory decisions on consumer and business lending and the need to maintain diversity in the financial services sector. In our view all these issues are equally important. Like the BBA we would also prefer to see a description of a marketplace in which consumers are provided with clear product information from which they can make informed choices. This would ensure that consumers themselves have responsibility for their financial choices.

Whatever the new structure, we believe that there should be constructive dialogue and interaction between the prudential regulators and conduct of business regulators. Changes in conduct of business regulation can have impacts for prudential regulation and vice versa. This is demonstrated by the current FSA's mortgage market review which although is aimed at conduct of business regulation has implications for prudential regulation. For example, if there are changes in the way new business is written there may be implications for the back book leaving lenders exposed to potential prudential risks that were unintended.

22 September 2010

Written evidence submitted by Royal Bank of Scotland Group plc

Executive Summary

— This document responds to the Treasury Committee's Call for Evidence into the Government's plans for changing the UK financial sector. It draws on RBS' initial views on HM Treasury's consultation on these plans, which it is currently analysing. Therefore this response is a summary of our position.

— RBS fully supports the need for change, both in the banking sector and its regulation. Given its part in the crisis, RBS is both affected and constructively engaged. Alongside other major UK banks, RBS has made significant efforts to increase capital and liquidity buffers, and reduce leverage:[28] combined with the changes recently agreed by the Basel Committee, the banking system will have a significantly reduced probability of default. Much work is now also underway to enable banks to fail without a seizing up of the financial system or creating domino effects. Taken together, these measures provide better responses in our view to the challenge of systemic risk, than the calls for scale or scope restrictions.

— Supporting the above are moves to strengthen regulatory frameworks and quality of supervision. Regardless of the debate about regulatory models, it seems clear that the tripartite arrangements were stressed by the events of 2007–08, as was acknowledged in part by the changes introduced under the Financial Services Act 2010. We also share the view that a strong focus on system-wide as well as individual entity risks is essential.

— Consequently, this note therefore starts from a position that is broadly supportive of efforts to strengthen the UK's regulatory framework. It seeks to help achieve both a finalised framework that works well and one that—in addressing weaknesses in the tripartite framework—does not overlook potential challenges that the new design may otherwise pose. The following comments therefore focus on areas which would benefit from further careful consideration.

The Financial Policy Committee

1. RBS fully supports the objective of ensuring a greater focus on systemic or aggregate risks across the financial system. Financial and wider economic stability, however, is not solely dependent on the financial sector: consideration also needs to be given to the impact of other policies, notably monetary and fiscal policies. To be fully effective, a fully consistent and coordinated approach across all policy areas should be pursued. The mechanisms for achieving this in the new framework are limited to cross-membership between the FPC and MPC; they would benefit from further development.

2. As noted in the consultation paper, the macro-prudential tools to be deployed by the FPC could have far-reaching consequences for the financial sector and the economy more widely. In framing an objective for the FPC it is important that it takes into account the need to strike an appropriate balance, between effective regulation and economic growth.

3. Given the significant impact that the FPC would have on the financial sector and the wider economy, accountability mechanisms need to be strong. We support the measures proposed in the consultation paper in this respect, but feel they could be further strengthened. The accountability of the Bank of England more generally also needs to be examined, given that the Bank will have significantly stronger and wider-ranging powers: the need for additional checks and balances in the system should be examined.

[28] The UK's six largest banks (Barclays, Lloyds, HSBC, RBS, Santander and Standard Chartered) have seen an average 57% increase in their Tier 1 capital ratio, from 7.6 percentage points in June 2005 to 11.9 percentage points in December 2009—the highest level for over 50 years. Leverage has fallen from 35 times, at its peak at the end of 2008, to 21 times as at December 2009. Data is from publicly available information.

Prudential Regulation Authority

4. We believe that the PRA should have regards to the objectives of the FPC and the CPMA, and that these should be strong considerations so as to maximise alignment of objectives across the framework. The proposal to dispense with some or all of the principles for good regulation, and with competitiveness and innovation, is of concern and would benefit from further consideration. There are many examples where rulemaking has benefited from the disciplines of consultation and cost benefit analysis; such processes provide opportunities not just for industry but for other key stakeholders as well (such as consumer groups) to make their views known.

5. Given the open nature of the UK economy, and the challenges faced by developed economies generally in adjusting to a world where terms of trade have shifted significantly in favour of many fast-growing emerging economies, we believe that regard should be paid to competitiveness. In our view competitiveness does not necessarily translate into weak standards—and such a concern can be addressed by better defining a competitiveness objective.

6. Given the intention to move to a more judgement based, interventionist prudential regime, which questions firms' strategies and business models, and not just their risk management and controls, it is important that the PRA operates under strong accountability mechanisms and is as transparent as possible. We believe that any conflicts of interest of members should be managed on a case by case basis through individual members excusing themselves from particular discussions, rather than by "switching off" their collective input.

7. A large part of the success or failure of the new framework will hinge on getting the practical aspects right and ensuring effective coordination between authorities. Significant attention and focus should be paid to this issue. Part of the solution in this respect may well include having (in particular for firms regulated by both PRA and CPMA) a single authority responsible for authorisation, permission and for approvals of firms and individuals. The notion of a "lead supervisor" should also be explored.

Consumer Protection and Markets Authority

8. We support an effective regulatory and supervisory regime for retail conduct of business issues. We believe the regulator should work in favour of fair and reasonable outcomes for consumers, in which financial institutions are held to account in providing clear and understandable information, and consumers take responsibility for their decisions.

9. As with the FPC and PRA, we are concerned with the proposition that no account should be taken of the need for competitiveness or innovation. Innovation is the lifeblood of any business, and has provided many benefits to retail consumers—ranging from new payment mechanisms and the development of remote banking and associated services, to more varied mortgage products (such as fixed or capped rate pricing and offset mortgages), that can better fit customers' different needs.

10. Whilst we broadly agree with the comment in the HMT consultation that prudential and conduct of business regulation require different approaches and cultures, we would question the notion that the consequent tensions that this can create no longer exist in a system with separate regulators. As noted in relation to the PRA, it is not yet clear how the significant risks of supervision overlaps and gaps between the CPMA and PRA will be effectively dealt with.

11. One area where significant rationalisation could be achieved, as noted in the consultation, is with respect to the regulation of consumer credit: we would strongly support the mooted transfer of responsibility for consumer credit from the OFT to the new CPMA.

Markets and Infrastructure

12. The proposal to separate out primary and secondary market regulation of equities and debt markets will pose risks and challenges. The UKLA's primary function is more akin to market regulation, in ensuring a consistency of disclosure and process for listed securities, and it is important in our view that the UKLA should stay close to those markets on which the securities are admitted to trading. In addition, listing authorisation for many specialist products such as covered bonds and securitisations would not sensibly sit outside a markets regulator. In putting both retail and wholesale conduct regulation into the CPMA, it will be essential that the new regulator maintains an appropriate distinction between retail and wholesale markets regulation.

13. Whilst we accept the logic of splitting responsibilities, by transferring systemic market infrastructure supervision to the Bank of England, we would stress the importance of ensuring close coordination between the CPMA and the Bank of England in relation to regulating market infrastructures and individual firms subject to regulation by both the Bank and the CPMA. The CPMA is intended to regulate "all financial instruments". However, currently the Bank of England regulates wholesale markets in non-investment products. These markets work effectively and there has been no regulatory failure. Whilst accepting the proposed changes in institutional arrangements, we would not want to see any change in the substantive regulation of these non-investment product markets.

CRISIS MANAGEMENT

14. Whilst a greater focus on financial stability and system-wide risk should help mitigate future crises, the consultation does not make clear who will ultimately take the lead during a crisis. We believe that more thought should be given to this. Although the tripartite committee was in the event found lacking, it at least provided a formal forum for bringing together key parties involved in managing a crisis. The new framework does not address the need for a crisis management body.

15. We are also concerned that the tools outlined in the consultation appear to concentrate on dealing with individual failures and are short on tools to respond to market stress events. As the consultation paper makes clear, no two crises are the same and it is possible the next crisis could arise as a result of some other factor than the failure of an individual financial institution. We would therefore encourage the development of tools which can support the market overall as well as tools for dealing with "ailing" institutions.

OTHER POINTS—THE EU FRAMEWORK

16. By way of a concluding, general, but in our view important observation, the consultation paper says relatively little about regulatory developments in the EU and how the new framework would interact with the new authorities now being created. Given the importance of EU regulation at the national level, it is absolutely critical in our view that the UK authorities prepare for these new structures and that the PRA and CPMA are geared up to taking an influential lead in these bodies.

22 September 2010

Written evidence submitted by Intellect

INTELLECT

Intellect is the UK trade association for the IT, telecoms and electronics industries. Our members account for over 80% of these markets and include blue-chip multinationals as well as early stage technology companies, and play a crucial role in virtually every aspect of our lives. In the UK these industries together generate around 10% of GDP and 15% of trade, directly employing over one million people.

We are a trusted partner for Government, both in terms of policy development and policy implementation across numerous sectors. We look to ensure that all relevant engagement of policymakers and regulators with industry is both easy and as valuable as possible in order that the technology industry may play the fundamental role it merits in the success of UK plc. http://www.intellectuk.org/

EXECUTIVE SUMMARY

Intellect believes that the changes to the regulatory system of financial services in the UK must be supplemented by a greater understanding within the new regulatory bodies of the role that technology plays in the functioning of this critical industry.

Technology and financial services are inextricably linked in the 21st Century. A durable and effective regulatory system that learns from the problems of the last crisis in order to prepare for the next one must be able to understand and analyse that which underpins the entire financial services industry—technology.

Developments in recent years have presented the retail-banking sector in particular with information technology challenges of a new, complex and demanding nature. Intellect's experience of the current regulatory system is one that has found a knowledge gap relating to the role of technology within financial services; a knock-on effect being that proposals are brought forward that are cumbersome, ill-informed and demonstrate the lack of a joined-up approach within the existing financial regulator. Consequently Intellect believes that:

— There should be a formal recognition of the role of technology within the Government's planned reforms through a commitment to develop better expertise and knowledge amongst the regulators' staff.

— The new regulatory bodies should learn from the mistakes that the Financial Services Authority has made in the past in failing to use the neutral expertise that is available to them outside of the traditional financial services interest groups.

— More formal lines of communication should be established with the technology industry to each of the regulatory bodies to ensure that advice is available quickly when needed and to ensure greater stability, smarter regulation and improved implementation.

— There should be more focus on the importance of flows of information within the financial services system—between banks, from banks to regulators and on an international scale. Regulators will not be able to perform their functions if they are not able to receive and analyse accurate information from the system. The downfall of Northern Rock in 2007 was the first major event in recent years to highlight the need for financial institutions to have responsive, up-to date IT systems so that information can be shared, evaluated and acted upon.

— The regulation of infrastructure provision, whilst necessary, should be refined to avoid discouraging smaller, innovative suppliers from being involved.

With the establishment of the Prudential Regulatory Authority (PRA), the Consumer and Market Practice Authority (CMPA) and the Financial Policy Committee (FPC) there is an opportunity to address these issues and ensure that the new regulatory authorities are fully equipped to tackle the problems that a rapidly changing financial services system will face.

1. Intellect's Financial Services Programme

1.1 Intellect's Financial Services Programme brings together over 150 suppliers of information systems, services and consultancy to the financial services sector. After the public sector, the financial services industry represents the largest market place for many of Intellect's members. From software companies to service providers, enabling trading platforms and payment processing, technology is crucial to the sector. As such, the industry's regulatory regime is a key issue as, in many cases, it will be our members working with the financial institutions to ensure compliance. Global IT service providers sit alongside many specialised smaller companies and all play an active role in imparting their expertise and experience to better inform the development of financial services policy at a cross roads in the industry's development.

1.2 Many of Intellect's members are heavily involved in providing the fundamentally important technology platforms upon which the UK's financial services industry is built. For example, these members help facilitate the 5.7 billion automated payments that are made through the banking system on an annual basis. Indeed, through Intellect our members are working with the Payments Council to develop the future technology that will afford consumers and businesses alike more convenient, secure and efficient ways to conduct their transactions. Similarly, the 40 million online bank accounts that are registered in the UK would not function without the technological capability that our members design and supply. http://www.intellectuk.org/content/view/23/3/

2. Technology and Financial Services—a Brief Overview

2.1 The relationship between the financial services industry and the technology sector is one of fundamental importance. Technology not only plays a critical role in the functioning of the financial services industry, it is a hugely important factor in ensuring that the individual institutions within it can operate more responsibly and remain competitive in the global marketplace.

2.2 By facilitating greater, more accurate flows of information within and between banks, technology can diminish the threat of bank failure and systemic risk. The downfall of Northern Rock in 2007 was the first major event in recent years to highlight the need for financial institutions to have responsive, up-to date IT systems so that information can be shared, evaluated and acted upon. In 2008, the demise of Bradford and Bingley was, in part, because of antiquated information technology; the bank's senior figures did not have access to the company's up-to-date financial figures.

2.3 In the event of such a failure, the processes that will be in place to ensure that customers are guaranteed to get their money back, are technology enabled. It is these systems, when implemented, that will play a significant role in increasing customer confidence in their banks, tapering fear for the safety of their money and reducing the chance of another run on a bank.

2.4 By allowing new entrants to go to market with technology-enabled banking products and services, there is also the prospect of greater competition and choice for consumers. Indeed, technology can tread where regulation dare not—by helping to make it commercially viable for banks to lend to a wider cross section of suitable SMEs by allowing them to paint a more accurate picture of which SMEs are sound investments and which are not (as opposed to classifying all SMEs as undesirable "risks").

