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Treasury Committee

Financial Conduct Authority

Twenty-sixth Report of Session 2010–12

Report, together with formal minutes, oral and written evidence

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Contents

Report

1 Introduction

Conduct of Business regulation in the United Kingdom

1. The Financial Services Authority (FSA) was established in 1997 under the Financial Services and Markets Act 2000 (FSMA). This new super-regulator, as it was described at the time, brought together predecessor self-regulating organisations including the Securities and Futures Authority (SFA), the Investment Management Regulatory Organisation (IMRO) and the Pensions Investment Authority (PIA), together with the Banking Supervision division of the Bank of England.

2. Under FSMA, the FSA was given four statutory objectives:

- market confidence—maintaining confidence in the UK financial system;
- financial stability—contributing to the protection and enhancement of stability of the UK financial system;
- consumer protection—securing the appropriate degree of protection for consumers, and
- the reduction of financial crime—reducing the extent to which it is possible for a regulated business to be used for a purpose connected with financial crime.[1]

3. The new authority brought under one umbrella a combination of conduct and micro-prudential regulation across all aspects of the financial services sector.[2] Following its original proposals in July 2010, in February 2011 HM Treasury opened a public consultation on its proposals for "A new approach to financial regulation".[3] The Treasury proposes:

- An independent conduct of business regulator, now renamed the Financial Conduct Authority (FCA),[4] which will ensure that business is conducted in such a way that advances the interests of all users and participants of the UK financial sector.
- A macro-prudential regulator within the Bank of England, the Financial Policy Committee (FPC). This Committee will monitor and respond to systemic risks.
- A micro-prudential regulator for systemic firms, the Prudential Regulation Authority (PRA), created as a subsidiary of the Bank of England.

1 FSA Website, http://www.fsa.gov.uk/Pages/About/Aims/Statutory/index.shtml

2 Conduct regulation is the regulatory framework which applies to how market participants (both producers or users of financial products) interact; in its broadest sense this also includes governance and systems and controls infrastructures in regulated entities which are crucial to how those entities interact with others.

3 HM Treasury, *A new approach to financial regulation: building a stronger system*, Cm 8012, February 2011

4 The Government's original proposal was for this body to be called the Consumer Protection and Markets Authority (CPMA)

4. We have received a weight of evidence, often anonymous, criticising the FSA for its approach to regulation. We are told that the FSA was overly bureaucratic and that the culture within the regulator is overly legislative and self protecting through 'box-ticking'. **Given the evidence criticising the FSA, and following the perceived failure of regulation during the financial crisis, it was necessary for all concerned to make full use of the opportunity created by the split of the FSA into the FCA and PRA to ensure that the new bodies did not carry over the FSA's shortcomings through the new legislation.**

5. In February 2011, we made preliminary recommendations on the Government's proposals.[5] Our recommendations for the FCA included: emphasizing the importance of making definitions clear for regulators;[6] making competition a primary objective for the FCA;[7] ensuring that all the objectives and remit for the FCA were clear;[8] and enhancing transparency and coordination when regulators use their powers.[9] In June 2011 the Treasury published a draft Bill, largely consisting of proposed amendments to FSMA, the Banking Act 2009 and other statutes. Figure 1 summarises the proposed framework.[10]

5 Treasury Committee, Seventh Report of Session 2010-12, *Financial Regulation: a preliminary consideration of the Government's proposals*, HC 430–I

6 *Ibid.*, para 110

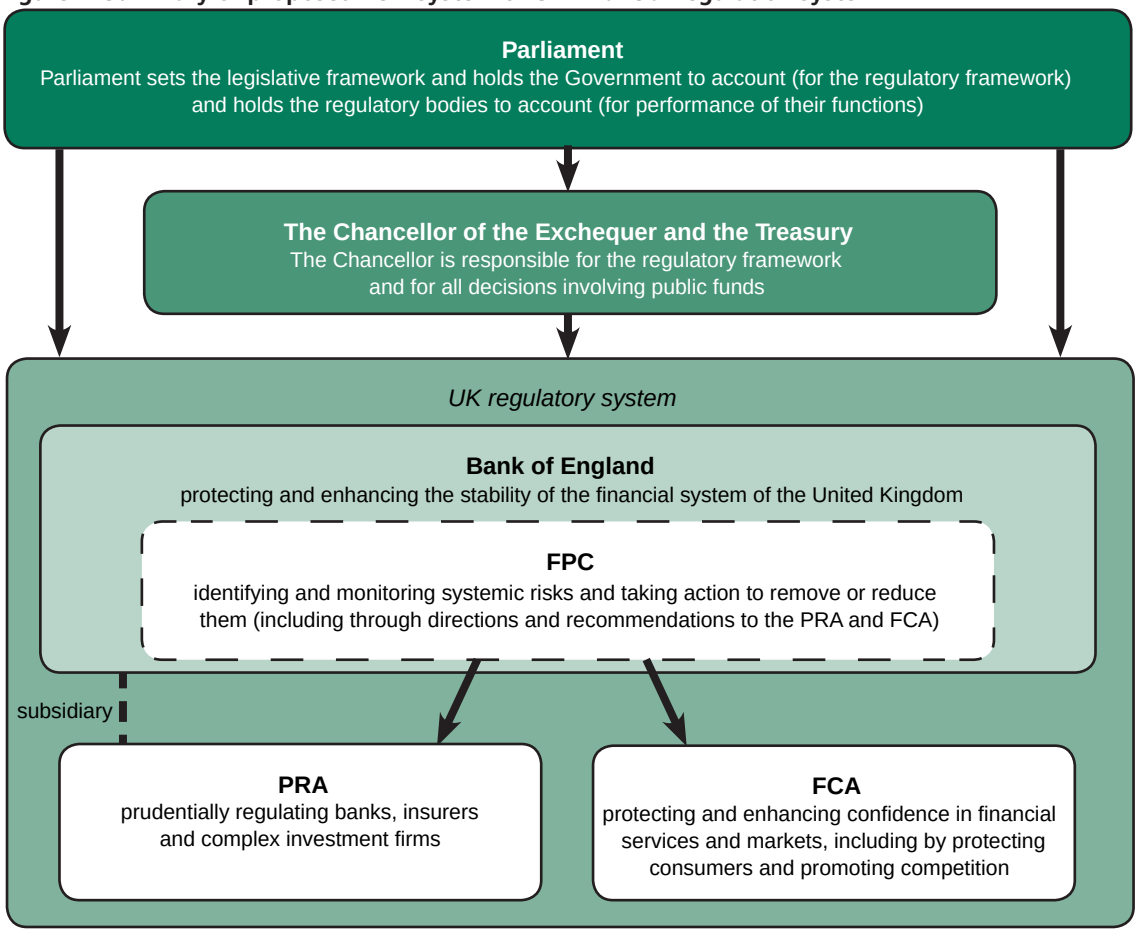
7 *Ibid.*, para 118

8 *Ibid.*, para 120

9 *Ibid.*, para 133

10 HM Treasury, *A new approach to financial regulation: the blueprint for reform*, Cm 8083, June 2011

Figure 1: Summary of proposed new system of UK financial regulation system.[11]



6. A Joint Committee was appointed to conduct pre-legislative scrutiny of the draft Financial Services Bill.[12] The Joint Committee published its report in December 2011.[13]

7. The Government's proposals represent a major change in the regulation of the financial services industry in the UK and the Government has set a deadline to have the legislation passed by the end of 2012.[14] This is a tight timetable, given the size of the reforms, especially given the lack of clarity in some of the proposals. In February 2011 we reported on the Government's initial proposals and were concerned that the Government might be proceeding with undue haste. We supported a complete rewriting of FSMA and said that the Government should to take the time required to get its reform of financial regulation right.[15]

11 *Ibid.,* page 8

12 Further information about the Joint Committee may be found on the Parliament website: http://www.parliament.uk/business/committees/committees-a-z/joint-select/draft-financial-services-bill/

13 Joint Committee on the draft Financial services Bill, Session 2010–12, *Draft Financial Services Bill*, HC 1447, HL Paper 236

14 HM Treasury, *A new approach to financial regulation: building a stronger system*, February 2011, para 8.2

15 Seventh Report of the Treasury Committee, Session 2010–12, *Financial Regulation: a preliminary consideration of the Government's proposals,* HC 430–I, paras 18 and 25

8. We announced an inquiry into the Financial Conduct Authority in September 2011. Among the questions we posed at that stage were:

- Are the objectives of the Financial Conduct Authority clear and appropriate?
- Does the FCA's approach to regulation, as outlined in the Financial Services Authority's June 2011 document,[16] represent an improvement on that of the FSA?
- To whom should the FCA be accountable? Are the lines of accountability clear?
- Are the powers of the FCA suitable? Will the exercise of FCA powers be subject to appropriate scrutiny? How should the FCA be interacting with industry as well as using its intervention powers?
- How should the FCA be interacting with other domestic regulators and agents? How should the FCA be interacting with international regulators?[17]

9. In October 2011 we wrote to the Chairman of the Joint Committee, the Rt Hon Peter Lilley MP, to emphasise the importance of the two Committees reinforcing each other's efforts.[18] To that end we informed the Joint Committee that we intended to concentrate on three issues: the accountability of the Bank of England, the accountability and objectives of the new Financial Conduct Authority, and the proposals of the Independent Commission on Banking.