2.5 However, there are also technology-based risks that equally need to be understood so that, where possible, they can be mitigated. The "Flash Crash" of May 2010, where the Dow Jones Industrial Average plunged 600 points and then recovered in the space of 15 minutes demonstrated how a system that relied upon technology to function could potentially be destabilised by this very reliance, with knock on effects for the economy. Similarly, the intertwined legacy IT systems that many established banks' business-critical operations are built upon, represent an obstacle to business change to meet ever-evolving regulatory, consumer and market pressures.

2.6 Consequently, if the UK's banking sector is to be reformed to meet the challenges posed in recent years and provide the backdrop to economic recovery, policy not only needs to reflect what technology can facilitate today, but what it will enable in the future. Regulation will only be effective and durable if it takes into account how it will be implemented and how the application of technology can be complementary. For an industry like financial services that relies so heavily upon technology, it is essential that policy is developed at all stages with a full understanding of it.

3. Intellect Response to the Inquiry's Terms of Reference

3.1 Please note: Intellect has not responded to all the issues set out in the Inquiry's Terms of Reference. Answers that are given to questions below are based upon Intellect's Members' expertise in the field of financial services.

3.2 As the consultation on some of the Government's proposals for reform of the regulatory system are still ongoing, there are only some issues that Intellect can give its views on at this time as consultation with Members is ongoing,

4. Overall

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?

4.1 Intellect welcomes the vigour with which the Government is addressing the issue of reform of the financial services industry. Its multi faceted approach to issues ranging from competition; to the structure and focus of regulators; to the availability of finance for business, amongst others, are necessary if the problems that caused and resulted from the last crisis are to be resolved. However, there are a number of issues that Intellect has identified.

4.2 Potential lack of technology expertise within regulators

Intellect believes there is a significant omission in many of the recent regulatory and policy proposals from a number of Government departments, regulators and executive agencies specifically relating to the technology expertise and knowledge of staff.

4.2.1 There is a general failure to recognise the importance of the technology that underpins the UK financial system, and the individual institutions within it, to its stability, prosperity and ability to deliver customer and economic benefit. This lack of understanding will translate into a negative effect on the durability and effectiveness of the regulatory regime as the development of technology outstrips the ability of regulation to develop as well. This will have the effect of restricting the evolution of the financial services industry as innovation is stifled, and/or it will fail to take into account the new regulatory challenges that the development of new technology poses.

4.2.2 HM Treasury's consultation "A new approach to financial regulation: judgement, focus and stability" suffers from a similar oversight. Whilst it does focus upon the traits and expertise that the Prudential Regulatory Authority; the Consumer Protection and Markets Authority; and the Financial Policy Committee will require if they are to be able to tackle the problems of the last crisis and prepare for the next one, it does not focus upon the need for these bodies to have any technology expertise or experience. If regulators are to play an effective, but not unnecessarily restrictive role in the financial services sector, they must have an understanding of how these institutions (eg the banks) operate. It is now fundamentally impossible to do this without appreciating the technology that not only underpins existing banking institutions, but will drive changes to their operations and strategies in the future. An example would be a lack of understanding amongst regulators how the bank's existing legacy IT systems (ie the multiple layers of intertwined IT platforms within banks that have been built upon over many years, are at the heart of established banks' operations, and to alter them would require significant operational risk and cost) are actually having an impact upon these banks' abilities to alter their behaviour and business strategies.

4.2.3 If the current regulatory focus on the financial services industry is about ensuring that no more avoidable crises befall it; that consumers are adequately protected; yet ensuring the City remains competitive on a global scale and able to contribute to the UK's economy, there needs to be 360 degree consideration of all relevant issues and factors. Policy needs to not only reflect how technology can facilitate better policy today, but also what technology will empower the financial services industry to do for its customers and investors tomorrow.

4.2.4 Intellect believes that to assume that these three bodies will take on an element of technological understanding to complement their own specific remits under their own volition is to leave the regulatory system open to ill informed decisions and will reduce its effectiveness. Consequently Intellect believes that there should be a formal recognition of the role of technology within the Government's planned reforms through a commitment to develop better expertise and knowledge within this area and to establish and maintain lines of communication with industry.

4.2.5 As a trade association a key part of Intellect's remit is stakeholder engagement, to ensure a two-way exchange of information between members and stakeholders within a particular market area. One of the key shortfalls of the FSA in recent years has been a general reluctance to engage in a two-way dialogue with stakeholders outside "the usual suspects" within the financial services industry. This is both a result of, and a catalyst for a lack of awareness of the role that technology, and the technology industry, plays within the financial services industry.

4.2.6 Across other market areas, regulators have a strong relationship with Intellect, as they appreciate that the knowledge and expertise within our membership is critical to meeting challenges that they have. For example, Intellect hosts a regular forum with Ofcom—providing a high level opportunity to discuss issues of strategic importance such as spectrum allocation, Digital Britain and the digital switchover. Similarly, Intellect has a strong relationship with Ofgem on important issues such as Smart meters and Smart Grids.

Indeed Intellect is a chosen partner for many Government departments (eg Cabinet Office, HM Treasury, Home Office, plus others) in terms of assessing the feasibility of many initiatives by mapping them to technology capability within industry—Concept Viability.

4.2.7 It is common sense that if a particular industry or utility is based upon the application of technology, as indeed most now are, the regulator needs to have a two-way relationship with industry. This is so that it can seek advice in areas where it does not have definitive answers, ascertain what challenges are on the horizon and work towards solutions that are not only possible, but are forward-looking. To do so is not a concession of fallibility, quite the opposite, it demonstrates a willingness to take on board the views of experts and increase the regulator's potential for its outputs to be beneficial for consumers, industry and the economy. Crucially, as this response also outlines below, it will allow decisions to be made that will minimise the potential for wastage of public money.

4.2.8 Intellect provides an ideal source of neutral expertise for policy makers and regulators to tap into, representing the aggregated expertise of the companies that provide the IT platforms which underpin much of the financial services industry and as outlined above it provides this expertise within numerous other sectors that are critical to the running of the UK's infrastructure and services. However, over recent years, it has been unable to build this relationship with the FSA.

4.2.9 The FSA has demonstrated a reluctance to attend Intellect meetings and engage in a meaningful dialogue that could assist their task of regulating such a critical (ie to the UK economy) and technology-dependent industry. When stating their reasons, the FSA have displayed a lack of awareness of the role that technology plays within and between financial institutions, and the technological impact of the various regulatory initiatives that are announced. We hope a reformed regulatory regime would address this and that appropriate expertise, and lines of communication to the technology industry, can be implemented.

4.2.10 Therefore Intellect believes that there are two possible solutions to this scenario that should both be integrated into plans for the forthcoming regulatory structure for financial services:

(i) The employment of technology-knowledgeable individuals within the Prudential Regulatory Authority and the Consumer Protection and Markets Authority. This will allow meaningful and beneficial dialogue to take place between regulators and the technology industry.

(ii) An objective for all three bodies (the the PRA, CPMA and FPC) to seek industry advice on specialist issues of importance to the functioning and regulation of the financial industry (within the context of their own specific remit), and to set up channels of communication with industry (ie through forums, councils etc) that ensure that advice can be easily and quickly sought.

4.2.11 These are "quick-win" solutions to problems that have been significant obstacles to the effectiveness of the FSA in the past and, as proposals stand, will continue to detract from the ability of the new regulators to perform their functions. It is critical that lessons are learned from the FSA in this regard and the same path is not followed.

4.3 *Ensuring information sharing between the regulators*

Intellect welcomes the Government's statement that there will be a review of the applications required by the new regulatory system in its entirety. However it is crucial that in this review the Government considers the lessons that have been learned from the recent banking crisis in terms of ensuring that accurate and relevant information can be shared between all relevant bodies. The review should have this theme at its centre.

4.3.1 As outlined above the downfall of Northern Rock in 2007 was the first major event in recent years to highlight the need for financial institutions to have responsive, up-to date- IT systems so that information can be shared. The application of appropriate technology can reduce systemic risk and supplement the regulatory focus that is currently cast upon the banking industry. If counterparty risk cannot be assessed because of deficiencies in the flow of information within and between individual banking institutions, the effectiveness of the PRA, and consequently the FPC will be reduced.

4.3.2 Similarly, if the CPMA is to fulfil its role of identifying potentially significant consumer protection or market integrity issues it is anticipated that it also will need to have access to accurate and comprehensive flows of information from banks, so that it can evaluate and advise the FPC.

4.3.3 In a submission to Lord Sasoon's 2009 consultation on the Tripartite system of financial services regulation, Intellect highlighted some of the challenges that exist between the sharing of information between a number of regulatory bodies and indeed with the financial services institutions within the system. These challenges will continue to exist under the proposed system. All three regulatory bodies will need to have flows of information from the banks and with each other that allow them to fulfil their individual roles, in a co-ordinated manner.

4.3.4 Consequently, developing appropriate and uniform data standards that are universally accepted and adhered to by all actors within the banking system is critical to ensuring that data can be shared accurately and can be analysed by banking institutions and regulators to spot the build up of systemic risk. A key challenge is that information standards and formats differ from institution to institution and finding

a means of standardising this information (and facilitating its sharing and analysis) is complicated by the legacy systems (see below) that are in place across most of the established, larger and most systemically important banks.

4.3.5 If the accuracy and flow of data is not treated as a priority by the new regulatory authorities, it could have the effect of undermining their effectiveness.

4.4 *Implementing crucial information systems*

As part of the IT systems required for the new regulatory system, Intellect would also urge the Court of the Bank of England and other relevant bodies responsible for ensuring that value for money is achieved in the procurement and implementation of IT systems for the new regulatory environment, to involve industry as early as possible to seek advice and work with those suppliers that will ultimately be rolling out the required systems anyway.

4.4.1 The case of the FSA's approach to implementing the Single Customer View (SCV) as part of the Financial Services Compensation Scheme (see Annex A—below) is an example of how not to do this. Ernst & Young, who carried out the feasibility study for the FSA, estimated that the cost of adapting the bank's IT systems to accommodate this new regulation was in the region of £1 billion. A commercially-focused SCV has been the goal of established banks for some time now, in order to manage individual customers' "touch-points" and allowing a more personalised service. There is a strong argument that if the FSA had sought to involve industry at an early stage to determine how to its own SCV, the result would have been quicker and easier to implement; and significantly less expensive. At a time when there are two state owned banks that need to deliver value for money, it makes little sense for regulation to "re-invent the wheel" when there are systems already in place within banks that can be adapted to achieve the same result.

4.4.2 Intellect already partners with the Office of Government Commerce, HM Treasury and the Cabinet Office to ensure that such situations are avoided and it would seem logical that the Bank of England consider this path as well.

Please see Annex A for a Case Study on the Financial Services Compensation Scheme.

5. The Financial Policy Committee

5.1 As outlined above, Intellect believes that the FPC should be able to call upon a number of experts, either individuals or Groups that can assist them in their work. There is a strong argument for the FPC being able to call upon the expertise of the technology industry as and when it is required. The right application of technology (specifically the flows of accurate information within the financial system) can assist the FPC in identifying the build up of systemic risk. It is foreseeable that the FPC, in its capacity to suggest changes to make the financial system more resilient, will need to draw upon the expertise of the technology industry to evaluate weaknesses in the system, identify areas where their oversight is limited and be made aware of how rapidly developing technology within the financial services system could also affect the stability of the financial services system.

5.2 Intellect would welcome the opportunity to work with the FPC to define such an advisory group.

6. The Prudential Regulation Authority

6.1 If the PRA is to adopt a judgements-based approach to financial regulation and supervision of individual operators within the system, it will not only need access to relevant information from these individual operators (as outlined above, there is currently no standard format for this data amongst the banks—a challenge in itself), but it will also need to be able to understand the technology platforms that these individual businesses are built upon. It is therefore also foreseeable that the PRA will need to call upon the expertise of the technology industry in an advisory capacity (to supplement its own technology-knowledgeable staff—as outlined above).

6.2 As with the FPC, Intellect would welcome the opportunity to work with the PRA to define such an advisory group.

7. The Consumer Protection and Markets Authority

To what extent will the regulatory and administrative burden increase for those firms who now have to deal with two regulators?

7.1 *Regulation of infrastructure provision*

Intellect does believe that there should be a balance between transparent and appropriate auditing of suppliers to potential entrants in the retail banking market, and unnecessary and costly oversight that prolongs the licensing process (extending "go to market" time for the entrant) and which ultimately will in itself act as a barrier to competition within the marketplace.

7.2 The role that the FSA currently plays, whilst necessary, should be evaluated and refined where appropriate to ensure that the role that the CPMA takes ownership of to this end, does not suffer from "mission-creep". A specific issue is the FSA's "adopted" role of scrutinising the contractual relationships

between the market entrant and its service suppliers—especially ICT suppliers that supply its systems and infrastructure. This could potentially cause a barrier to entry if the CPMA (like the FSA) does not have the necessary level of technical expertise to adjudge what ICT technology is appropriate, what represents a satisfactory level of risk and what is in the consumers' best interests with regards to ICT provision.

7.3 In the current regulatory system this prolonged time frame, as a result of increased FSA scrutiny, could eventually have the effect of discouraging smaller ICT providers from forming commercial relationships with prospective and new entrants to the retail banking sector. It is simply not as profitable for smaller ICT providers to be involved in such projects as it would be for them to be involved in other, less scrutinised markets. Intellect believes (and has submitted to consultation responses to the Office of Fair Trading and the Treasury Select Committee to this end) that innovative IT-enabled customer services and infrastructure are important to new entrants' entry and expansion in order to differentiate themselves from incumbents. A reduced field of suppliers to choose from will harm this ability. The public sector has, in recent years, seen a similar problem where smaller, innovative suppliers were discouraged from tendering for government contracts because of the costs of embarking on a time consuming and administration-heavy process. There is a danger that through increased regulatory scrutiny of ICT suppliers, the financial services industry could be sleep-walking into a similar situation.

7.4 Intellect believes there is an unnecessary degree of oversight on aspects of a potential entrant's undertakings that will not have a direct bearing on its ability to undertake deposit-taking activities. The CPMA should still be responsible for ensuring that prospective entrants are suitable and have appropriate capital and liquidity measures in place, but should look to streamline the process of scrutinising new and prospective entrants' ICT suppliers.

8. Conclusions

8.1 There is no avoiding the fact that the financial services industry is now, and indeed has been for a

number of years, reliant upon the technology that facilitates almost every activity and transaction within it. As this response will have hopefully illustrated, technology drives the industry, it sets its parameters, it is the next success story and potentially the cause of the next market crisis.

8.2 If the reform of the regulatory structure that governs the industry is to be successful (ie ensuring stability, protecting consumers, contributing to the economy, but not being unnecessarily restrictive) Intellect believes that the new regulators have a duty to understand how technology influences the market and how it can help the market develop. Regulators need to understand how the market is underpinned by technology so that future regulation is not left redundant at best; and harmful to industry at worst by technology developing at a quicker pace.

8.3 As part of its inquiry into financial regulation, Intellect would recommend that the Treasury Select Committee ponder three key questions that it may find useful in its deliberations over whether or not the Government is approaching regulatory reform in the right way:

(i) What are the circumstances in which a regulator (or regulators) does not have to understand how the organisations and the wider industry it regulates, operates?

(ii) What is the current financial services regulator's justification for not sufficiently understanding the role of technology within its industry focus, and for not seeking to do so?

(iii) How could the new regulators go about addressing this knowledge gap?

8.4 The importance of access to accurate and up-to-date information is crucial and could be a factor in the survival or demise of a financial institution and on a wider scale, the stability of the system. The simple fact is that if the new regulatory bodies do not have access to full and accurate information that originates from the financial services operators and is shared around the financial services ecosystem, it will not be able to make informed decisions on potentially critical issues. There is a significant challenge ahead for both regulators and Government to ensure that flows of information of a sufficient standard can be shared within the system. Currently this is a challenge that has not been met; has not been treated as a priority in the Government's regulatory proposals as they stand; and which could be the difference between the new regulators being able to discharge their functions effectively, and not.

Annex A

A.1 *Case study: Financial Services Compensation Scheme Reform*

(This case study was taken from Intellect's response to Sir James Sassoon's Review of the Tripartite System of financial regulation)

The FSA's consultation on FSCS Reform, published in January 2009, is an excellent example of the—or lack of awareness—displayed by the regulator towards the technology supplier industry. It raises a number of issues that a new regulatory regime should consider:

A.2 *Engage with industry early and comprehensively*

The consultation was published jointly with a feasibility study, produced by E&Y. This study, which estimated the costs of the FSA's proposals, was apparently produced without consultation with IT firms—the very companies on whom the deposit taker would be reliant to implement the proposals. If a similar study were repeated for another regulatory initiative, particularly one with such a focus on IT (for example, a chapter in the consultation was called 'Changes to the IT infrastructure of deposit takers and the FSCS), Intellect would early engagement with the IT industry.

A.3 *Demonstrate awareness of procurement best practice*

has extensive experience of working with public sector bodies to help ensure an effective procurement process with information technology suppliers. Based on this experience, and consultation with our members, Intellect believes the timescales set out in the aforementioned consultation are impracticable in their nature. This could result in significant procurement and implementation difficulties.

A.4 In its response to the FSCS consultation, Intellect expressed concern that the proposals did not meet with the best practice guidelines set out by the National Audit Office in its publication "Delivering successful IT-enabled business change", published in November 2006. In this report, the NAO identified three key and recurring themes in successful programmes and projects:

(i) The level of engagement by senior decision makers of the organisations concerned;

(ii) Organisations' understanding of what they needed to do to be an "intelligent client"

(iii) Their understanding of the importance of determining at the outset what benefits they were aiming to achieve and, importantly, how programmes and projects could be actively managed to ensure these benefits were optimised.

Like other public bodies, the FSA should follow this best practice.

A.5 *Concept Viability: the benefits of engagement*

Regulatory change can present a massive task for the financial institutions and the FSA, and in this case study, the FSCS itself. However, because of the issues that are being dealt with and the number of bodies involved, there is great value in encouraging a wider dialog with other stakeholders, who will be able to assist the relevant institutions by helping to develop innovative solutions to problems that may be raised via the new regulatory regime.

A.6 *A means to achieve this might be through Concept Viability, a service that Intellect has successfully that allows both public and private sector clients to take market soundings to test the practicability of their ideas at the earliest stage. Flaws in proposals can be highlighted without competitive issues being compromised, and innovative solutions through emerging technologies can be discussed alongside frank dialogue about the risks incurred. This is a service supported by the Office of Government Commerce, the Cabinet Office, HM Treasury and other departments and executive agencies.*

September 2010

Written evidence submitted by Highclere Financial Services

I wish to comment in both general and specific terms although this submission relates in its entirety to the regulation of the retail financial services industry. Evidence, backing up various comments, is appended in the annex.

Since FSMA came into force in December 2001 a consequence of regulation by the FSA has been the following;

(i) a reduction in consumer confidence;

(ii) substantial increases to adviser fees due to the burgeoning cost of FSA operations (which are duly passed on to consumers);

(iii) a massive culling of advisers due to the intended Retail Distribution Review;

(iv) a planned reduction to consumer choice due to the removal of commission from savings and investments;

(v) the ending of the simplicity of polarisation with consequent consumer confusion; and

(vi) the summary removal of the IS-year longstop defence against stale claims.

A Reduction in Consumer Confidence

It is ironic that the FSA has not only failed in its statutory aim of increasing consumer confidence but has actually reduced confidence by its inept handling of the banking crisis and its failure to understand retail financial services.

This latter point is highlighted by the Retail Distribution Review which itself was born of Sir Callum McCarthy's Gleaneagles address in September 2006 within which he suggested that the "model was broken". Subsequent proposals by the FSA, within the numerous RDR consultation papers, have served to promote changes that will reduce the consumer's access to independent financial advice.

Increases to Adviser Fees

When regulation first surfaced via FIMBRA in 1988 the cost for my business was £300 pa it then escalated to over £6,000. The FSA itself has grown out of all proportion since its inception with their annual spending having risen from £58.3 million in 1998–99 to the latest advised figure of £391.7 million.

The cost regulation lays heavily on IFAs which stands out by juxtaposition of the complaints statistics provided by the Financial Ombudsman Service and the new business distribution figures supplied by Datamonitor.

Pensions and Investments		*Total Business*	
IFA distribution	48.3%	IFA complaints	2.0%
Bank distribution	36.2%	Bank complaints	61.0%

The costs of regulation naturally pass on to the consumer, to his ultimate disadvantage. There must be a better means of reconciling regulation and cost and simultaneously ensuring that the sectors that maximise consumer deficit receive the greatest scrutiny and meet the requisite proportion of the regulatory costs.

Culling of Advisers due to the intended Retail Distribution Review

The point of regulation is to provide confidence for consumers, remove bad practice and ensure a suitable level of competence.

The Retail Distribution Review has been described by John Redwood MP as "a sledgehammer to miss a nut". He has correctly divined that making higher qualifications retrospective and removing commission as an option within investment and pension plans will make it impossible for many advisers to continue within the industry.

Advisers with 30 years experience and unblemished records are being driven out of the industry leaving millions of consumers without an adviser.

A Planned Reduction to Consumer Choice

Currently consumers have a choice regarding the payment of a fee, advice delivered via the commission route or a combination. This has worked for hundreds of years as it will continue to do in other sales oriented industries.

Just as important is the impact that commission removal will have on the ability of advisers to prospect for new clients. It is well known that consumers do not readily make those sensible financial decisions but have to be prodded into insuring and providing for their retirement. Historically advisers have been able to prospect for new clients by contacting them and inviting them to meet to discuss the issues. This is possible because no fee has been levied for the meeting. If an invitation to meet was accompanied by the knowledge that the meeting would result in a fee then consumers already unwilling to do the right thing would be far less inclined to meet. The commission included within the plan costs served to spread the cost of the advice over a four year period to the consumers advantage.

Let us not forget that commission spread over a term of years is not too different to house purchasers arranging a mortgage over an extended period because the cost of purchase is beyond their capability or preference. The same argument extends to hire purchase and personal loans.

Regulation should not specify the means by which consumers interact with advisers. It should ensure they are not conned or disadvantaged but not dictate commercial terms.

The Ending of the Simplicity of Polarisation

Until 2004 the financial services industry was polarised. This meant that the adviser was either independent, and legally the agent of the client, or was tied to one provider and legally the agent of the insurer.

This procedure worked without any downside. Unfortunately the FSA was prevailed upon by the banks and other interested parties to scrap this clear distinction and introduce in its place something called depolarisation.

This was dressed up as offering greater consumer choice which was nonsensical. Depolarisation has caused massive consumer confusion where, instead of the previous black and white situation, the consumer is now confronted with advisers operating from the whole of the market, advisers using a selected panel of companies, advisers working on behalf of one company and advisers owned by insurers. Additionally there are firms offering both whole of market and tied advice.

This situation is sufficiently farcical that when I asked the FSA to provide details regarding complaints about IFA firms it was unable because its records do not allow a distinction between the various types of advice!

The Summary Removal of the I5-year Longstop Defence

Until FSMA 2000 the industry was treated identically to all other UK citizens in that a 15 year longstop defence was available. FSAM makes no reference to the longstop an omission that the FSA chooses to interpret as meaning that Parliament did not intend for the Financial Ombudsman Service to recognise the longstop defence.

The Limitation Act 1980 has not been repealed. A scrutiny of Hansard confirms that the longstop was never discussed let alone debated. The removal of this legitimate defence has been applied despite Parliament not having debated, agreed or in any other way acceding to such a change.

The impact of the removal of the longstop is to ensure that firms and individuals can never be free of the potential for a latent claim to chase them in retirement. There are already instances of sole traders and partners dying and the FOS chasing their widows for sums of money regarding ancient advice.

This removal is considered by most legal advisers as in defiance of S6 of the Human Rights Act. Forgetting the legal arguments it is morally indefensible. The FSA arguments that the nature of financial advice may be long-term is dramatically weakened when one consider the other occupations to which such an argument can be levelled—barristers, solicitors, doctors, dentists, politicians, regulators, civil engineers, architects, builders, etc.

Summary

The previous Financial Services Act has impacted greatly on the industry's ability to interact with consumers and it is no surprise that the savings and protection gaps widen further each year.

The future of financial services regulation within a new financial services act cannot be glossed over as an afterthought nor can it be left to the FSA or the new CPMA to decide what is best. Their history of over-regulation has shown an intrinsic inability to understand the adviser-client relationship and an unerring ability to distort the market to the consumers ultimate disadvantage.

October 2010

Written evidence submitted by Citizens Advice

Introduction

1. Citizens Advice welcomes this opportunity to make a submission to the Treasury Select committee enquiry into Financial Regulation. The Citizens Advice service is a network of over 400 independent advice centres that provide free, impartial advice from more than 3,000 locations in England, Wales and Northern Ireland. In 2009–10 the CAB service dealt with over 140,000 enquiries relating to a broad range of financial services. In addition the CAB service dealt with 115,000 issues relating to mortgage and secured loan arrears and over a million problems relating to consumer credit agreements. We believe that this experience makes us well placed to comment on the problems faced by consumers entering markets for retail financial services and credit and related products in particular.

2. As a consumer advice organisation, Citizens Advice is mainly concerned with the parts of the Government consultation relating to the CPMA and our observations in this submission will be focused on the following question:

> The Consumer Protection and Markets Authority (CPMA)—Do the reforms provide adequate protection for the consumer.

3. Citizens Advice welcomes the intention to establish the CPMA as a strong consumer champion. In recent years we have seen a succession of widespread problems with financial products and services including payment protection insurance, bad practice in sub-prime mortgage markets, irresponsible lending of unsecured credit and the ongoing saga of bank charges. We continue to see cases of consumers suffering often severe detriment in each of these areas. As a result we believe that a powerful market regulator with the tools and the appetite to deal with consumer problems quickly and effectively is absolutely essential to re-build consumer confidence in the financial services sector.

4. Implicit in the current HM Treasury (HMT) consultation is the suggestion that the current regulatory set-up has failed to deliver such a champion. Citizens Advice would agree that the regulation of financial services could and should be improved. Moving forward requires a reasoned critique of the performance of the FSA (and the Office of Fair Trading (OFT) with respect to the Consumer Credit regime) in the recent past as regulators of financial services.