10. We held four evidence sessions in our inquiry. On 25 October we took evidence from three representatives of firms which will be regulated by the FCA: Angus Eaton, Operational and Regulatory Risk Director, Aviva Plc, Paul Killik, Senior Executive Officer and Partner, Killik & Co, and Philip Warland, Head of Public Policy, Fidelity Worldwide. On 1 November we heard from the Financial Services Authority: Lord Turner, Chairman, Hector Sants, Chief Executive, Martin Wheatley, Managing Director, Conduct Business Unit and CEO-designate of the FCA, and Margaret Cole, Managing Director, Enforcement, Financial Crime and Markets. On 2 November we took evidence from a panel of consumer representatives: Peter Vicary-Smith, Chief Executive, Which?, Christine Farnish, Chair, Consumer Focus, and Gillian Guy, Chief Executive, Citizens Advice Bureau. Finally, on 8 November we heard from Mark Hoban MP, Financial Secretary to the Treasury and Emil Levendoglu, Deputy Director, Financial Regulation Strategy, HM Treasury. We are grateful to all witnesses for their contributions to this inquiry and also to all those who submitted written evidence.

11. This report opens with a section describing how the FCA fits into the proposed regulatory structure, and also considers the objectives of the FCA. It reviews the proposed lines of accountability for the FCA and make recommendations on how these might be improved. It outlines the FCA's place in the wider regulatory architecture, specifically discussing how the FCA should coordinate with the PRA and the European Union, before

16 FSA website: www.fsa.gov.uk/pubs/events/fca_approach.pdf

17 Treasury Committee website, http://www.parliament.uk/business/committees/committees-a-z/commons-select/treasury-committee/news/fca-tors/

18 Letter from the Chairman of the Treasury Committee to the Rt Hon Peter Lilley MP regarding the Draft Financial Services Bill, 25 October 2011. Available on the Committee's website.

considering and making recommendations on the practicalities of the FCA (including their approach to supervision, staffing and coordination with industry). Finally we report on the proposed new powers of the FCA including early warning notices, product intervention and the pre-approval of some financial products.

12. We would like to thank our specialist advisers the Rev John Tattersall, John Willman, John Tiner CBE and Richard Andrews for their expert advice and assistance in this inquiry.[19]

13. We will return to the issues discussed in this Report in the light of the Government's revised proposals, which are due to be published as the Financial Services Bill early in 2012. This Report forms a part of the Committee's long-running work on the new regulatory architecture, which includes our Report of February 2011, *Financial Regulation: a preliminary consideration of the Government's proposals*, and our Report of November 2011, *Accountability of the Bank of England*.[20]

19 Relevant interests of specialist advisers are as follows (a complete listing of interests can be found in the Formal Minutes of the Committee available on the Committee's website):

John Tattersall: Non-executive director of UK Asset Resolution Limited , R Raphael & Sons PLC, CCLA Investment Management Limited, The Gibraltar Financial Services Commission and UBS Limited

John Willman: Recently authored for: City of London, Pictet & Cie, Pricewaterhouse Coopers and The TIMES Group

John Tiner: Partner and CEO of Resolution Operations LLP. Non-Executive Director of Lucida Plc, Friends Life Limited and Credit Suisse Group (and chairman of the Audit Committee). Former Chief Executive, FSA

Richard Andrews: Director, KPMG.

20 HC 430 and HC 874 of Session 2010–12

2 How the FCA fits into the proposed new regulatory structure

Strategic and operational objectives – the role of competition

14. The statutory objectives of the FCA will determine both what the regulator sets out to achieve and how it goes about it. They are, therefore, extremely important. Under the current legislation the FSA's decisions do not normally take into account considerations, notwithstanding the strength of the arguments for a particular course of action, unless these are specifically derived from their statutory objectives and 'have regard' duties. We would expect the FCA to take a similar approach.

15. The design of the FCA's objectives has already evolved considerably from the Government's June 2010 proposal of a conduct regulator with a single primary objective of "ensuring confidence in financial services and markets, with particular focus on protecting consumers and ensuring market integrity" balanced by a set of statutory secondary considerations, where in the event of conflict the Government would expect the primary objective to override any secondary considerations.[21]

16. The Government's stated aim in the original consultation was for the conduct regulator to be focused on the "pursuit of a single objective".[22] This was described by HM Treasury in a later document as being in order to "simplify the regulatory objectives prescribed in the Financial Services and Markets Act 2000 (FSMA)".[23]

17. This evolved to a more complex structure in the February 2011 consultation document: *A new approach to financial regulation: building a stronger system.*[24] The draft Bill reflects this evolution. It sets out a strategic objective for the FCA, three operational objectives, a requirement for the FCA to discharge its general functions in a way which promotes competition, and also a number of 'have regard' and other duties, creating a hierarchy of four tiers of objectives and duties.

18. These multiple levels of objectives and 'have regard' duties in the draft Bill, taken together, are much more complex than either the Government's June 2010 proposed formulation or the two-level formulation of four statutory objectives supplemented by a number of 'have regard' duties that primarily governed the operation of the FSA under the Financial Services and Markets Act 2000.

19. In our report, *Financial Regulation: a preliminary consideration of the Government's proposals,* we recommended that the proposed Consumer and Markets Protection Authority (CPMA), now the Financial Conduct Authority, have competition as its primary objective:

21 HM Treasury: *A new approach to financial regulation: judgement, focus and stability, Cm 7874, June 2010, pp 32–32, paras 4.6–4.8*

22 *Ibid.*, page 31, paragraph 4.3

23 HM Treasury: *A new approach to financial regulation: Summary of consultation responses, November 2010, p 6, para 2.13*

24 Cm 8012, para 1.26.

> The CPMA [now FCA] should have competition as a primary objective. This will benefit consumers directly and indirectly. Not only will there be a greater choice available for consumers, but the transparency which effective competition brings should reduce the need for heavy-handed regulation. Greater competition should also help prevent firms becoming too big to fail. We do not, however, believe that the regulator should have a remit to facilitate innovations—a properly functioning market will do that.[25]

Our view has not changed.

The operational objectives and the role of competition

20. As currently drafted, the draft Bill sets out three operational objectives:

- Securing an appropriate degree of protection for consumers;
- Protecting and enhancing the integrity of the UK financial system, and
- Promoting efficiency and choice in the market for certain types of services.[26]

These three operational objectives do not include an explicit competition objective.

21. Our view that it should has been supported by the Independent Commission on Banking, who welcomed the Government's commitment to give the FCA a primary duty to promote competition and recommended that this duty be clarified:

> The efficiency and choice operational objective should be replaced with an objective to "promote effective competition" in markets for financial services.[27]

The ICB drew on our earlier reports in support of its conclusions.[28]

22. The draft Bill sets out the FCA's responsibilities in respect of competition as a requirement for it to "discharge its general functions in a way which promotes competition".[29] This ranks below the level of the strategic and operational objectives. It provides the promotion of competition with a lower level of significance; it is at best ancillary to the delivery of the strategic and operational objectives. We were disappointed that HM Treasury did not make promoting competition a primary objective for the new authority.