Learning the Lessons of the Past

5. Paragraph 4.24 of the HMT consultation states that the CPMA will build on "the progress recently made by the FSA towards a more interventionist and pre-emptive approach" and that the starting point will be the current FSA Retail Conduct of Business Strategy. Citizens Advice believes that this is the right call on both counts. From our perspective the current FSA is unrecognisable from the organisation that five years earlier frustrated us with a slow and inadequate response to PPI problems. Today's FSA seems more focused on consumer problems, with a better understanding as to how these can arise and a greater appetite to intervene when necessary stop further bad practice and organise redress for those consumers that have already suffered detriment.

6. We believe that this change rests on some key foundations that will have to both carry over to the CPMA and develop further if the new body is really going to be a strong consumer champion. Three stand out points are as follows.

Outcomes Based Regulation

7. Firstly we are impressed by the move to a more "outcomes based" view of regulation. For too long the FSA seemed bogged down in debates about the structure of the regulatory regime—rules, principles and they way the related to a preference for market "self correction"—rather than getting on with the job of ensuring that markets worked well for all consumers. Philosophical debate about the relationship between the regulator and the market is pretty irrelevant when sub-prime mortgage lenders are lending irresponsibly and aggressively seeking to re-posses families in financial difficulty. It is outcomes that matter.

Focus on the Causes of Consumer Problems

8. Secondly the FSA retail conduct strategy appears to be moving away from an over-reliance on disclosure as the main consumer safeguard to a more rounded and complete view of the causes of consumer problems. This is welcome. While consumers will always need clear and reliable information about products and services, these paper safeguards are never going to be by themselves sufficient to prevent consumer detriment. This is because detriment can be embedded in the way that products are sold, the way that the relationship between the firm and consumer unfolds over time and also in the way that products are designed and brought to market.

9. Again we believe that payment protection insurance provides a good example. Consumers bought (or were mis-sold) unsuitable products despite the product disclosure rules because of bad sales practices but also because of features built into PPI products—excessive complexity that did not seem to benefit consumers and product features such as blanket exclusion clauses (such as those excluding mental illness for disability cover) that set bear traps for consumers to fall into.

10. Therefore we welcome the recognition in the FSA's Retail Conduct strategy that the regulator must be prepared to intervene at all stages of the product cycle including the way that products are designed. Working with firms to spot the features of products that could cause consumer detriment and pre-empting these before they come to market is a better approach than just relying on enforcement and redress to clear up after a mess.

11. These approaches must be carried over to the CPMA and developed. For instance the FSA currently has no clear remit to look at whether products offer consumers value for money. While the FSA does have a remit to look at aspects of this under Unfair Terms legislation, it is not a price regulator in the full sense that it can question whether charges are reasonable or whether the charging structure of a particular product tends to disadvantage some consumers more than others. Both these questions have been raised in connection with bank charges for instance.

Focus on Prevention

12. The third point is about the need to take this emerging concern with preventing consumer problems a step further, to ensure that markets for financial products and services work better for consumers. This was one of the key aims of the mortgage market review and implicit in the FSA's self-criticism is an understanding that an effective regulator needs to take a more active and strategic role in shaping the way that a market or markets as a whole meet needs of different groups of consumers.

13. In the context of the mortgage market this has so far focused on tightening up conduct standing in a range of areas such as lending, arrears management and default charges. It has also raised questions about product regulation and whether some of the products brought to market were suitable for the needs of the consumers they were aimed at. Were self certificated sub prime right to buy mortgages ever a good idea?

14. We believe that the CPMA needs to pick up this more strategic approach and develop it, in particular to ensure that the position of lower income and more vulnerable consumers is not ignored, or worse still exploited, by the market.

The Need to Focus on Financial Inclusion

15. Here we would highlight the way that competition in financial services markets may work simultaneously to the benefit of some consumers and to the detriment of others. For instance competition in unsecured credit markets may have driven down headline interest rates, but this was in part funded this through very high commissions on PPI products sold disproportionately to lower income consumers. Likewise the OFT market investigation into personal current accounts showed how the benefits of "free in credit" banking for better off consumers are paid for by the often eye-watering bank charges levied on poorer consumers some of whom get trapped in a cycle of debt-charges-debt.

16. However such unfair and unhealthy equilibriums may not be unpicked to the benefit of vulnerable consumers by even robust conduct of business alone. Firms may exit the market (as we are seeing with PPI) or may discontinue or restrict services to more marginal consumers. An intervention to deal with market failure may succeed at the cost of producing a "missing market" for some consumers who become more financially excluded as a result.

17. As a result we believe that the CPMA, as a strong consumer champion, should be empowered and expected to intervene not just to protect consumers against conduct and other market failures but also to ensure that consumers have reasonable access to products and services that are suitable for their needs. The increased emphasis on product design in the current FSA Retail Conduct Strategy is very welcome. But the CPMA must build on this and take steps to both influence and if necessary prescribe what firms should bring to market as well as what they should not.

18. In short we believe that the CPMA should have a clear and well developed objective to ensure that, as far as is possible, there is no patterned or systematic exclusion of any group of consumers from financial goods and services markets and that goods and service are available that take account of their specific needs.

19. Immediate priorities here would be ensuing that lower income consumers have access to transactional banking without exposure to heavy charges and that lower income consumers have access to suitable credit products from mainstream providers.

20. So the three points outlined above highlight our support for the idea that recent progress by the FSA provides a good platform that the CPMA must build on. However we would also like to raise four notes of caution where we believe attention must be paid to prevent this progress from stalling or even reversing in the handover to a new regulator.

Focus on Protecting Consumers

21. As a consumer advocacy organisation Citizens Advice believes that the CPMA should have an unequivocal and unmediated consumer protection objective. We do not believe that this focus should be subordinated to macro-economic or market stability objectives or to a view of ensuring confidence in the markets that might conflict with the consumer protection objective. We also believe that the financial inclusion objective outlined above should be a complimentary primary objective rather than a subordinate "have regard to"—consumers are not a homogeneous group and a consumer champion may face competing claims from different groups. We believe that the regulator should above all be a champion for those consumers least able to champion their own case.

22. The governance of the CPMA should reflect its stated role as a consumer champion rather than a referee trying to balance the interests of consumers and the financial services industry. The interests of industry would of course be represented through both what the consultation describes as the 'have regards' principles of good and proportionate regulation and through continuing practitioner panels. But the CPMA board should be constituted primarily with the view to ensure that the Authority meets primary consumer protection (and we would argue inclusion) objectives.

Focus on Swift Action

23. The CPMA should be set up with duties to ensure that it deals with growing consumer problems quickly and completely. The CPMA should be required to investigate evidence presented by designated bodies (such as FOS, the Consumer Panel or specified consumer groups such as designated super-complainants) within a specified time frame; with an additional requirement to take action to remedy any detriment it finds within a further specified timeframe. This would mirror the super-complaint process under Section 11 of the Enterprise Act 2002 already in place for the OFT and certain economic regulators but not the FSA. It would ensure that the CPMA develops sufficiently quick and complete responses to widespread consumer problems, something that we believe has been a failing of the FSA in the past.

Keep the Good Aspects of Existing Regimes

24. We are also concerned that none of the positive consumer protection aspects of the current FSMA regime are lost in translation to the new regime. For instance we note that paragraph 4.50 of the HM Treasury consultation concludes by describing a "restorative safety net" though FOS and the compensation scheme, but there is no mention here of a collective redress role for the CPMA. We believe that the power to order a firm or firms who have breaches the rules to provide consumers with redress is one of the most powerful tools in the regulators argument. Indeed we expect to see the revised Section 404 collective redress scheme powers contained in Section 14 of the Financial Services Act 2010 implemented.

Moving Consumer Credit to the CPMA

25. Finally it is important to note that another major transition is outlined in the HM Treasury consultation—moving consumer credit from the OFT to the new CPMA. Citizens Advice supports this proposal but believes that the manner of the transfer will be very important. We are concerned to ensure that the transfer does not result in any reduction in standards of consumer protection nor stall progress towards more effective regulation of consumer credit—a sector of the financial services industry where we continue to see the most evidence of widespread and enduring consumer detriment.

October 2010

Written evidence submitted by Mr Alan Fiber

Summary

Proposal that CPMA has power to supervise certain activities of registrars acting for stock-market listed companies, eg "rights issues", "open offers" and other corporate actions, where any individual can be disadvantaged by thousands of pounds, and that the Financial Ombudsman Service has power to adjudicate in disputes between individual consumers and registrar companies when invoked. Detail and reasoning is attached with this email.

1. Contrary to general belief, activities of company registrars are totally outsid the ambit of the FSA and of FOS except to the extent that any act—additionally to registrars' work—as share brokers. One of the largest UK registrar companies has told me that it has around 1,200 basic staff, often heavily augmented by temporary staff, but that because they subcontract all share-broking activities, only one employee, with absence cover, is covered by FSA or FOS despite the great play they make in publicity seeming to apply to all their activities about being covered by the FSA and FOS.

2. Nearly every UK stock-exchange-limited company subcontracts registrar activities. Whether the tiny proportion of quoted companies handling their own such work might be exempted from this proposal for CPMS and FOS supervision, or be supervised under existing or amended company legislation could be discussed by experts.

3. All company registrars act in a quasi-judicial and quasi-financial capacity, where any decision can disadvantage an investor by thousands of pounds, yet there is no recourse except through the courts, and for that the investor may have their procedures and even evidence withheld by the alleged guilty party.

4. Every corporate action, eg "rights issue" or "open offer", has a deadline date and time for valid receipt of shareholders' election or instructions. Each applicant is required normally to enclose a cheque with his instructions, usually for some (or many) thousands of pounds, for buying additional shares according to the terms of the "rights issue", "open offer", etc. For each applying consumer, it is crucial whether his/her application is deemed to have been received before or after the publicised deadline. Rejection as "received too late" is costly for each applicant, in making available substantial money to meet their cheque additionally to loss of desired investment opportunity.

5. There are million of such corporate action nominations every year. Even a small proportion being wrong ascribed as received "too late" is a large number involved very large sums in total.

6. Consumers currently are seriously disadvantaged, usually powerless, when their application is wrongly rejected. Legal cases and other reliable documentary evidence have demonstrated that even mailing instructions and cheque "Recorded" or "Registered" delivery does not guarantee delivery, nor registrars' correct processing, on on time. It is precisely at these corporate action times that registrars require to recruit large numbers of temporary staff, with additional risks of administrative and processing problems and errors. Being outside FOS ambit, consumers' only recourse if through the courts, ie further costs, substantial delays, etc.

7. Where the consumer undertakes legal action, under present arrangements, procedures and even evidence can be withheld by the alleged guilty part, blatantly unjust. Detail in point 6 of "Recommendations" below.

Recommendations

1. That CPMA has power to supervise certain activities of registrars acting for publicly listed companies, eg "right issues", "open offers" and other corporate actions, where any blameless individual can be disadvantaged by thousands of pounds and that the Financial Ombudsman Service has power to adjudicate in disputes between individual consumers and registrar companies when involved.

2. Registrars, standard procedure is to stamp each application with "Received too late" or similar where that occurs. CPMA might decree such be applied by machine, incorporating security against improper or unfair use, perhaps evidencing date and time (or at least batch nunmber, etc) of stamping, for settling subsequent queries or disputes. An independent observer to verify this equipment is correctly set and working in each relevant snap inspection. Current practice appears to be such stamping by hand, without date or time, with no indpendent verification whatever of when stamp applied, which can be backdated after the consumer has complained about a genuinely-wrong rejection.

3. Given the quasi-judicial function of registrats and that its outcome can affect any shareholder by thousands of pounds, it is essential that at least one totally independent skilled observer is enabled to certify correct allocation of applications as "in time" or "too late". That will require agreement well beforehand by such independent observer that the registras' procedures, including staff supervision, timing equipment, etc are sufficient and operational. Snap inspections will be necessary during the period for receipt of applications, also immediately before and after deadline, and subsequently. More than one independent observer may be necessary, certainly desirable to minimise building too friendly a relationahip between observer and registrar staff and supervisiors. Appropriate observers, suitably instructed, might be provided by staff of probity seconded from eg london Stock Exchange, non-local off-duty (freelancing) JPs, bodies like UKSA, APCIMS, TISA, IMA, Proshare and perhaps CPMA, AITC, etc. Independent checks are necessary on possible conflict of interest or loss of independence for each individuals allocation to observing duty, Such bodies will welcome this demonstration they are safeguarding the interests of the investing public, their reason for existence in most instances.

4. CPMA to make compulsory under this regulatory powers, or at least to stress in their code of practice, that it is normal practice (as it is) that the name of directors be given on letterheadings, etc each annotated with all or major professional-body designatory letters to which each belongs, as evidence of probity and specialist professional knowledge (to top or lesser standards, to those able to assess such). This is espeically important for directors ultimately responsible on legal, financial and compliance matters. One might expect designatory letters to appear at every opportunity, as excellent advertisement for the firm and individual, yet some registrars appear to have gone to unusual lengths to hide this information, presumab ly to minimise risk of complaint ro professional bodies. All professional bodies stress to all members the desirabilty of using their designatory letters to the full. If for any good reason this recommendation is not actioned for eg letterheadings, surely it must be mandatory in at least one publicly-accessible source, eg annual Companies House returns of directors' particulars, given the quasi-judicial and quasi-financial nature of their work. Alternatively, the CPMA could rule that the names and professional qualifications of directors ultimately responsible for at least legal, financial and compliance matters be stated, in standard paragraph format, in locations they designate, eg letterheadings, brochures, websites.

5. CPMA to rule that registrars' standard procedure on any corporate-action nominating shareholder complaint, or request for verification of their application or instruction, be checked and answered in appropriate detail unless there is *prima facie* good reason not to. No longer admissible for registrar to respond "We are professional and our systems cannot make mistakes" or similar bland brush-of.

6. As with all financial organisations, registrars' telephones initially caution callers that calls may be recorded, etc. Where a complaining shareholder requests transcript of a conversation, eg for use in a court case, or to verify whether there are grounds for such a case, it is at present totally unclear to complainant whether ther elevant conversation was recorded or not, enabling refusal to supply the recording or its transcript, claiming it never existed, where factual evidence in the conversation is to the registrars' disadvantage. Since it is, at least currently, impractical for most private UK shareholders to record all potentially-relevant outgoing calls, this is an unsatisfactory position requiring improvement by the CPMA, perhaps in co-operation with the Data Commissioner's office. The public, not only shareholders, need transparency on whether a call is recorded or not, with failsafe assumption it is recorded if not otherwise stated, perhaps especially for calls on direct lines to senior management, and where calls initially answered on general customer lines are transferred to management.

7. Corrections to existing serious public disadvantages are needed even if relevant powers are to be exercised by any authority other than CPMA or FOS.

18 October 2010

Written evidence submitted by Chris Hulme CertPFS CeMAP

There are some simple things the FSA need to do:

Firstly, rather than increasing the qualification level for those already practising, increase the vetting at entry to the industry in a similar way that other professions do, time served with existing businesses for example to work on good practice.

Secondly, let regulatory changes bed in, don't change them every five minutes and make it impossible to keep up with what we need to do to comply.

Thirdly, be helpful with advisers—when we ring for clarification or assistance in understanding the handbook, don't just quote the handbook, help us interpret it. It's no use interpreting it when it's all gone wrong, help us avoid it going wrong—strangely this is something else other professional bodies do as well . . .

Fourth, introduce an interim DA Permission (say six months) for advisers of Networks that fail—such permissions will allow the advisers to continue in business and resolve their future regulatory structures going forward.

Fifth, look at the figures—DA advisers or Network advisers aren't the biggest risk or bring in the most complaints—banks do!

October 2010

Written evidence submitted by the World Development Movement

Executive Summary

The financial reform consultation does not provide a clear mandate or mission for the regulation of commodity derivatives. The underregulation of these products has contributed to excessive volatility in commodity prices for end-users, hurting domestic commercial and consumer interests as well as undermining international development goals. WDM recommends charging the new Consumer Protection and Markets Authority with regulating commodity derivatives trades in order to reduce excessive speculation, price volatility and counterparty risk.

1. The World Development Movement (WDM) is a UK campaigning organisation which tackles the root causes of poverty. WDM is a democratic membership organisation with 15,000 supporters and 60 local groups. We lobby governments and companies to change policies that keep people poor.

2. WDM shares the Treasury's aim of promoting "confidence in stability, integrity and efficiency of financial markets". However, in this regard we have been surprised and dismayed by the considerable gap within the Treasury report around the legislative and regulatory standards governing derivatives trading in general, and the trade in commodity futures derivatives in particular.

3. The consultation document briefly mentions that Over-The- Counter (OTC) financial markets, exchanges and other trading platforms will be regulated by the Consumer Protection and Markets Authority (CPMA) and that investment banks will be monitored by the Prudential Regulation Authority (PRA). However, the regulation of commodity derivatives is not specifically addressed within the remits of the proposed agencies. This means there is no improvement upon the current situation in which the FSA, which is nominally responsible, does "not have dedicated rules for commodities and commodity derivatives markets. Rather, its regulation of commodities markets is derived from several different regimes and its overall approach combines these."[i]

4. The regulation of commodities derivatives must be addressed specifically as these markets have clear and immediate impacts on spot markets, and therefore on both direct consumer and commercial buyer prices in the UK. Recent food inflation and rising input costs for food manufacturers, hauliers, and aviation companies—driven in part by financial speculation on commodity derivatives—is damaging for the entire UK economy, especially at a time of fragile growth.

5. As an organisation primarily concerned with international poverty issues, we are in particular concerned that commodity trading must be regulated to reduce volatility in food prices and ensure that the patterns of the global food prices in 2007–08 are not repeated. According to the World Bank, the 2007–08 food price spike resulted in the number of people in extreme poverty increasing by 20 million.[ii]

6. Research by the World Bank[iii], the UN Special Rapporteur on the Right to Food[iv], UN Conference on Trade, Aid and Development[v], and the World Development Movement[vi] demonstrate the central role of financial investors in the 2007–08 world food crisis. As outlined by these reports, it is evident that the increase in food prices in 2007–08 was due to the financialisation of commodity markets. For example, the World Bank stated that:

> "commodity related activity on the financial side can induce higher price variability in the sense of exacerbating the length and the amplitude of price cycles, as they most likely did during the "perfect storm' of 2007–08."[vii]

According to an analysis for WDM by Prof Jayati Ghosh, Chair of the Centre for Economic Studies and Planning, Jawaharlal University:

> "it is clear that the recent volatility in world trade prices of important food items simply cannot be explained by real demand and supply factors . . . FAO data show very clearly that there was scarcely any change in global supply and utilisation over this period [January 2007–September 2010]."[viii]

7. A wave of recent reforms and discussion in the US and EU have reshaped the future of the regulation of commodities. The Dodd–Frank Wall Street Reform and Consumer Protection Act in the US specifically focuses on regulating agricultural commodities and position limits. However, effective implementation of the Act is dependent upon countries like our own similarly reforming regulation so as not to create a system of arbitrage in which American money uses Europe as an underregulated offshore haven.

8. The European Commission will be addressing the regulation of commodity speculation during the 2011 review of the Markets in Financial Instruments Directive. Specifically, OTC regulation will be addressed shortly in the proposal for a Regulation on OTC Derivatives, Central Counterparties and Trade Repositories. It is essential that the UK government support strong measures through reforms to these regulatory instruments in order to create greater transparency and efficiency in these markets, and so that effective limits can be applied to prevent financial institutions from distorting the price of essential commodities such as food grains or oil.

9. Recommendations

In order to curb systemic risk and ensure an efficient market flow and efficient price formations, we recommend that the CPMA be given clear responsibility for regulating both OTC and exchange-traded commodity derivatives, with the regulatory objectives of:

— *Reducing counterparty risk,* for example through improved transparency and channelling of a vast majority of over-the-counter deals through clearing on an exchange.

— *Reducing price volatility,* through increased margin requirements for purely speculative derivatives transactions.

— *Reducing excessive speculation,* for example, through the introduction of strict position limits on the amount of contracts that can be held by financial services for speculative purposes (as introduced in the US Dodd-Frank Act).

4 November 2010

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[viii] Ghosh, J. (2010). Commodity Speculation and the Food Crisis. (Available from WDM).

Further written evidence submitted by Aviva

Impact of European Legislation

1. Aviva is the UK's largest insurer, a leading pan-European insurance group, operating within eleven European countries with approaching 40 million customers, and an owner of a substantial global asset management business.

2. Given our large constituency base we have a unique insight into the impact of the regulatory regimes of the EU and a number of its Member States in relation to UK headquartered financial services companies.

3. Aviva's approach to the Single Market is that we believe the goal should be a fair, open, competitive market at national and EU level, with companies free to underwrite on a commercial basis on a "level playing field".

4. We congratulate the Commission in its' approach to better regulation and its process of carrying out extensive consultations before proposing legislative initiatives. We hope these efforts to achieve considered and balanced legislation to continue.

Overall Environment for Insurance Companies Headquartered in Europe

5. Eight out of the 10 largest insurance groups in the world (as well as the world's leading wholesale insurance market) are headquartered in Europe—Insurance is a uniquely European success story, led by the UK insurance industry which is the largest in Europe and the third largest in the world.

6. For the UK, insurance is an integral part of the UK economy: managing investments amounting to 24% of the UK's total net worth (£1.6 trillion), contributing the fourth highest corporation tax of any sector and employing around 275,000 people in the UK alone.

7. EU and UK regulations must not competitively disadvantage EU insurers internationally. One of the core foundations the European Commission laid down for Solvency II was to ensure the global competitiveness of EU insurance companies. We believe this goal should stretch beyond Solvency II and be considered in all EU legislation affecting EU headquartered insurance companies.

Better Regulation

8. There has been a significant amount of regulatory reform stemming from the Commission in recent years, which while largely welcome, has been resource intensive for both policymakers and industry.

9. The implementation of Solvency II alone has been the biggest change to insurance regulation for a generation. In the coming months the Commission's work on Undertakings for Collective Investments in Transferable Securities (UCITS), Markets in Financial Instruments Directive (MiFID), Pensions, Transparency, Packaged Retail Investment Products (PRIPS) and the Insurance Mediation Directive (IMD) are all likely to generate significant costs for industry, which will ultimately impact customers.

10. There must be a greater focus by the Commission on enforcement of Directives after they've been adopted by Members States—it is felt that this will help iron out many idiosyncrasies within the Single Market, lead to the establishment of a common EU rule book and allow the formulation of better regulation going forward.

11. We reassert the vital need for the EU to maintain its approach to better regulation—ensuring that there is no knee jerk or inappropriate legislation which could result in unintended consequences. In addition the Commission must allow adequate time periods for companies to reply to consultations.

Unintended Consequences

12. We understand and support the desire for lessons to be learned from the crisis, and agree with the need for regulations to operate at an international/EU level.

13. It is vital that the difference in the role and business models between banks and insurers is recognised. Insurance companies are participants in, and stabilisers of, the financial system and not drivers of it. They provide a valuable source of stability through their demand for long term assets that match the duration of their long term liabilities.

14. Insurance companies were not the cause of the economic crisis. As demonstrated earlier this year by the Geneva Association,[29] core insurance businesses do not pose a systemic risk.

[29] http://www.genevaassociation.org/PDF/BookandMonographs/Geneva_Association_Systemic_Risk_in_Insurance_Report_March2010.pdf

15. There is a risk that measures designed for the banking sector read across to the insurance and asset management sector. For example measures around the definition of capital if read across would have a significant detrimental effect given the business model of insurance and regulatory regime proposed by Solvency II—unnecessarily removing billions of pounds of capital from the sector.

Asset Management

16. The most significant area for possible unintended and disproportionate read across between sectors is from the banking to the asset management sector where many banking Directives also apply to asset management firms (eg the continuing updating of the Capital Requirements Directive).

17. However, the business model of banks differs fundamentally from that of asset managers' where clients' assets are kept separate from the assets of the managers. Therefore a one-size fits all approach should be avoided.

18. The upcoming review of MiFID must carefully balance both "buy side" and "sell side" issues. The City of London Corporation and the City UK have already begun to explore work in this area and have shown that "buy side" and "sell side" interests can be constructively incorporated.

Customers

19. With all financial services legislation, it must be remembered who the ultimate customer is. Measures to reform the wholesale markets have the potential to impact on the management of pension funds, trusts and investment funds, which in turn leads to a poorer return for the final retail customers and weaker capacity to provide products they need to save for their future.

20. Insurance is about protection—managing risks within society, protecting customers, households and businesses from unforeseen events and ensuring that citizens are able to plan adequately for their retirements. We are, therefore, very supportive of initiatives that promote consumer protection, but they must not be disproportionate and add undue burden on the end customer.

21. We are keen that policymakers within the EU avoid any move towards product regulation rather than market regulation which would be to the detriment of competition and innovation and ultimately once again, customers.

Solvency II

22. Aviva was and still remains highly supportive of the Level 1 Directive, and the Implementing Measures should remain faithful to its economic, risk-based approach.

23. It is essential that the Commission robustly defends the economic principles enshrined at Level 1 and pushes back against pressure to move away from these economic principles, particularly around the definition of capital available to meet solvency requirements..

24. While we accept the economic approach is appropriate to manage business. In terms of regulatory requirement it is important to manage a transition in an orderly fashion for existing business. Solvency II must not result in avoidable market dislocation.

25. Given European insurers unique role in the global economy, a appropriate solution must be found to ensure that EU headquartered companies can compete competitively around the globe. This is especially important in relation to the US. We recognize the progress that the Commission has made to propose a possible solution but encourage them to ensure that it will appropriately address the issue.

Corporate Governance

26. Many of the problems in relation to corporate governance identified by the economic crisis related to companies inadequately identifying and managing risks. Insurance as an industry is about just that; managing risks.

27. As a company and a sector we pride ourselves on leading best practice in these areas within the financial services industry—our Chief Risk Officer (CRO) reports directly to the CEO, we have a strong internal audit committee and our executive remuneration packages are prudent, proportionate and based on long term goals.

28. As a regulated financial services company and long term institutional investor we have a unique perspective. We use our influence to engage and encourage other companies to raise their governance standard. We are also leading calls for stock exchanges around the world to embed a provision for sustainability reporting into listing rules and follow Aviva's lead—we put our own Corporate Responsibility report to a separate investor vote at our 2010 AGM, the first financial services group in the world to take this step.

29. We have concerns, however, that the direction of travel globally, while broadly encouraging and in line with the UK's Walker review, also signals a potential danger to the "comply or explain" approach which is so vital in encouraging responsible governance.

6 December 2010

Further written evidence from Aviva

General Cost of Regulation

1. Regulation will have a different cost impact on different firms, dependent on a range of factors including their size and product offering. I would therefore direct the Committee to look more broadly at the correlation between the overall running costs of the Financial Services Authority (FSA), Financial Services Compensation Scheme (FSCS) the fees gathered, and the tax take from the sector.