23. During the course of our inquiry it became clear that the relationship between the strategic and operational objectives and the FCA's requirement to discharge its duties in such a way to promote competition led to understandable confusion from those giving evidence to the Committee. Nevertheless, the evidence we have received from industry and

25 Treasury Committee, Seventh Report of Session 2010–12, *Financial Regulation: a preliminary consideration of the Government's proposals*, HC 430–I, para 118

26 Draft Bill - New Financial Services and Markets Act clause 1B (3)

27 Independent Commission on Banking, *Final Report: Recommendations*, September 2011,p 241

28 See evidence from Sir John Vickers in the Nineteenth Report of the Treasury Committee, Session 2010–12, HC 1069, Q127, and Independent Commission on Banking, Final Report, September 2011, paragraph 8.78

29 Draft Bill - New Financial Services and Markets Act clause 1B (4)

others is overwhelmingly supportive of a competition objective and calls for an active role of competition in the FCA's operations to be made clearer. The Association of Private Client Investment Managers and Stockbrokers (APCIMS) told us:

> The FCA should have a primary duty to promote competition [...] we are not entirely clear whether there is a common understanding amongst all stakeholders and the FCA as to the exact nature of this duty.[30]

24. The importance of increasing the prominence of effective competition in the FCA's objectives was also emphasised by the consumer groups. Consumer Focus suggested replacing the efficiency and choice objective with an objective to "promote effective competition in the financial services market".[31] This echoes the Financial Services Consumer Panel who said:

> Requiring the FCA only to discharge its general functions in a way which promotes competition, when this is compatible with its other objectives, is not a strong or clear enough obligation. [32]

25. Even the FSA described the current structure as confused. Martin Wheatley, the Chief Executive-designate of the FCA, told us that "our current position is that there is an confused structure, that we would prefer to have a stronger position on competition and a clearer objective on competition".[33] The FSA suggested changing the objectives in the draft Bill as follows:

> The operational objective of 'efficiency and choice' is replaced with an operational objective to promote effective competition (across financial services markets, not solely retail banking) for the benefit of consumers.[34]

26. The Joint Committee on the draft Financial Services Bill recommended that:

> the FCA's operational objective of "promoting efficiency and choice" should be replaced by "promoting competition, efficiency and choice for the benefits of consumers".[35]

27. When we put our concerns about the objectives, and the relationship between them, to the Financial Secretary to the Treasury he said "we are prepared to listen to comments about both the overall objective and the operational objectives".[36] Shortly after this, the Chancellor made a statement to Parliament that:

> Financial services legislation next year will specify that one of the objectives of the Financial Conduct Authority is to promote effective competition in the interests of

30 Ev w55

31 Ev 73

32 Ev w13

33 Q 91

34 Ev 84

35 House of Lords, House of Commons, Joint Committee on the draft Financial Services Bill Report (2010–12) *Draft Financial Services Bill* HL Paper 236, HC 1447, paragraph 103

36 Q 207

> consumers. A new statutory competition remit will provide the FCA with a clear mandate for swifter, more effective action to address competition problems in financial services. Within months of the ICB report, legislation will be introduced to bring the change into force.[37]

28. **We have been encouraged by the willingness of the Financial Secretary to reconsider the objectives as set out in the draft Bill and by the Chancellor's assurances that competition would be an objective of the FCA. Competition should be central to the culture of the FCA. This is not for competition's own sake, but because effective competition benefits consumers. We agree with the substance of the recommendation of the Joint Committee, and recommend that it is best achieved by giving the FCA an additional primary objective "to promote effective competition for the benefit of consumers".**

The Strategic objective

29. The Treasury document containing the draft Bill contains the latest formulation of the strategic objective: "protecting and enhancing confidence in the UK financial system".[38] The Treasury states the purpose of the strategic objective as follows:

> In discharging its general functions, the FCA must, so far as is reasonably possible, act in a way which –
>
> (a) is compatible with its strategic objective [as defined in the act], and
>
> (b) advances one or more of its operational objectives.[39]

While the strategic objective is not the driver of the FCA's activities—this is the role of the operational objectives—compatibility with the strategic objective is a pre-requisite of action being taken. In this sense, the strategic objective, and the interpretation of it by the FCA, will trump the operational objectives. Consequently, under the current formulation, the strategic objective would play an exceptionally important role in setting the tone and direction of the FCA.

30. During the course of our inquiry we have not seen a clear and straightforward explanation of the proposed interaction between the strategic objective and operational objectives. Nor has the Government published a considered explanation of the need for an overarching strategic objective supported by three operational objectives. This complicated arrangement evolved during the consultation process, nullifying the original intention to have a simple objective. The shortcomings of the existing regulatory framework did not lie with the lack of a single over-arching objective but rather, to a significant extent, arise from the neglect of competition. The more complex the hierarchy of objectives the greater the risk of confusion between them.

37 HC Deb, 19 December 2011, col 1017

38 HM Treasury: *A new approach to financial regulation: the blueprint for reform*, Draft Financial Services Bill, p 72, para 1B (2)

39 *Ibid.,* paragraph 1B (1)

31. The latest formulation of the strategic objective in the draft Bill is "protecting and enhancing confidence in the UK financial system".[40] We have received evidence from consumer groups expressing concerns that this risks the FCA working to enhance confidence even when that confidence is misplaced: rather than leaning against widespread over-confidence, a literal interpretation of the objective could potentially lead to the FCA making things worse. Consumer Focus wrote:

> There is a significant risk that the new regulator will promote policies that promote short term confidence even where this is not properly grounded. Customers of Equitable Life and Northern Rock no doubt had plenty of confidence in the system until it was too late.[41]

32. The FSA, notwithstanding their close involvement in preparing the draft Bill, has also expressed concern. Lord Turner told us:

> We have suggested in our letter to you that we are not convinced that the most appropriate statement of the top-line objective of the FCA is enhanced confidence in the system.[42]

This was followed up in a written submission from the FSA suggesting that the strategic objective be changed to "promoting fair, efficient and transparent markets in financial services".[43] This is similar to the proposal from Which?, who suggested "ensuring a fair and transparent market in financial services"[44]. Both the Citizens Advice Bureau and Consumer Focus endorsed this suggestion when they appeared before us on 2 November 2011.[45] When we put these concerns to the Financial Secretary to the Treasury, he indicated that HM Treasury was willing to reconsider this formulation.[46]

33. The Joint Committee on the draft Financial Services Bill recommended that "the FCA's strategic objective should be amended to focus on promoting fair, efficient and transparent financial services markets that work well for users".[47]

34. **We agree with the concerns put to us that the strategic objective as set out in the draft Bill risks creating the conditions for the FCA to pursue a course of seeking to enhance confidence in markets when that confidence may, at times, be misplaced. There is also a risk of confusion created by multiple tiers of objectives and duties. We agree that the FSA's own suggestion for the strategic objective "to ensure fair, efficient and transparent markets in financial services" is an improvement. We welcome the Government's open mindedness in relation to the strategic objective, but urge the Government to re-examine the need for it. The revised strategic objective is already**

40 *Ibid.*, para 1B (2)

41 Ev 71

42 Q 78

43 Ev 54

44 Ev 620

45 Q 149 & Q 152

46 Q 205

47 House of Lords, House of Commons, Joint Committee on the draft Financial Services Bill Report (2010–12) *Draft Financial Services Bill* HL Paper 236, HC 1447, para 99

largely embodied in the current operational objectives. With the addition of the proposed competition objective, the objectives would cover all that is required. The absence of a further strategic objective would avoid the problems inherent in creating a complex hierarchy of purposes, and would more closely reflect the Government's original aim of simplicity.

Competition powers

35. In considering a competition objective, it is also important to consider which body should exercise competition powers. Currently the FSA does not have explicit competition powers. These lie with the Office of Fair Trading (OFT) and, with respect to mergers and markets investigations, the Competition Commission. The FCA will have, however, a new mechanism to refer a matter to the OFT for consideration.[48] Martin Wheatley, CEO-designate of the FCA, advocated a stronger role for the FCA in advancing competition:

> We would rather have a clearer competition objective so that we would have the ability to step into cartels, price, areas that we felt were unfair—so that we would not only have to take regard of competition once we fear one of our other objectives is not being met. So our view is we want a stronger role in competition than the original draft had suggested.[49]

He also concurred with the position set out by the FSA in a memorandum to the Committee:

> We do not believe it would be appropriate for the FCA to have responsibility for (largely) firm-specific Competition Act 1998 enforcement. The OFT has the relevant technical legal and economic expertise and experience. Nor would it be appropriate for the FCA to have a role in relation to mergers in the financial services sector, for the same reasons.[50]

36. When the Joint Committee on the Draft Financial Services Bill subsequently took evidence from Mr Wheatley his position had changed somewhat, and he sought to go further in seeking a clear demarcation between the OFT and FCA with competition powers moving to the FCA:

> [...] the draft legislation as currently presented does not go far enough [...] it would be much clearer if we could have a redrafted objective that gives us a very clear competition remit. It would remain the case that, if we wanted to make super complaints, we would have to make those super complaints to the Competition Commission, but it would remove the overlap that currently exists between partly our remit and partly the OFT's remit with regard to financial services.
>
> In practice we would not want there to be an overlap. We would want there to be quite a clear demarcation line. We would need to build up some of the expertise and resources, but it would be unfortunate if we left the responsibilities in two separate

48 Financial Services Authority, *The Financial conduct Authority: approach to regulation*, June 2011, box 2

49 Q 90

50 Ev 84

places. Our ideal model is that we have a very clear demarcation line and that we would take on competition issues within financial services.[51]

37. The Office of Fair Trading wrote to us stressing both its support for the FCA to have a "'top line' objective to promote competition" and at the same time its concern that the FCA should not be given 'concurrent' competition powers which would compromise the ability of the OFT to use its competition tools in financial markets.[52] The OFT cites a number of reasons for maintaining the status quo in relation to competition powers, including the need for consistency in the use of competition tools, the need for the right skill-set (which the FSA does not currently possess), and the risk of fragmenting the competition regime.