2. The correlation between the regulatory fees, tax on the financial sector, fines and costs of the FSCS should provide an indication as to the growth in regulatory costs relative to the size of the financial services sector. This should allow an analysis of the effectiveness of that regulation given that it should result in fewer failures requiring compensation from the FSCS and fewer serious incidents of non compliance resulting in regulatory fines.

Aviva Direct Costs

3. The "direct" costs of regulation—the annual fees and levies that Aviva pay to the FSA, FSCS and Financial Ombudsman Scheme (FOS) is in excess of £6 million per annum.

4. The total cost of these fees and levies for insurers as an industry in 2010–11 equated to £138 million.

5. These direct fees have increased substantially in recent years, particularly for general insurers (Aviva is a composite insurer—writing both life and non-life business). The FSA has increased its fees considerably in excess of inflation for the past number of years.

6. Insurers are subject to regulation by, and pay fees to, other financial regulators—eg. The Pensions Regulator and Financial Reporting Council (FRC)—but the amounts involved are relatively small compared to FSA costs.

Aviva Indirect Costs

7. Aviva is subject to considerable internal costs to ensure compliance with regulatory requirements. Given the time constraint along with the difficulty of the task, it is not possible to accurately and in any substantial detail quantify these indirect costs. One complication in making such as assessment is that many costs (eg holding capital or operating a complaints handling system) would also occur in the absence of regulation.

8. That said, as indicators:

(a) Aviva's UK business had 121 meetings with the FSA in 2010—excluding those as part of the Advanced Risk-Responsive Operating framework (ARROW) which takes place every two years (essentially a planned schedule of ARROW visits to the firm throughout the regulatory period).

(b) The UK Risk and Compliance teams cost in the region of £10–15 million per annum.

(c) We have a team of four full time equivalents (FTE) within HR to manage FSA registrations and applications along with 3.5 FTE responsible for financial advisors vetting and applications for regulatory approval.

9. The largest regulatory costs for an insurer such as Aviva tends not to arise from ongoing compliance, but rather from one-off costs associated with implementing major changes in regulation—changes to customer documentation for example prove highly costly. Aviva has evolved through numerous mergers and takeovers over the course of 150 years; as a result currently operates between 50 and 100 separate IT systems—this makes apparently relatively minor changes complicated and costly.

Highly Significant Upcoming Regulatory Changes

10. The insurance industry is currently preparing itself for implementation of two hugely significant regulatory changes coming in the next couple of years—namely Solvency II and the Retail Distribution Review (RDR). Aviva is supportive of both of these initiatives as they will deliver significant benefits to consumers. It is important that Government and regulators appreciate that the implementation costs for both of these will be very high.

(a) It is estimated that the average cost for a major firm implementing Solvency II (excluding any capital increases) will be more than £100 million.

(b) Earlier this year, the FSA substantially increased their estimate of the cross-industry costs over the first five years of the RDR to the range of £1.4–£1.7 billion.

Benefit to Consumers

11. Aviva supports effective regulation which addresses an indentified market failure or consumer detriment and aids confidence in the sector such as the RDR. However, when considering whether to introduce new regulatory requirements, regulators should rigorously assess whether the benefits are justified by the additional costs.

12. There is a need to balance the need to provide customers with products that meet their needs and to protect the taxpayer from the fall out of failures by financial services firms with maintaining a healthy financial services industry. Too much regulation may discourage innovation and inhibit the provision of products and services that customers may otherwise benefit from.

13. Instances where the cost of regulation outweighs the benefit to customers include:

(a) *Total Premium Disclosure*—this has cost Aviva in the region of £1 million and the sector approximately £20 million. The FSA required that quotes for pure protection products (eg income protection) include information on the product's "total premium" (the amount the customer will pay over the duration of the contract). Independent research commissioned by the ABI has found that customers consider the "total premium" irrelevant to monthly affordability.

(b) *Disclosure under the FSA Handbook COBS regime; specifically "key features documents"*. The level of information required in key features documents is, in Aviva's view, over prescribed and inconsistent in terms of transparency and Treating Customers Fairly. The focus seems to have gone too much towards compliance rules, rather than outcomes for customers. Over prescription has resulted in the document being, in some cases, nearly 12 pages in length. Our own research in 2009 indicated that the majority of customers have little desire to read the detail due to a genuine lack of interest for most and a belief that the document will be highly technical (reinforced by the density and quantity of text). As mentioned previously, documentation is one of our highest costs, and in this instance has little consumer benefit.

Market Costs

14. The introduction of the RDR will lead to a reduction in the number of Independent Financial Advisors (IFAs). Those advisers who remain are likely to serve fewer customers as the provision of advice is pushed further up-market. There is a risk that large volumes of consumers may disengage with financial services or make financial decisions (without advice) that do not ultimately meet their needs.

15. ABI research has indicated that on average full financial advice costs £670. As a result, a majority of the adult population are outside the target market for full advice and as such do not get the benefit of such advice. This highlights that the indirect costs of regulation extend beyond the compliance costs incurred by firms—also detrimentally effecting consumers.

16. The FSA's solution for the majority of people unwilling or unable to pay is Simplified Advice, which the industry has been tasked to develop. For this service to be viable it requires a proportionate approach to regulation from both the FSA and FOS, which focuses on delivering the most beneficial outcomes for consumers and removes the possibility of future retrospective action.

17. Another recent and contentious issue has been with regard to the regulation of Payment Protection Insurance (PPI). We know that there is already a significant protection gap in the UK because customers fail to seek out appropriate insurance, a situation made much worse with the introduction of a point of sale prohibition. With unemployment expected to continue growing, this will leave many more people at risk and in greater financial difficulty than would otherwise have been the case.

18. Estimates of the cost to Aviva are difficult to make, however, Aviva accepts that whilst standards have improved, the industry still has work to do to demonstrate that consumers are treated fairly and for confidence in this sector to be re-built.

19. There are many other upcoming reforms which have the potential to impact on firms, market structures and consumption patterns; these include initiatives from the EU including the Insurance Mediation Directive, Packaged Retail Investment Products and Over the Counter Derivatives and within the UK, the Mortgage Market Review and Consumer Credit Regime.

Conclusion

20. The insurance industry is highly regulated, and subject to significant conduct of business and prudential requirements, which result in significant direct and indirect costs to firms such as Aviva.

21. Insurers will be expected to bear considerably higher costs arising from regulatory requirements over the next few years—some of these are certain while others remain speculative. In addition to the direct costs these changes are likely to give rise to considerable internal costs and opportunity costs, which reduce the ability of firms to innovate and improve customer propositions.

22. Aviva supports effective regulation where it addresses an indentified market failure or consumer detriment and the estimated benefits are justified by the estimated costs. We would urge the Committee assess new regulatory proposals using to these simple tests.

23. The new regulatory bodies in the UK, the CPMA and the PRA, should be required to assess if the estimated costs of their proposed regulations exceed the estimated benefits delivering beneficial outcomes for consumers—and be held to account on this basis. They should also hold post-implementation reviews to assess whether the benefits do indeed outweigh the costs.

24. To more quantifiably answer the crux of your question regarding the cost of regulation, I would recommend a broader analysis which looks at the correlation between the overall running costs of the FSCS & FSA, the fees gathered, and the tax take from the sector.

10 January 2011

Written evidence submitted by Brewin Dolphin

RDR AND PRIPS—MEASURES, COSTS, OVERLAP AND THE INDUSTRY IMPACT

INTRODUCTION

Further to our briefing paper on RDR for the TSC and the debate in November 2010 (attached) the table below shows the issues covered jointly and severally by the two proposed Regulations.

The European Commission is consulting on a Directive to ensure a common level of consumer protection for Packaged Retail Investment Products (PRIPs). The scope of PRIPs is broadly similar to the RDR covering a similar product range and issues (although it does not cover professionalism which includes qualifications and competency). The fact that PRIPs is likely to be implemented shortly after the RDR means there is a real risk of further confusion, costs and "gold plating".

	RDR	*PRIPs (To be implemented as part of MiFID2,[30] UCITS, IMD)*
SCOPE		
Unit Trusts	Yes	Yes
Investment Trusts	Yes	Yes
Investments packaged as life insurance policies	Yes	Yes
Stakeholder pension schemes	Yes	No (ongoing work by EIOPA)
Personal pension schemes	Yes	No (ongoing work by E)
Structured deposits	Yes	Yes
Structured securities	Yes	Yes
Derivatives	No	Yes
Deposits	No	No
Stocks and Shares	No	No
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	Yes	Yes
SELLING PRACTICES & TRANSPARENCY		
Key Investor Information Documents	No	Yes
Client Categorisation	No	Yes
Best Interest of the Client	No	Yes
Suitability	No	Yes
Conflicts of Interest	No	Yes
Inducements	Yes	Yes
Adviser Charging (no trail)	Yes	Yes
Independent/Restricted	Yes	Yes
QUALIFICATIONS	Yes	No
DEADLINE	31 December 2012	Estimated 2014–15
COST	£1.7 billion	€500 million +

> "The Commission estimated that the PRIPs disclosure and sales rules would cost intermediaries, insurers and banks across Europe between €350 and €550 million with another €110 million or €220 million in ongoing costs. The impact for European advisers and brokers would be between €50 and €125 million in one-off costs and €50 to €80 million in ongoing costs."[31]

Brewin Dolphin (BD)—turnover in 2010 was £250 million and below we set out the RDR principal measures and our projected costs of their implementation.

[30] MiFID2—implementation estimated 2013
[31] Citywire 26 November 2010

Qualifications and Competency

The particular aspect of RDR not addressed in PRIPs is adviser qualifications. While competency is part of the overall MiFID regime—most IFAs in the UK are not presently subject to MiFID (they may well become so following PRIPs, though possibly not in respect of competency).

We agree that all advisers need to be suitably qualified to advise on retail investment products and that mis-selling scandals of the past should be tackled. Therefore, we fully support the FSA in its aim to ensure that there is a credible infrastructure in place and that all advisers are fully qualified. However, we believe that the RDR implementation timetable is not long enough to enable the industry to deal with all those who will need to become qualified under the new regime and to approve and monitor all firms' individual CPD systems.

BD estimated costs of training and exams including opportunity costs for all staff to be RDR compliant are £3.3 million and will be in addition to our existing £1 million T&C budget.

Other Measures in RDR and also Included in PRIPs with Costs

Restricted Status of firms, ie those not able to offer the full range of products within the scope of RDR. These firms will be required to implement the following changes to their practices and incur these estimated additional costs (for firms the size and scope of BD):

- Client communications—Restricted status and new adviser charging rules must be communicated in writing to all clients (one way only) cost: £150,000.
- Restricted status compulsory oral communication—text to be read to new clients over the phone or in person taking five minutes per client—BD costs based on new business in 2010—£630,000.
- Additional reporting requirements to the FSA—set up costs £35,000 and ongoing annual costs £23,000—total £58,000 in year 1.
- Additional reporting requirements for clients—systems modification and set up costs estimate £100,000., with minimal ongoing annual costs.
- Designated Professional Bodies (eg Law Society) members may not refer business to "Restricted" firms (or they must refer business to Independent firms) ~ 1/4 of BD's business is introduced by solicitors and accountants and so could result in unquantifiable but considerable loss.
- Fee only charging by financial advisers—whether Restricted or Independent—may drive many small firms out of business and thereby reduce competition and consumer choice. Full and fair disclosure of all fees and commissions to the client should be a sufficient measure. PRIPs also bans third party payments and the proposals here are broadly similar to RDR and there is a significant overlap with the rules on inducements.

Conclusion

- The full implementation of the RDR should be delayed until the PRIPs proposals are agreed by the European Commission. The considerable cost differential for implementation between the FSA's latest estimate for RDR of £1.7 billion for the UK industry and the EC estimate for PRIPs of €500 million + for all EU members, is too wide to contemplate doing the job twice.
- The RDR proposes disproportionate "one-size-fits-all" measures that have angered the financial services industry and risk a loss of confidence in the Regulator itself and among consumers.
- The RDR process and costs should be reviewed and the good principles of professionalism and transparency taken and introduced at the same time as PRIPs selling practices and transparency proposals, under the new Consumer Protection and Markets Authority (CPMA) regulatory structure which the Coalition Government plans to introduce.

17 January 2011

Written evidence submitted by Stephen Mason and Nicholas Bohm

BANKING AND FRAUD

Background

1. The contemporary use of electronic machines by banks is so widespread, that it is difficult to imagine that the banking system would continue to work at all if such machines were withdrawn. But reliance on electronic machines carries with it hidden risks. There is an important but neglected distinction between purely mechanical machines, such as the first machines produced in the nineteenth century to dispense cigarettes, etc, and modern machines that rely on software, such as cash dispensers ("ATMs"). Software has approximately five defects per 1,000 line of code. Given that most machines that rely on software have millions of lines of code, most commercially produced software products will have thousands of undetected defects. This is why software vendors have to issue updates to software (quite apart from the making of

improvements). Such updates are correctly described as "security updates", because some defects can be manipulated by a thief, for instance, for fraudulent purposes. Errors in the construction of purely mechanical machines are apt to make them fail in obvious ways; but software introduces such an enormous increase in complexity as to result in errors whose consequences are very hard to detect.[32]

2. The following is offered by way of example. A person authorized to enter a building may be issued with a token (often a plastic card with a magnetic stripe or a chip). To gain entry to the building, the user must swipe the card in a reader, insert the chip part into a reader, or press the card against the surface of a reader located on a wall or door. They may also be required to insert a code. Given this technology, it is taken for granted that the communications between the various items of software prove that (i) the card is physically present, and (ii) that the person to whom the card was issued is the person who enters the building. This assumption can be corroborated by evidence that they used various machines (mainly computers) in the building for a number of hours before leaving. Whilst the evidence that the authorized user used a computer is not conclusive that the person was either physically in the building or used the machine, nevertheless there would be strong circumstantial evidence to indicate they were present in the building from the moment the card was swiped in the reader.

3. However, machines run by software and controlled by a bigger machine that is linked to all the machines in the building (controlling computers, readers on different doors, cctv, air conditioning systems, etc) are also often linked to the internet. If the machine and the networked machines are linked to the internet, it is possible that a third person from another country (for instance) might gain access to the system remotely by taking advantage of defects in the system's software and might manipulate the system to make it appear that a person has entered (or left) when they have not.

4. The point is this: the fact that the software on a reader adjacent to a door is recorded as having communicated with the software in the central computer to send a message that a particular card has been pressed or inserted into the reader, does not prove that (i) the person whose card it was issued to was in physical possession of the card, nor (ii) that the card was physically present against the card reader to cause the software to send the message to begin with.

5. Contemporary banking systems operate on the basis of an association of links (some of which are very flimsy) that the banks themselves use to assume that either (i) their customer, or (ii) another person with the authorization of the customer, is at the ATM or a computer terminal when undertaking an on-line transaction. A bank can never know if their customer is the actual person at the ATM or computer terminal. The bank *assumes* that the customer is a the ATM if (i) the software in their system communicates with the software linked to an ATM, that (ii) a card is apparently physically present in the ATM, and (iii) the software on the card communicates with the software in the ATM in an attempt to verify that the card is a genuine card, and (iv) the personal identity number (PIN) (one form of electronic signature33) if correct, is that of the customer. Banks use the evidence thus accrued to assess automatically whether to allow the transaction to take place. The problem is that banking systems are not perfect, and can be manipulated, but representatives from the banks and banking industry are on record as claiming over the previous 40 years that their systems are safe and cannot be broken into by malicious outsiders, only for each new item of technology that is introduced by the banking sector to be proven to be open to successful attack.

The Law

6. When a customer claims that money has been withdrawn from their bank account without their authorization, the legal issue is straight-forward: whether the bank had the authority under its mandate from the customer to debit the account. Where a customer carries out a transaction at an ATM, for instance, the mandate will be fulfilled if the card issued to the customer and the correct PIN are entered in the machine by the customer. It is a primary issue whether the bank can prove that the customer or a person authorized by the customer authorized the withdrawal of the money, or that the carelessness or gross negligence of the customer enabled an unauthorized person to do so (where the mandate authorizes a debit on that basis).

The burden of proof

7. It is often suggested in the media that the burden of proof is on the customer to prove they did not withdraw the money. This is not correct. This has never been the legal position.

8. Prior to the Payment Services Directive and Payment Services Regulations 2009 (SI 2009/209) ("PSR"), it was for the bank, where it relied on the signature of the customer, to prove the signature was that of the customer if the customer did not accept the signature as their own. As a PIN is one form of electronic signature, the burden of proof has remained with the bank at all times. Under the new law, it is now for the bank to prove on the balance of probabilities that the card issued to the customer was inserted into the ATM by the customer or by a third party with their authority, and that the PIN was entered by the customer or by a third party with their authority. Article 59(1) of the Payment Services Directive (regulation 60 of the PSR) provides that where a user denies effecting or authorizing a transaction, it is for the bank to prove that the payment transaction was authenticated, accurately recorded, entered in the accounts, and not affected by a technical breakdown or some other deficiency.

[32] For references for the points made here, and for a more detailed treatment of this topic, see Stephen Mason, *Electronic Evidence*, (LexisNexis Butterworths, Second edition, 2010) Chapter 5 and the references contained therein.

Evidence

9. In the case of *Job v Halifax PLC* (not reported) Case number 7BQ00307,[33] Mason argued on Mr Job's behalf that the bank had to produce evidence of the trail of communications between the various items of software associated with the transactions in dispute. The learned county court judge rejected this. However, the position has changed, and where the customer does not accept they authorized the transaction, article 59(2) of the Payment Services Directive (regulation 60 of the PSR) provides that the use of a payment instrument (that is, the card issued to the customer by the bank) is not in itself necessarily sufficient proof either that: (i) the transaction was authorized by the customer, or (ii) that the customer acted fraudulently, or (iii) the customer failed with intent or gross negligence to fulfill one or more of his obligations under Article 56.

10. Regulation 60 of the Payment Services Regulations now provides that it is for the bank to provide a complete chain of evidence to prove their case: beginning with the records of the ATM, any communications systems used between the ATM and the bank back-end systems, and the processing of the data in the bank's systems. So much the better; but the introduction of these more detailed requirements will still not be sufficient to protect the customers of the banks, however, if the general rule continues to be applied that machines may be assumed to work correctly. Such a rule effectively negates the requirement for evidence that systems are in fact working correctly, thereby ignoring the vulnerability of commercial software.

The card

11. One problem relating to the nature of the evidence is the card issued to the customer by the bank. The customer is almost always told by an employee or agent of the bank to destroy the card when the customer has cause to make a complaint. The card includes an Application Transaction Counter ("ATC"). The ATC is increased by one each time a transaction takes place. A test of the card will help to determine whether the ATC has been increased, and the test can enable a comparison of the transactions recorded on the customer's statements to establish whether there are any discrepancies. This is important evidence, and can help demonstrate whether the customer is telling the truth when they assert that they were not responsible for the disputed transaction. As a direct result of the bank telling the customer to destroy their card, the bank deliberately requests the destruction of evidence, knowing that legal proceedings may be taken by the customer to recover the money. For this reason, a bank can be held in contempt of court where such advice is given and acted upon. That banks issue such instructions to the customer is of utmost concern, because many customers destroy their cards when given such instructions by their bank, only to learn much later that the information on the card could have demonstrated that they were telling the truth.

The Reporting Regime

12. Since April 2007 (Home Office Counting Rules For Recorded Crime, Fraud and Forgery) consumers have been compelled to report fraud to their bank, and not to the police. If the bank determines that the customer was responsible for the withdrawal (or somebody authorized by them, or they were negligent), then the bank will not reimburse the customer. The customer can then complain to the police, but all the police will invariably do is give the customer a crime report number, and refuse to take any further action.

13. The reasons why the police do not tend to take action seem to be: (i) the high number of cases reported, (ii) the time, expense and expertise necessary to follow up such a complaint, and (iii) the apparently low importance attached to such crimes.

The Reaction of the Banks to the Customer

14. When a customer complains to a bank about unauthorized withdrawals, some banks act with commendable speed and within the law. The legal position is set out by regulation 61 of the PSR, that is (subject to regulations 59 and 60) the bank must immediately refund the amount of the unauthorized payment transaction to the customer, and where applicable, restore the account to the state it would have been in had the unauthorized payment transaction not taken place. Unfortunately, there are a number of banks which do not comply with this requirement, and undertake what they call an "investigation", only to inform the customer that as far as the bank is concerned, the withdrawal was carried out by the customer. The customer then in practice has to gather evidence to prove they were *not* responsible for the transaction.

Financial Ombudsman Service

15. It appears from the evidence that we have seen of how complaints are adjudicated by the Financial Ombudsman Service by people that have had money stolen from their accounts, that employees working for this authority have no understanding of the technical issues relating to digital evidence, nor do they appear to understand that it is for the bank to prove it did not let a thief steal its customer's money. Even when evidence from witnesses is put forward by the customer to demonstrate that they were not in the

[33] The judgment is reproduced in full in the *Digital Evidence and Electronic Signature Law Review* 6 (2009) 235–245.

vicinity of an ATM when money was withdrawn, adjudicators at the Financial Ombudsman Service continue to accept the evidence provided by the bank. Often the bank will merely assert that because they claim the chip was read, it therefore follows that the customer was responsible for taking the money. It seems that adjudicators at the Financial Ombudsman Service tend to agree with the banks. The Service does not obtain evidence from the bank about the transaction in question to enable the customer to submit it to an appropriate expert for evaluation. It provides an inadequate protection for bank customers with disputed transactions.

In our view, the following action should be considered if this issue is to be taken seriously:

16. The government must change the rules for reporting and dealing with theft from banks accounts (either via ATMs or on-line), and for providing accurate figures for theft and fraud. At present, the only figures given for losses are those provided by UK Payments Administration Limited. These figures are not very clear and lack transparency. For instance, where a bank declines to refund a customer, the money in dispute is not considered by the bank as a loss, which means the loss is not reported to the UK Payments Administration Limited, and is not included in the overall figures produced by this agency. The amount of money that might be in dispute may be considerable, and the figures given by the UK Payments Administration Limited are highly likely to be inaccurate for this reason.

17. Police forces must have more funding to train police officers in digital criminal activities. It is crucial for the authorities to acknowledge that education, training and the provision of appropriate information technology to the police in respect of these crimes is essential. The failure to understand this fundamental point in the 21st century means that criminals will continue to be successful in stealing money.

18. The banks must put more robust methods in place to provide for the security of customers' accounts. They will not do so without the necessary incentive; and while they can pass the loss to their customers, they lack that incentive. The authorities appear to regard banking security as a matter for the banks. This approach worked well enough when a bank robbery meant that the bank lost money: it is up to the bank to decide how much to spend to protect itself from loss.[34] But modern banking is different: now bank robberies are electronic, and banks can protect themselves from loss by allowing it to fall on their customers by relying on the willingness of the law to presume that their systems are working correctly. In these new circumstances, banks can no longer be the judges of how to prevent fraud, because it is not them but their customers who carry the risk. This places wholly new demands on the competence of bank regulators, and it is not clear either that they recognize this or that they possess the necessary skills.

19. Consideration must be given to the general rule that machines may be assumed to work correctly. This rule ignores the susceptibility of commercial software to being manipulated successfully to the detriment of the customer.[35]

Further Comments

20. Crime relating to bank accounts is complex. Unfortunately, the banking sector and police are, in general terms, treating this problem simplistically.

21. Some indication of the scale and importance of the issue can be derived from the case of *R v Bunu*. It was heard at Hull Crown Court in July 2008. Not guilty pleas were entered and a five to six day trial ensued. The accused was found guilty of conspiracy. Media reports indicate that when he was arrested, police officers recovered details of more than 1,900 accounts (some on a laptop), eight false cash point fronts, detailed lists of supermarkets around the country, card-cloning devices and between £3,000 and £4,000 in cash. The fingerprints of the accused were found on tape used to stick the false fronts on cash machines. It was estimated that about £43,000 was stolen, but it could have around £1.1 million if they had used all of the 2,000 sets of details they had obtained. In four months, two thieves obtained details from more than 2,000 victims and cloned them on to loyalty cards, writing the PINs on the signature strips. They then travelled around the country to withdraw up to £500 a time with each card and using different cash points to avoid detection.

22. Apart from the importance of this case as a demonstration of how easy it is for criminals to steal from banks using ATMs, there is a more telling point. In discussing the case after the conviction and sentence with one of the lawyers, it became clear that there was no indication by the banks or the prosecution as to whether each of the customers whose account details had been obtained by the thieves had been informed that their accounts had been compromised. Conceivably, customers might have had money stolen from their account by way of ATMs, but the banks might have asserted that it must have been the customer who made the withdrawals, even though it might have been because of the actions of Bunu and his accomplices. In this respect, it ought to be a requirement for the crown or the police or the banks, or all of these agencies, to inform the customers that their accounts have been compromised (unless this occurs in any event).

[34] Banks and their customers are debtors and creditors. Although it is commonplace to speak of "my money in the bank", and indeed hallowed by the Companies Acts to include an entry in a company's accounts for "cash at bank", the cash actually held by a bank belongs to the bank, not its customers. The customers' only assets are their debt claims against the bank (if their accounts are in fact in credit). So when cash is stolen from a bank, it is the bank's cash, and the bank suffers the loss—the customers are not affected (unless the loss brings down the bank, of course).

[35] See Stephen Mason, *Electronic Evidence*, (LexisNexis Butterworths, Second edition, 2010) Chapter 5 for a detailed consideration of this presumption.

23. The members of the Committee are welcome to get in touch for further information, should they consider it necessary.

17 January 2011

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Supplementary written evidence submitted by the Financial Services Consumer Panel

At the inquiry proceedings on 18 November you asked a number of questions about the Panel's role currently and what we envisage for the future and encouraged all the Panels to come back and provide more information in relation to the costs and benefits of regulation and the role of the Bank of England in the new structure. This further information is provided below.

Clarification of the role and remit of Panel and its role in transition and in the future

1. The Financial Services Consumer Panel (FSCP) is a statutory body by virtue of s10 of the Financial Services and Markets Act 2000 (FSMA 2000). Initially established by the Financial Services Authority (FSA) in December 1998, the Panel advises the FSA Board on the interests and concerns of consumers, including SMEs', and reports on the FSA's performance in meeting its objectives in the regulation of financial services.

2. The emphasis of the Panel's work is on activities that are regulated by the FSA, although it may also look at the impact on consumers of activities outside, but related to the FSA's remit. The Consumer Panel works to advise and challenge the FSA from the earliest stages of its policy development to ensure the FSA takes the consumer interest into account. The Panel also takes an interest in broader consumers issues in financial services where it believes it can help achieve beneficial outcomes and where it thinks there is a lack of consumer representation. This is an important role; the consumer interest in the financial services sector is not well represented by consumer bodies because of their focus on particular issues relevant to their membership and their limited resources for research.