38. **While we recommend that the FCA be given a formal competition objective, requiring it to consider where financial services and markets are operating in a way which is consistent with competition, we were not convinced of the need to transfer the OFT's powers with respect to competition law to the FCA. We were, on balance, persuaded of the merits of the approach whereby the FCA can refer issues of competition law to the OFT. The staff at both the FCA and the OFT are already adjusting to rapid institutional change. We recommend that this issue be revisited once the FCA has bedded down, and with a track record both of the use of its powers and its ability to refer cases to the OFT on which to draw. The effectiveness of these arrangements, which would be less disruptive than transfer to the FCA, can then be reassessed.**

Defining the consumer

39. The Government proposes a broad definition of "consumer" in the draft Bill which is similar to the approach taken in the existing Financial Markets and Services Act. In the document which is intended to set out how the FCA will go about achieving its objectives, the FSA says that the term "consumer" covers:

- 'retail' consumers buying financial products or services for their own use or benefit (e.g. travel insurance, ISAs, or mortgages), either directly or through a regulated firm;
- 'retail' investors in financial instruments, for example shares, bonds and exchange traded funds, and
- various kinds of 'wholesale' consumers.[53]

40. We have heard concerns that the current broad definition in the Bill does not sufficiently differentiate the various sorts of consumer, and that there would be a qualitative improvement in the clarity of both the rights and responsibilities of different types of consumers were this specified more clearly in the Bill itself and not delegated to the FCA to set out in its detailed rulebooks.

51 Oral evidence taken before the Joint Committee on the Draft Financial Services Bill on 10 November 2011, HC 1447–xiii, Q 955 & Q 957

52 Ev 134

53 Financial Services Authority, *The Financial conduct Authority: approach to regulation*, June 2011, chapter 3 (Box 1)

41. For example, the Council of Mortgage Lenders said that "The regulator should have an appropriate degree of protection for consumers and should reflect a differential approach not only between market and retail consumers, but within the retail market itself".[54] The Financial Service Practitioner Panel wrote:

> A universal definition of consumer the FCA is also likely to encourage a tendency towards "one size fits all" approach to regulation [...] the financial services industry is too complex for policies to be applied across sectors without serious consideration of their effectiveness in different arenas.[55]

42. Christine Farnish of Consumer Focus told us:

> Part of the problem here is the definition of consumer in the Bill. This is a unique set-up for a regulator that has consumer responsibilities as well as other public policy objectives. In all other sectors of the economy where you have sector-specific regulation, and indeed in Europe, consumer is defined normally as someone who is not a participant in the market activities, not doing it by way of business, who is usually either an ordinary domestic retail consumer or a small business. In this legislation, consumer is defined broadly to include everything from my mum to a hedge fund manager and that seems to us very odd.[56]

43. When we put the question to the FCA as to how it would have regard to the differing degrees of experience and expertise that different consumers have, Martin Wheatley told us:

> That partly derives from the broad legal definition of consumer, which is different from the common man test of a consumer, so the broad legal definition has consumers including everything from retail consumers through to hedge funds, through to major parts of the infrastructure like stock exchanges or clearing houses. In that sense, what we are saying is it is not that within retail consumers we are going to try to judge the responsibility and the duties that we owe to different groups. It is more reflecting that institutional consumers, corporate large wholesale consumers, have the ability to take more responsibility and they have the legal powers to read the 200-page document and understand exactly what it means. That is the sense in which that was in the document.[57]

44. It would not be practical to legislate explicitly for all the different types of participants in financial markets as this would both make the primary legislation unwieldy and restrict the flexibility for the FCA's approach to consumer regulation to evolve with the sectors it regulates. However, the Government's approach to this definition is so broad that it leaves a lack of clarity as to the relative approach that the FCA should take to different types of consumer.

54 Ev w86

55 Ev w5

56 Q 154

57 Q 101

45. **We recommend that the Government examine the scope for differentiating between retail consumers and wholesale consumers in the Bill, and clarify the balance of protection and consumer responsibilities that attach to these different groups.**

Consumer responsibility

46. The FSA has proposed that, underpinning the powers and culture of both the regulator and industry, the FCA should take into account "the general principle that consumers should take responsibility for their decisions".[58]

47. HM Treasury reported, in the results of its consultation, that the principle of consumer responsibility received differing levels of support:

> The principle on consumer responsibility also attracted broad support from industry, but consumer groups argued that it should be qualified to reflect, for example, the existing information asymmetries between providers and consumers.[59]

48. The evidence that we received broadly followed this, gaining general support from industry representatives, but less so from consumer representatives. However, many industry representatives who, in general, supported the principle, told us that more clarity was required. The Confederation of British Industry welcomed the principle but told us that "it needs to be implemented effectively in practice".[60] The FSA agreed with this sentiment and assured us that work was being done to clarify the principle. Hector Sants told us:

> I think the question of what we mean by consumer responsibility has not been adequately teased out and there is not an accepted view as to what we mean by consumer responsibility, and I think it would be very helpful to the FSA going forward if we could get—we will probably never achieve entirely—a much greater consensus on what we mean by that.[61]

49. Some consumer groups were keen to stress that they were not just seeking qualification on the principle, as the Treasury suggested, but were arguing for it to be removed altogether. Peter Vicary-Smith, of Which?, told us:

> We would amend to remove the consumer responsibility principle completely because it creates an imbalance having a consumer responsibility and then not others. So not to leave it to the industry. The consumer responsibility is already established in common law, so consumers have responsibilities not to lie and so on already in there. To reinforce it in the ways envisaged, we think is over the top. With the imbalance of power and information that exists, it is very difficult for all consumers, in the place they are at the moment in terms of their financial education, to be able to engage on a level playing field with the industry. Thus, placing more

58 Financial Services Authority, *The Financial Conduct Authority: approach to regulation*, June 2011, para 3.8

59 HM Treasury, *A new approach to financial regulation: the blueprint for reform*, Cm 8083, June 2011, para 289

60 Ev w42

61 Q 79

> responsibility on to the consumer without that being mirrored we think is just going way too far.[62]

50. Other consumer groups also told us of the apparent imbalance that resulted from 'consumer responsibility' being defined as a general principle with no equivalent 'firm responsibility'. Mark Hoban responded to the concerns of consumer groups by telling us that "It is very difficult to quantify precisely the amount of responsibility a consumer should take, because it depends on the context and perhaps the product".[63]

51. The Joint Committee on the draft Financial Services Bill recommended that "consumer responsibility be complemented by an amendment to the draft Bill to place a clear responsibility on firms to act honestly, fairly and professionally in the best interests of their consumers".[64]

52. **We sympathise with the need for balance as reflected in the recommendation of the Joint Committee and believe that the lack of clarity about the principle of consumer responsibility needs to be rectified in good time to allow for further scrutiny of the proposals.**

International Competitiveness

53. The financial services industry makes a major contribution to UK GDP and employment.[65] Much of this industry is both international in nature and highly mobile. Its global competitiveness is the chief source of its success. In recognition of this, the FSA is currently required to have regard to "the international character of financial services and markets and the desirability of maintaining the competitive position of the United Kingdom".[66]

54. When we questioned Mr Wheatley, CEO-designate of the FCA, on this topic, he did not wish to see the FCA having such a duty. He told us:

> It creates a set of conflicts and I don't think it is part of the function of a regulator to have to take regard to that as well as consumer protection and intervention and the various other things.[67]

62 Q 153

63 Q 229

64 Report of the Joint Committee on the draft Financial Services Bill, HC (2010–12) 1447, Paragraph 126

65 For example:

The UK financial sector contributed about 10 per cent of Gross Domestic Product (GDP) in 2009, and employed around 1.1 million people as of September 2011 (Source: Office for National Statistics)

The UK's financial services sector contributed more than 12 per cent of the Government's total tax take during the last fiscal year (Source: Financial Times)

The London equity market had a global market share of 17 per cent in 2009 (Source: Financial Markets in the UK, 2010)

The UK fund management industry holds assets under worth £4.1trillion in 2009 (Source: Ibid)

66 Financial Services and Markets Act 2000, Para 2(3) (e)

67 Q 106

55. Much evidence was received that contradicted this view. Many organisations wrote to us to express concern that a similar duty was not being carried over to the FCA. The Financial Services Practitioner Panel said that "there is a significant difference between competition and competitiveness [...] the regulator should have regard to both".[68] The Prudential explained that:

> It is crucial [...] to be able to compete on a level playing field internationally and that the UK does not lose out to other countries wishing to increase their domiciled funds.[69]

56. Since its inception the FSA has recognised the risks that regulation can pose to the encouragement of innovation. Regulation can also create barriers to entry. Consumers benefit when markets are fully competitive. It was partly in response to these concerns that, after considerable pressure from outside parties and Parliament, the last government added a duty to have regard to the competitive position of the UK.[70] **Recognising that an effective regulatory system can attract business, it is important that the new regulatory bodies established by the Government do not ignore the impact of their actions on the competitiveness of the UK. The relationship between competitiveness and the means by which the Chancellor's assurances that competition will be an objective of the FCA will need to be carefully scrutinised. We may return to this issue.**

The Consumer Credit Act 1974

57. The FSA is currently responsible for the regulation of Banking including the provision of current account products, loans and mortgages to retail consumers. However, the FSA is not responsible for the regulation of all aspects of consumer credit as products provided under the Consumer Credit Act 1974 fall under the responsibility of the Office of Fair Trading (OFT).

58. This split of regulatory responsibility leads to a number of anomalies: an overdraft can fall under the auspices of the Act (and regulation by the OFT) but the same account in credit falls under the ambit of the FSA; a financial services group may contain a bank which provides loans regulated by the FSA and a credit card company which provides credit regulated by the OFT.

59. On 21 December 2010 HM Treasury and the Department for Business, Innovation and Skills published *A new approach to financial regulation: consultation on reforming the consumer credit regime*. This consultation document considered the merits of transferring responsibility for consumer credit regulation from OFT to the FCA. The consultation stated that the Government's preferred option was to bring consumer credit into the same regulatory regime as other retail financial services. The Government received over 100 responses from a range of stakeholders and indicated that it would announce its decision

68 Ev w5

69 Ev w17

70 Financial Services Authority, A new regulator for the new millennium, January 2000, p 11

on the future of consumer credit regulation later in 2011.[71] This has been subsequently delayed to 2012.

60. The locus of the regulation of consumer credit is a very important consideration in the structure of UK financial services regulation. Over 100,000 organisations are currently licensed under the consumer credit act and subject to regulation by the OFT. [72] A number of concerns have been raised on the floor of this House, in particular about whether this is the right regime for regulating payday lending and other sub-prime lending activity.[73] This sector provides significant short term credit to a large number of consumers, but particularly to those on the fringes of mainstream finance. This throws into sharper relief the balance of power and information between borrowers and lenders.

61. When we asked the Minister whether the Government had decided what to do about consumer credit, Mr Hoban told us he had not.[74] He added :

> It is a different regulatory regime to the one that the FCA will operate, so it is a complex issue that we are thinking about very carefully.[75] [...]
>
> I recognise that the Financial Services Bill is an opportunity to legislate for that, and we will need to think about that quite carefully.[76]

62. Consumer credit legislation is crucial to millions of people. We agree with the Treasury Minister that the Financial Services Bill represents an opportunity to legislate for any changes in the regulation of consumer credit and are disappointed that seven months after the consultation closed, the Government was yet to make up its mind. **We recommend that the Government reach a conclusion soon to give an early indication of its thinking and in good time to include any changes in the forthcoming Financial Services Bill.**

71 For more information see http://www.bis.gov.uk/policies/consumer-issues/consumer-credit-and-debt

72 Q 244

73 For example, debate on Debt Advice and Debt Management on 1 December 2011.

74 Q 243

75 Q 244

76 Q 246

3 Accountability

The importance of accountability

63. As the recent financial crisis has shown, the appropriate regulation of the financial sector in the UK is important for everybody in the country. It is therefore crucial that the regulators not only have the correct remit and powers, but are also seen, in the public interest, to be fully held to account for their actions. By challenging the regulator to explain the reasons for its decisions the quality of those decisions is likely to improve. Better accountability of the FCA can therefore do much more than boost public confidence in the regulator; it can improve the quality of regulation.[77]

64. However the scope for effective challenge is, in practice, limited under current arrangements and this may have contributed to poor regulatory performance both before and during the financial crisis. Fidelity told us that the accountability arrangements for both the FSA and the FCA were "largely ineffective".[78] Yet the FCA will largely mirror the current arrangements under the proposals as they stand.[79] Withers LLP also told us that the FSA had not been accountable enough and that the FCA needed to improve on this:

> The new regulators ought to be subject to an equivalent disclosure requirement as the firms and individuals they regulate to be open and co-operative and to disclose anything relating to the regulators of which the regulated firms and individuals would reasonably expect notice. At present, there is a double standard that the FSA has sought to exploit since it has become more intensive, intrusive and litigious in its approach. In this regard, it would be welcome if the FCA could be required to provide guidance on request so that it is clear what the FCA's expectations are.[80]

Brewin Dolphin, Cazenove Capital Management and Rathbones believed that the FSA's *Approach to the FCA* document did not bode well for its future accountability, and Killik & Co wanted more independent challenge for the FCA.[81]

65. The evidence we have received is supplemented by a wealth of private criticisms of the culture and regulatory approach of the FSA made in private briefings to the Chairman of the Committee by some of the most senior figures in the financial services industry. These people have said that they are reluctant to put their names to criticisms of the FSA on the grounds that it might prejudice their working relationship with the regulator. We appreciate that firms will be reflecting their own interests in what they say, but the scale and substance of the criticisms makes it improbable that they do not reflect an underlying problem.

77 For example, the Treasury Committee overcame the initial FSA reluctance and led to the production by the regulator of a substantive report on the failure of RBS, improving the quality of debate about lessons learnt.

78 Ev 81

79 HM Treasury, A new approach to financial regulation: the blueprint for reform, June 2011, para 2.124

80 Ev w101

81 Ev w110 and w151

66. When we reported on our inquiry into the Retail Distribution Review (RDR) in July 2011,[82] the FSA rejected our recommendation within hours of the embargoed copies of our report being issued. We have since received an apology from the FSA for the handling of this issue,[83] but the fact that a non-elected public body would so hastily dismiss recommendations from a parliamentary Committee raises concerns about the accountability and culture of the FSA.

Membership of the FCA Board

67. The FSA Board consists at present of the Chairman, the Chief Executive, the Managing Director and Interim Managing Director of the Conduct Business Unit, a Deputy Chair and Senior Independent Director, and ten Non-Executive Directors. The membership and functioning of the FCA's Board will be important to the success of the regulator as a whole. The role of the Board in the shortcomings of regulatory performance in recent years is not something that we have been able to consider carefully in the tight timetable provided by the Government.[84]

68. Nevertheless, significant evidence was received on this issue. Aviva told us that:

> The selection process for appointing members to the FCA Board should be transparent. This process should aim to ensure that the FCA Board's expertise covers all financial sectors supervised by the FCA, including insurance and asset management.[85]

It went on to say:

> The FCA should be subject to scrutiny by Parliament; with both the Chair and CEO attending sessions at the Treasury Select Committee who could review performance of the organisation against its strategic and operational objectives. The discipline of attending regular sessions would sharpen focus amongst the Board and Executive Management Team in terms of their roles, delivery and the challenges that exist.[86]

69. Nationwide argued that the appointment of Board members of the regulator should be subject to parliamentary scrutiny:

> The TSC [Treasury Select Committee] should scrutinise the Chancellor's appointments to the Boards of both regulators. The TSC has a veto on the appointment of, for example, the Chair of the Office of Budget Responsibility, but an equivalent check does not appear to have been suggested in respect of the regulators.[87]

82 Treasury Committee, Fifteenth Report of Session 2010–12, *Retail Distribution Review*, HC 857

83 Q 115

84 The FSA's own report *The failure of the Royal Bank of Scotland* (2011) discusses the role of the FSA Board before, during and since the financial crisis (paras 688–697).

85 Ev 77

86 Ev 78

87 Ev w47

70. The role that FCA Board members will play cannot be fully determined until other aspects of the legislation are finalised. Issues of importance will include the extent to which the Board offers external challenge, retrospective review, coordination with the National Audit Office on value for money of the organisation and involvement in key appointments. We will expect to call FCA Board members to give evidence to us. The Board should play an important role and will require high quality people. Following publication of the legislation the Committee will return to this aspect of FCA governance.