3. Members of the Panel are recruited through a process of open competition and encompass a broad range of relevant expertise and experience. FSMA 2000 provides that the Panel membership must have a fair degree of representation to consumers of financial services.[36] There are currently eleven members of the Panel as listed below and these positions change every three years on rotation.

Adam Phillips (Chairman)	Caroline Gardner	David Metz
Kay Blair (Vice Chairman)	Tony Hetherington	Lindsey Rogerson
Stephen Crampton	Nick Lord	Mike Dailly
Bill Martin	Claire Whyley	

TERMS OF REFERENCE

4. The Financial Services Act 2000 provides that the FSA must have regard to any representations made to it by the Panel[37] and that it must consider any representation made to it by the Panel[38] and if the FSA disagrees with a view expressed, or proposal made, in the representation, it must give the Panel a statement in writing of its reasons for disagreeing.[39]

5. Beyond its statutory basis the Consumer Panel has a Memorandum of Understanding with the FSA and formal terms of reference set out its role and responsibility as follows:

(1) The Financial Services Consumer Panel ("the Panel") is established by the Financial Services Authority (FSA) under the Financial Services and Markets Act to represent the interests of consumers. The Panel is independent of the FSA and can speak out publicly on issues where it considers this appropriate.

(2) Panel members are appointed by the FSA, in accordance with Nolan principles in order to represent consumers, with HM Treasury's approval in the case of the Chairman. The FSA Board approves the Panel's annual budget and provides a dedicated secretariat to support the Panel.

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36 FSMA 2000 s10(6)
37 FSMA 2000 s10(4)
38 FSMA 2000 s11(2)
39 FSMA 2000 s11(3)

(3) The main purpose of the Panel is to provide advice to the FSA. As such it does not carry out responsibilities on behalf of the FSA. For example, the Panel does not undertake consumer education, nor does the Panel take up individual consumer complaints.

(4) The emphasis of the Panel's work is on activities that are regulated by the FSA, although it may also look at the impact on consumers of activities outside but related to the FSA's remit.

(5) The Panel will have regard to the interests of all groups of consumers including those who are particularly disadvantaged in the context of financial services, including consumers who have little or no access to financial services.

(6) The Panel will:

(a) represent the interests of consumers by advising, commenting and making recommendations on existing and developing FSA policy and practices as appropriate;

(b) speak on behalf of consumers by reviewing, monitoring and reporting to the FSA on the effectiveness of FSA's policies and practices in pursuing its duties; and

(c) keep under review and influence actual and potential developments in financial services to enable it to fulfil (a) and (b) effectively.

(7) In addition, it can advise the Government on the scope of financial services regulation.

(8) The Panel can consider other matters that assist it in carrying out its primary functions.

(9) The Panel shall publish an Annual Report on its work and expenditure.

(10) The Panel can speak out publicly when it wishes to draw attention to matters in the public interest and when it disagrees with the FSA.

Limitations to the Current Role of the Panel

6. From the above terms of reference and the wording of the statute it is clear that the Consumer Panel's focus has been on advising, influencing, supporting and challenging the FSA rather than having a more public campaigning role. The Panel's powers are related principally to this internal lobbying role rather than having external powers of public persuasion or a campaigning objective. However this role is significant because it is an opportunity to influence thinking, to represent the consumer interest and advance the cause of consumer protection as a counter to the industry's powerful lobbying machine.

Role of the Panel in the Transition

7. During the transition to the new twin peaks model of regulation the Consumer Panel will continue to discharge its role. We will be specifically concerned to ensure that current consumer protection initiatives are carried through and the more interventionist, outcome approach to regulation comes to fruition.

8. We will want to ensure that stated commitments to improved regulatory outcomes and the new approach to the regulation of conduct of business are taken forward and indeed gather momentum, that the organisation maintains sufficient resources and expertise to operate effectively and that the transition does not distract it from its regulatory functions.

9. As an adviser to the FSA the Panel anticipates that it will be influential in ensuring that the new Consumer Protection and Markets Authority has the powers to act as an effective champion of the consumer interest delivering more effective consumer protection than has been the case with the FSA. We will advocate the cultural change necessary for the elements of the FSA which transfer to the CPMA to develop their consumer protection credentials, their expertise, an effective approach to consumer engagement, improved transparency and to develop effective accountability mechanisms in the new structure. We will also be advocating the development of formal processes for co-ordination and communication between the peaks to ensure the benefits of an effective supervisory approach are not lost and that overlap/underlap does not occur.

Future Role of the Panel

10. We have argued in our evidence to the HM Treasury consultation that the Panels need to be given an enhanced role under the new structure. Specifically we have suggested that the Consumer Panel be given greater resourcing in the transitional stages, of which the FSA have been supportive, so that it has the power to more strongly represent the consumer interest. We will also need to consider the powers and resources required for the future role, particularly as it will be dealing with a new and evolving structure and should have formal relationships with the FPC and PRA. We have also argued that the Panel should regularly appear before the House of Commons Treasury Committee to ensure greater accountability for the new regulators to Parliament.

11. We expressed this in our evidence to the HM Treasury consultation as follows:

59. We believe the role of the Panels should be enhanced in the new regime to improve the CPMA's governance. In particular, we would like to see increased and effective Panel resourcing and a stronger obligation on the CPMA through statute to consult and take note of the Panel's recommendations and challenges.

60. Moreover, the three Panels representing consumer and practitioner interests should not only provide input to the CPMA. We believe the Panels have become an effective part of the FSA's governance structure and should be enabled to advise the FPC and PRA, to ensure that consumer and practitioner interests are adequately represented. When applicable, the FPC and PRA should have a duty to liaise with and consult the Independent Panels to ensure that there is proper scrutiny of decisions.

61. Specifically in the case of the Consumer Panel, we recommend that it has a formal duty to report to the Treasury Select Committee on a regular timetable.

12. Responses to the Treasury consultation supported an obligation on the regulator to consult and reflect on views from the Panels in relation to key decisions and to ensure that there was greater transparency as to how the regulator would take account of the panels' recommendations. Requiring this would assist our role.

13. A key element of the Panels' ability to provide effective oversight and challenge to the CPMA and PRA will be the power to request information relevant to the performance of their role. At present, the Panels do not have this power. It is therefore possible for the regulator to refuse to answer questions in a way which obstructs the work of the Panels. This has not happened in the history of the relationship with the FSA, but the new less integrated architecture means that this power will be essential to ensure the exercise of effective governance.

Costs and benefits of regulation

14. The Panel's evidence emphasised the need for effective and efficient regulation. Our concerns about the costs of regulation relate to the likelihood that increased regulatory costs will be borne by consumers. It remains in the consumer and public interest to have effective regulation and it is important that the value of regulation is given proper recognition in public debate rather than being constantly portrayed as a burden on business.

15. Regulation protects and acknowledges good players. The extent of regulation is often equated with the extent of market failure. The work commissioned by the FSA and the Practitioner Panel on the costs of regulation confirms that much of what regulation requires is good business practice and that separating costs of regulation versus business as usual is difficult and often arbitrary.[40] Treating customers fairly, good complaint handling, transparency about performance and meeting consumers' information requirements are all examples of what customers would expect in a retail environment where competition is effective at delivering products and services which are good value and which meet customers' needs.

16. The level of intervention currently required in these areas points to a failure of culture and a lack of embedding of a consumer perspective in financial service and product provision. Where the market is failing to deliver good outcomes for customers the cost of regulation is high and the regulator is in effect pressing the industry to introduce good business practise in those firms where they are not already embedded.

17. The real cost of regulation to society is in the failure to regulate effectively. The social and economic impact of withdrawing financial services is underlined by Government measures to ensure their continuance. A good example is the impact of exclusion from access to transactional banking services which are now effectively a utility. Utilities have to be regulated so that charges are kept to a reasonable level and the poor do not pay more. Transactional banking is an obvious example of where intelligent regulation is needed, but Investments and long term savings are necessary for individuals and the economy, the terms on which people engage with these can not be left solely to a market which inevitably services only the more profitable segments.

18. As the report by the Better Regulation Executive for the Department of Business, Innovation and Skills pointed out:

> *"But looking at costs alone distorts the picture. Better regulation also seeks to maximise the 'net benefit', ie benefit minus costs. Although regulation may have a cost for society it is intended to deliver benefits and can have an overall positive effect for society. For example, competitive markets create benefits like extra trade and reduced prices. Regulation means cleaner air and water, safer workplaces and food as well as the safety net created by the minimum wage."*[41]

[40] Deloitte, The cost of regulation study. Commissioned by the Financial Services Authority and the Financial Services Practitioner Panel, 2006.

[41] BIS, Better regulation, better benefits: getting the balance right, October 2009, 7.

19. The analysis of the benefits of regulation has often been weak and driven by quantitative rather qualitative analysis. This is particularly so in the area of consumer risk, evidenced by examples such as the proliferation of mis-selling and competition concerns associated with PPI and the unfair level of charges on bank accounts. The FSA's report on assessing the benefits of regulation recognised that direct benefits are often difficult to quantify and set out a complicated framework for identifying metric that can be used to proxy for final market outcomes.[42] We welcome instead the FSA's commitment to producing a Conduct Risk Outlook.[43] We hope that this will provide a framework to identify conduct issues before significant detriment arises for consumers, and to frame a dialogue with firms and consumer groups on these issues. We look forward to this producing a more realistic basis for establishing the benefits of regulating financial services.

20. There is an opportunity to re-energise the better regulation agenda by putting the consumer interest at the heart of regulatory policy and practice. The House of Commons Regulatory Reform committee urges more accountability to citizens and end users, a view supported by the FSA report on the benefits of regulation which notes that in order to achieve some of the benefits of regulation incentives between Financial Services firms and their customers need to be better aligned.[44]

New structure vests too much power in role of Governor/Central Bank

21. We believe proper resourcing, increased accountability, effective governance and good communication and co-ordination between regulators will be the key in delivering effective regulation no matter what the structure. However, we have expressed reservations about the implied hierarchy in the proposed system and expand below on the some of the issues in relation to a central bank carrying out the prudential regulation functions.

21.1 Central banks have traditionally not been particularly open or transparent about their operations. The new role will be quite a culture change for the Bank. The Panel has been advocating reform in the area of transparency in the FSA for a long time and while some progress has been slow. Transparency, accountability and consumer engagement need to be features of the new regulatory structure from Day 1. While we welcome the proposed accountability mechanisms for the PRA there needs to be a specific consumer/public perspective, proper impact assessment and a focus on accessible communication. At the very least the PRA should be subject to the same accountability mechanisms proposed for the CPMA. We will expect to see, in the words of the IMF, robust mechanisms to ensure transparency and a high degree of accountability of the Central Bank's actions in practice.

21.2 The perception of the Bank acting as a narrow advocate of city interests remains rather than an institution accountable to Government. John Kay talks of the Bank of England acting as a

> "co-ordinator of a self-regulating club of financial institutions. The implicit deal was that financial institutions were permitted to act as a cartel in return for a commitment to conservative behaviour. In times of difficulty they would provide mutual support, which the Bank would co-ordinate, in order to maintain financial stability."[45]

21.3 The main concerns of the Consumer Panel in relation to FPC and the PRA are regarding the composition of the boards, with an overly strong Bank of England and industry basis and the lack of a consumer or broader public policy perspective. We would not want to see the supervision of business conduct downgraded as a result of the structural changes and a failure to adequately consider the possible negative impact on citizens.

21.4 Research has indicated that central banks that are also responsible for bank regulation will be more sensitive to the profitability of the banking sector and therefore less likely to alter interest rates solely on the basis of financial stability objectives.[46]

21.5 The FSA was broadly criticised for its failure to balance competing objectives. The Bank of England will be placed in a similar position and will need to be clear as to how this conflict will be managed from the outset. We are concerned that too narrow a focus on the stability of the banking system could be unnecessarily damaging to sections of the population. It is not clear that there is adequate or effective public accountability in the proposed structure.

[42] Oxera, A framework for assessing the benefits of financial regulation, Report prepared for Financial Services Authority, June 2006.
[43] Adair Turner, Speech to the BBA, Protecting Consumers and Winning Trust, 13 July 2010.
[44] Oxera for the FSA, as above.
[45] John Kay, "The new financial services leviathan: has competition been a casualty of the financial crisis?" in Rethinking Financial Services, Consumer Focus, June 2010.
[46] Mark S Copelovitch and David Andrew Singer, Financial Regulation, "Monetary Policy and Inflation in the Industrialized World". The Journal of Politics, Vol 70, No.3, July 2008, pp 663–680

21.6 The formal mechanisms for communication and co-ordination across the regulatory system are yet to be detailed. There remains an area of overlap in prudential regulation between PRA and CPMA and there are some significant co-ordination issues to address.[47]

I hope this information is helpful and please let me know if there is any further clarification you need.

December 2010

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[47] The Australian twin peaks model has separate prudential and conduct regulators in addition to the Central Bank who all have representation, along with the Treasury on an overarching Council of Financial Regulators. Similarly the recommendations of the Canadian Expert Panel on Securities Regulation suggest the need for a permanent co-ordinating body that will promote co-ordination of regulatory policy. Eric J Pan, *Structural Reform of Financial Regulation in Canada*, A Research Study Prepared for the Expert Panel on Securities Regulation.