The FCA, Parliament, industry and the public

71. Which? wrote to us with specific suggestions to improve the accountability of the FCA from that of the FSA:

> In order to further increase the accountability of the regulators we believe there needs to be greater transparency around the agendas, forward plan and minutes of board meetings to provide full information about when the Board is taking key decisions—though we acknowledge that financial stability considerations may occasionally limit the amount of information which can be disclosed in advance. [...] In addition we believe it would be beneficial if the regulator made itself more available to scrutiny. This could take the form of a monthly question time where senior figures and board members were required to take questions from key stakeholders.[88]

They went on to say:

> In the past it has been very difficult to hold the FSA to account for its decisions and the Treasury has been reluctant to question FSA decisions publicly in order to preserve the appearance of regulatory independence.[89]

72. Brewin Dolphin plc, Cazenove Capital Management Limited and Rathbone Brothers plc told us that the government proposals needed more detail:

> We would prefer the FCA's accountability to the Treasury to be set down in greater detail. In addition, we would favour a greater degree of accountability to the Treasury Select Committee. The FSA's high handed treatment of the TSC's valuable work on RDR and the content of their June 2011 'Approach for the FCA' document, with minimal consultation or justification for the new structure, do not bode well in this regard. [90]

73. We recently held an inquiry into the accountability of the Bank of England. We made several recommendations as a result of our inquiry, but concluded that "it is generally agreed that the accountability process for monetary policy have been effective since 1997. [...] The system of accountability of the MPC [(Monetary Policy Committee)] shows that it is possible to create effective accountability structures while at the same time removing

88 Ev 64

89 Ev 62

90 Ev w39

politicians from day-to-day decisions".[91] We were interested, then, when Lord Turner suggested extending the practices of the MPC to the FCA, saying:

> You can draw the analogy with, for instance, the independence of the Bank of England and the Monetary Policy Committee for setting the interest rate. [...] But the way in which they do that is very clear to the external world because there is a minute of the MPC, which sets out clearly, so that the world can understand, the arguments that were put forward on either side. It deliberately makes transparent those arguments. [...]
>
> We could extend that to the FCA. You could require that FCA board minutes, to a much greater extent than at the moment, where they deal with a direct public policy issue, are published and set out clearly the arguments for and against, in the way that the MPC minutes or the FPC minutes do. You could, as you have not done with the FSA in the past, ask along non-executive members of the board for you to say, "Well, tell me what the debate was about the RDR. Tell me what the debate was about the MMR. Did you receive good enough papers from the Executive to drive that decision?" and so on. [...] I think there are particular ideas that could create a better sense of visibility of the nature of those decisions and of a clear sense of accountability.[92]

The Joint Committee on the draft Financial Services Bill recommended that the FCA be required to "publish Board and Panel minutes and agendas, where possible and appropriate".[93]

74. Full accountability of the regulator will improve the quality of its explanations for decisions to those most affected by them, both the public and the industry. As a consequence, shortcomings in the regulations, and possible improvements, are more likely to be flagged up. The Confederation of British Industry (CBI) believed that the responsiveness of the regulator should go beyond explanation and amount to an enhanced form of accountability to firms. The CBI discussed the distinction between informal challenge and accountability to firms of the regulator:

> The FCA, however, should be more accountable to the firms that it regulates. Firms will frequently challenge decisions informally, and this discussion and debate will help achieve the best regulatory outcomes. Formal challenges to decisions or processes to hold the regulator to account should occur far less frequently, and the bar for their use should necessarily be set high. But they are needed to hold the regulator to account for its actions.[94]

75. The Financial Services Practitioner Panel highlighted the importance of the regulator interacting through representative industry panels and recommended that the interaction be extended to the prudential regulator as well:

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91 Treasury Committee, Twenty-first report of Session 2010–12, *Accountability of the Bank of England*, HC 874, para 29

92 Q 116

93 HC (2010–12) 1447, paragraph 327

94 Ev w42

> We believe that the Practitioner Panels as proposed for the FCA will provide a valuable forum for interaction with industry at an early stage of policy development and to provide high level debate on areas of concern for the industry and regulator.[95]

76. The Financial Services Consumer Panel highlighted the importance of two-way interaction with the regulator:

> It is particularly important that the requirement on the FCA to publish a response to representations received, regardless of whether it is in favour of such representations, is carried forward.[96]

Brewin Dolphin plc, Cazenove Capital Management Limited and Rathbone Brothers plc went on to tell us:

> The FCA should also be accountable to the industry it regulates. This should take the form of a comprehensive quarterly or annual report which would detail the FCA's costs; identification and scale of risk, as well as successes and failures during the period.[97]

77. It is vital that the FCA enjoys the full confidence of consumers, market participants, and parliament which requires proper transparency and accountability. The current legislation does not make adequate provision either for transparency or accountability. To enhance transparency, the board of the FCA should publish minutes of its meetings in broadly the same way as the MPC and using similar criteria (subject to any specific concerns of confidentiality which the Chairman of the Board should raise with the Chairman of the Treasury Committee). It is of course crucial that the FCA is led by an appropriately resourced team of professionally competent and politically independent individuals. To enhance accountability they will be required to give evidence to this Committee and to reinforce the importance of that process the CEO should be subject to pre appointment scrutiny by the Committee. Further the Committee should have the statutory right to make requests for factual information and papers from the FCA Board and to request retrospective reviews of the FCA's (and FSA's) work.

78. The FCA's accountability to the industry should not be of the same type. While necessarily based primarily on legal and statutory obligations**, the FCA's accountability to industry should be supported by a duty on both parties to a high level of engagement and exchange of information.** This is discussed further in paragraph 132 onwards.

79. The industry has complained a great deal about the shortcomings of the regulator in recent years, focusing on alleged unnecessary costs, bureaucracy, high-handedness and an excessively legalistic approach.[98] If Parliament is to respond to these concerns **it is incumbent on the industry to provide the evidence that different regulatory behaviour is in the public and consumer interest. The regulated industry, and particularly the trade bodies, should be more forthcoming about their concerns. A new regulator, led**

95 Ev w7

96 Ev w14

97 Ev w39

98 See paragraph 4

by a new Chief Executive, provides an opportunity for a better relationship—it should be seized.

80. **The Current legislative proposals do not provide adequate accountability, nor the framework for sufficient scrutiny of, and explanation by, the regulator. We therefore recommend:**

- **That the board of the FCA publish full minutes of each meeting.**
- **That the legislation provide that the Chief Executive of the FCA be subject to pre appointment scrutiny by this committee.**
- **That the legislation provide that the FCA Board be responsible for responding to requests for factual information and papers from Parliament.**
- **That the legislation provide that Parliament may request retrospective views of the FCA's work.**

4 The FCA's place in the wider regulatory architecture

Relationship with the FPC and PRA

81. The FCA will be responsible for the regulation of conduct of business, but will need to work closely with the wider regulatory architecture. There is concern that having a regulatory structure made up of three separate bodies (FCA, PRA and FPC) will not be efficient and it may be difficult to maintain strong relationships among the different bodies. The FSA told us of its concerns:

> The draft strategic objective is very broad. The FSA is concerned that this formulation does not adequately capture the distinctive nature of the FCA's responsibilities and that it overlaps significantly with the responsibilities of the PRA and FPC.[99]

82. This was echoed by the Association of British Insurers, who told us that the work of the FPC will have an impact on that of the FCA:

> The FCA will need to form and maintain close relationships with the Bank of England. The FPC's work on macro-prudential measures will impact substantially on the FCA and it must ensure that it is fully involved in the FPC's work (it will not be adequate simply to rely on the FCA's CEO being a member of the FPC). We have a particular concern that responsibility for regulation of clearing and settlement will rest wholly with the Bank of England—this is vital architecture that supports the operation of markets so it requires a close working relationship to be established with the FCA as the regulator of markets. We believe an appropriate specification of shared responsibility, which has precedents in other jurisdictions applying similar twin peaks regulatory model, is needed for the UK.[100]

83. The Government proposes that the Chief Executive of the FCA will sit on the FPC to ensure good coordination between the two bodies.[101] When we asked the Minister whether there should be more structural linkage between the regulators he responded:

> We need to think carefully about the relationship between the FPC and other bodies. We should not think of the PRA reporting to the FPC, as they have very different responsibilities, although there is a shared interest. In the same way, there may well be conduct issues that give rise to a greater systemic risk to the stability of financial services, so that is why it is important that you have the chief executive of the FCA on the FPC, to make sure that link is there.[102]

99 Ev 54

100 Ev w61

101 HM Treasury, *A new approach to financial regulation: building a stronger system*, Cm 8012, February 2011, para 2.78

102 Q 260

84. Coordination between the FCA and PRA is equally crucial. There are some two thousand firms which will be 'dual-regulated', that is, their conduct of business will be regulated by the FCA, while for prudential purposes they will be regulated by the PRA. Angus Eaton from Aviva, one such firm, told us of his concerns:

> I think it is the co-ordination, ostensibly, which is the heart of our concern, from experience in truth. We completely respect the fact that conduct regulation is important and needs to have the appropriate airtime, and indeed we see that as a very important component of our business. With two regulators, and indeed other regulators, balancing that is a challenge for us.[103]

85. Others were even more apprehensive. The Smaller Businesses Practitioner Panel told us that the structure had not taken into consideration the business models of smaller businesses, which would be disproportionately affected as a result:

> The new structure of two regulators as proposed has an inherent danger of overlap and underlap between the regulators. Although there is an overall statutory duty to coordinate, we believe that this split will introduce additional risks and greater costs into the system, which will not necessarily be better for the significant number of smaller firms which will be dual regulated. Firms' business models, particularly for smaller firms, are not split according to prudential and conduct issues. This means that reporting to different regulators on these lines will place a heavier regulatory burden especially on small firms.[104]

86. Martin Wheatley told the Joint Committee on the Draft Financial Services Bill that:

> Our presumption is that we will start with a single rule book from the point of the legal creation of the two organisations, but the reality is that we will be two separate organisations, with two separate sets of objectives operating to two different lines of accountability. Over time it is going to become quite clear that the industry is dealing with two quite separate regulators. While we can try to manage that initially, a single point of contact does not really work if you have two regulators with two different sets of interests.[105]

87. While it is crucial that the two regulators coordinate their work, it is also true that they will, inevitably, be subject to different institutional pressures, as well as statutory obligations. Their regulatory interests will diverge. The MoU between the regulators will therefore be an important document. The Chancellor explained to the Joint Committee that it had not been published because he wanted to take account of recommendations made by this Committee in our Report on the accountability of the Bank of England and by the Joint Committee themselves:

> I took the decision that, given that the Treasury Select Committee [...] only produced their report on all of this on 8 November, if I had rushed out a draft MoU, it would

103 Q 40

104 Ev w26

105 Oral evidence taken before the Joint Committee on the Draft Financial Services Bill on 10 November 2011, HC 1447–xiii, Q 997 [Baroness Wheatcroft]

> have made it clear that I had not had time to digest the TSC report. That is why there is a delay in producing that because I want to take on board the recommendations of the TSC and, potentially, the recommendations of this Committee as well.[106]

88. The Financial Secretary told us that it was important for the MoU to receive adequate scrutiny:

> ... as we take the Bill through Parliament, it is important that the MoUs are exposed so that there is debate and discussion about them, in the same way as we would wish to ensure that most statutory instruments are published in draft during that process as well.[107]

89. The Tripartite system of regulation, consisting of the Treasury, the Bank of England and the FSA, was based on a Memorandum of Understanding. This MoU was supposedly based on the principles of clear accountability, transparency and avoidance of duplication. Under it, the Bank of England was responsible for maintenance of the stability of the financial system as a whole, the FSA for authorising and supervising individual firms, and the Treasury for the legislative and institutional structure of the regulatory system. The financial crisis revealed the weakness of arrangements based on a Memorandum of Understanding. The Treasury Committee in the last Parliament strongly criticised the arrangements.[108]

90. **Given previous unsatisfactory experience of regulators operating within a Memorandum of Understanding, we recommend that the relationship between the FCA, PRA and FPC be set out more explicitly in primary legislation and in as much detail as possible in secondary legislation. This can help to avoid regulatory gaps or overlap. This will also provide greater clarity and should limit the scope for institutional bickering about obligations under the MoU, although with the risk of some loss of flexibility. With that in mind, and given that the shape of the financial services industry and the market conditions is fast-moving, the relationship between the regulators needs to be kept under constant review. It is also important that full consultation takes place. We recommend that the Government's proposals be aired early for scrutiny, and certainly in time for the Committee stage of the Financial Services Bill.**

The PRA veto

91. The Government proposes to give the PRA a veto over the FCA where, in the opinion of the PRA, an action by the FCA may either threaten the stability of the UK financial system or result in the failure of a PRA-authorised person in a way that would adversely affect the UK financial system.[109] This reflects the Government's concern that an action of the FCA in relation to a significant firm (or product) could in theory have a systemic

106 Oral evidence taken before the Joint Committee on the Draft Financial Services Bill on 15 November 2011, HC 1447–xiii, Q 1024 [Mr Brown]

107 Q 261

108 See Fifth Report from the Treasury Committee, Session 2007–08, *The Run on the Rock*, paras 269–77

109 HM Treasury, *A new approach to financial regulation: building a stronger system*, Cm 8012, February 2011, para 2.147

impact whereas it believes it is highly unlikely that an action by the PRA, as micro-prudential regulator, in relation to an individual firm, is unlikely to lead to systemic effects on the protection of consumers.

92. During the course of our inquiry, it has been hard to identify a concrete example of a product that is so detrimental to consumers that it should be banned, but so systemically important to require the veto. When we asked the Minister for examples of situations where this power might be exercised he did not give specific examples but wrote to us after the session to explain the intentions behind the veto:

> The veto serves as a backstop and the Government does not expect its use to be a routine matter. In the event that FCA action is likely to affect the stability of a PRA-authorised firm or of the wider financial system, the Government would generally expect the PRA and FCA to agree a course of action that will enable both regulators to act consistently with their objectives. This could include adjustments to the speed or the manner in which the FCA action is implemented. However, there is a risk that in exceptional circumstance the PRA and FCA may not be able to come to an agreement. In particular, they may not agree as to the level of risk that the FCA action will result in the disorderly collapse of affirm. In this case, the PRA must have a backstop veto power, as it will be the prudential expert on the firms it authorises and have the ultimate mandate to help protect financial stability.
>
> [...] In practice it is far more feasible that the PRA's veto power would come into play because a product that the FCA wished to ban was so fundamental to the stability of a systemically important firm, rather than because the product itself was so important to wider financial stability. Such a scenario is, however, remote, as it is highly unlikely that a PRA-authorised firm would be allowed to rely so heavily on the income from a single (type of) product, especially a product about which the FCA had consumer protection concerns.[110]

93. We received a number of submissions expressing concern that the existence of the veto would lead to the FCA being seen as subservient to the PRA or second class. Which? wrote "we are very concerned about the PRA's power to veto an FCA decision [...] the concept of 'too big to fail' risks becoming extended to 'too big to be forced to treat your customers fairly'".[111] Consumer Focus told us that "we strongly believe that the PRA veto [...] should be deleted in its entirety".[112]

94. We recommended in our Report on the Government's preliminary proposals that any use of the power must be made public, and if this were not possible immediately, the regulatory bodies concerned should write to the Chancellor to notify him and explain the reasons for their difference of opinion.[113] The draft Bill proposes that the PRA must inform the Treasury of any use of the veto. It also requires the PRA to publish its direction to the

110 Ev 87

111 Ev 62

112 Ev 75

113 HC (2010–12) 430, para 133

FCA, although there is an exemption where the PRA considers this would be against the public interest.[114]

95. **We do not believe that the case for a veto over the FCA's powers has yet been made. The Government should publish persuasive evidence to support the need for it if it wishes to proceed with the proposal. If it were to persist with this proposal, we recommend that the Government set out in more detail in legislation the circumstances in which a veto could be used. The veto's use, or threat of use, would be appropriate candidates for retrospective review under the arrangements we recommend in paragraph 78.**

96. By granting a veto right over decisions taken by the FCA to the PRA, the Government risks both the perception and reality that the FCA ranks below the PRA and is a second class regulator. This would affect the FCA's behaviour and ability to do its job effectively. Figure 1 (in the introduction to this report) implies that both the FCA and PRA are subject to direction by the FPC, in which case it would seem more sensible for the power of veto to lie with the FPC. The Investment Management Association told us:

> We have concerns over the veto power given to PRA over FCA (section 3H) and the risks that some banks will be over-protected; if not only through its use, but through FCA's perception of when it might be vetoed. Generally we think the FPC as well as FCA should be consulted before its use; so section 3J(1) needs amending.[115]

97. The Financial Policy Committee will have an overall mandate to consider systemic issues and powers to direct both the PRA and FCA, so it is logical for the FPC rather than the PRA to hold such a veto power which aligns to the existing proposals with its right to direct the FCA on systemic issues. **We recommend that if the Government were to maintain its commitment to a veto, it amend the draft Bill to ensure that the veto power lies with the FPC and may only be used in exceptional circumstances. We also recommend that the Government make provision for the PRA to make referrals in this area to the FPC.**

The European Union

98. The redesign of the UK regulatory framework needs to be considered in the wider EU context. Under the single internal market in the EU, financial services regulation is established at a EU level and cascaded down to member states.

99. As part of the international response to the financial crisis supra-national efforts on financial regulation have sharply increased, both at a global level though the G20 and within the EU. In December 2010 the EU reinforced the European regulatory framework for financial services with the creation of the ESRB and three European Supervisory Authorities (ESAs), namely the European Banking Authority (EBA), European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions

114 HM Treasury, *A new approach to financial regulation: building a stronger system*, Cm 8012, February 2011, pages 88–89

115 Ev w51

Authority (EIOPA).[116] The FSA's own estimate is that around 70 per cent of the FSA's policy making effort is driven by European initiatives and that most elements of the regulatory regime for markets are now established at the EU level. [117] The FSA stated that:

> The FCA will therefore need to prioritise engagement with Europe and particularly the European Securities and Markets Authority (ESMA), which will have a central role in drawing up detailed standards and monitoring the performance of market-facing supervision by national regulatory authorities (see Chapter 6). EU legislative changes in prospect are likely to extend the FCA's market-facing responsibilities.[118]

100. The 'twin-peaks' model of financial regulation that is set out in the draft Bill does not align directly with the EU model of three regulatory authorities. The three EU supervisory authorities will have responsibility, in varying degrees, for both prudential and conduct issues for their market segments; whereas the PRA will be the micro-prudential regulator for systemic financial institutions—banks, buildings societies, certain brokers and insurers—and the FCA will both be a market wide conduct regulator and micro-prudential regulator for less systemic institutions.

101. The Government intends that the PRA will sit on the EBA and EIOPA, and the FCA on ESMA. They will co-ordinate their work under a Memorandum of Understanding to ensure that the UK's interests are adequately represented at a European level. During our inquiry we have received evidence voicing concerns that more work needed to be done to ensure that the UK continued to be represented with a strong voice in Europe. APCIMS wrote to us that:

> The FCA must be involved sufficiently far upstream to influence ideas and processes at their inception, when there is enough fluidity to allow for inputs from different sources, if it is to minimise the risk of being caught later by potentially disadvantageously legislative proposals when room for manoeuvre is less [...] The FCA must be empowered to deal adroitly with the ESAs and to develop a relationship with them that enables it to exert maximum influence, especially over regulatory policy formulation and rule making, within the new legal framework.[119]

102. Particular concerns have been raised by the insurance industry, where many firms will be regulated by the FCA both for conduct and prudential matters but where representation at a European level is through the PRA. Specific concerns were raised in relation to conduct issues. The London and International Insurance Brokers Association wrote:

> We have serious concerns that the "twin peaks" approach will weaken the UK's voice in the European Supervisory Authorities. EIOPA remains responsible for insurance intermediaries but it is clear that the PRA will represent the UK. It is essential that the FCA is not regarded as a junior partner and adequate arrangements are made to

116 More information about the establishment of the ESRB may be found at: http://www.esrb.europa.eu/about/background/html/index.en.html

117 FSA website – http://www.fsa.gov.uk/pages/About/What/International/index.shtml

118 Financial Services Authority, *The Financial conduct Authority: approach to regulation*, June 2011, para 5.23

119 Ev w58

> ensure the FCA plays a full role in EIOPA's work on all issues affecting intermediaries.[120]

103. Concerns have also been raised about the risk of dilution of the UK's influence at a European level as a result of the loss of a number of senior staff from the FSA who previously sat on these committees. The Association of British Insurers added "this is likely to require new skills on the part of UK representatives on the ESAs—negotiating and influencing skills and a higher level of political awareness will be needed in addition to a high degree of technical skills".[121] When we asked Mr Sants about this he told us:

> Some of the turnover in our senior staff has undoubtedly affected our representation on some of the key regulatory committees, because those are elected roles by the European regulatory community and they are elected on a personal basis, so if they leave the organisation the FSA does not automatically have the right to reappoint somebody to those roles. So the process of splitting up the FSA, which has been the cause of some senior people leaving, has been somewhat disruptive to our representation ability. [...]
>
> In the longer term, I am content that the Bill and the supporting documentation does have clarity of responsibility for who is leading the process of representation on the key European regulators; the PRA, as you know, in respect of insurance and banking, and the FCA in respect of securities. There obviously will be the need to co-ordinate between the PRA and the FCA, as indeed at the moment, for example, there is the need on the EIOPA, the insurance one, which I represent on the management board. I have to co-ordinate with the pension regulator, which I think we do pretty well, and there is a need for us already to co-ordinate with the FRC and so forth in respect of ESMA. So co-ordination within the UK regulatory community is nothing new. We will have to make sure we have set up the right processes to do that.[122]

104. When questioned on the memorandum of understanding Lord Turner, Chairman of the FSA, told us:

> I cannot see a better way of doing that than through having a memorandum of understanding [...] this would not surprise you—is that whatever you write down in the memorandum of understanding, what really matters is the degree of interface and working relationships between the individuals involved. I think it will be absolutely essential that the PRA and FCA, even when they have split up, are continually in a relationship where people know each other, talk to each other, and so on.
>
> I think one of the surprising things, frankly, in retrospect, when banking supervision moved out of the Bank of England into the FSA is that although the FSA's banking supervisors were primarily people who had come from the bank, there was a great deal of, "Well, we are now a separate institution and we are not going to talk to you

120 Ev w81

121 Ev w62

122 Q 140

closely, except to the extent that we formally have to". We have to avoid that in the FCA/PRA relationship.[123]

105. While we agree with those who emphasise the importance of relationships between the regulators over and above a form-driven exercise, we note the need to fashion the right structural relationship for that co-ordination over the long term. It is essential that the design of this relationship mitigate the inevitable divergence in direction and weakening of relationships over time as personnel change and the UK authorities increasingly focus on their specific mandates.

106. **A Memorandum of Understanding is unlikely to be the appropriate method to establish the basis of co-ordination between the PRA and FCA in respect of their seats at the EBA, ESMA and EIOPA. We recommend that the Government consult on the appropriate level of co-ordination and set this out in secondary legislation in order to ensure both adequate scrutiny of the basis on which the two regulatory authorities will co-ordinate, and legal clarity about how they should do this. We further recommend that the Treasury take steps to ensure that the impending change to the FSA does not lead to a fragmentation of UK representation in the EU, and that the UK's market position in the provision of European financial services be given an appropriate level of consideration within each of the ESAs.**

123 Q 141

5 How the FCA should approach its work

Supervisory Approach

107. In June 2011, the FSA published *The Financial Conduct Authority: Approach to Regulation*. The introduction sets out that it was "designed to set out how the Financial Conduct Authority [...] will approach the delivery of its objectives" and that it "outlines initial thinking which will be further refined in the period between now and end-2012".[124] When we asked Martin Wheatley about the document he told us that "I was part of the production of the document—even though I had not taken up post",[125] and that:

> I think it is fair to say that the document is setting out our early stage thinking as to how we think the FCA will operate, and clearly it is setting that out with some idea of the legislative framework but without absolute certainty of it. It was a document to promote debate, and I think we have had a very good discussion with the industry. It is not a final blueprint.[126]

We consider aspects of the FCA's proposed new approach and powers in greater detail below.

A single supervisor across different areas

108. The FCA will be responsible for micro-prudential supervision of 24,500 firms across a wide variety of sub-sectors including personal investment firms, insurance intermediaries, mortgage intermediaries, investment managers and many others; it will also be the conduct authority for over 27,000 firms which additionally include retail and whole banking, investment, securities and insurance markets.[127] The concept of a regulator supervising many different sub-sectors of the financial services industry is not new. It is the current arrangement under FSMA, where much detailed regulation is given effect by the FSA's detailed rule-making powers, subject to their duty to have regard to proportionality.[128] This duty will be carried over and the FCA will operate under a number of regulatory principles, including that the burden imposed should be proportionate to the benefit obtained.

109. During the course of our inquiry we have heard concerns from a number of witnesses that the FCA will adopt too much of a "one-size fits all" approach to regulation. The Building Societies Association stressed the need for further consideration and "careful planning to ensure that the new FCA's approach to conduct of business regulation is effective, fair and proportionate and, in particular, that smaller firms are not disproportionately affected by regulatory burdens".[129] Killik and Co told us that "we would

124 Financial Services Authority, *The Financial conduct Authority: approach to regulation*, June 2011, page 3

125 Q 53

126 Q 52

127 Financial Services Authority, *The Financial conduct Authority: approach to regulation*, June 2011, tables 1–3

128 Financial Services and Markets Act (2000) Paragraph 2 (3) (c)

129 Ev w82

like to see the FCA developing a deeper understanding of the firms it regulates and were curious as to how this would be achieved within a programme to reduce direct contact".[130]

110. **While it would be impracticable and inefficient to seek to legislate for the detailed regulation for every subsector, there is an opportunity to consider a more explicitly differentiated regulatory approach between the broad classes of regulated activity and specifically between retail, professional and wholesale financial services. We recommend that the Government examine the scope for differentiating between classes of financial services activity, for example by distinguishing between the FCA's mandate and powers for retail financial services, services for professional clients and wholesale financial services.**

Supervising themes or firms?

111. The FSA sets out in the June 2011 document that "the delivery of high-quality information-gathering and business analysis will be central to the success of the FCA. It will form the basis of the FCA's decisions on where to intervene and which tools to use".[131] It elaborates on this as follows:

- Forward-looking and preventative: the FCA will design an approach that includes enhanced sector and cross-sector analysis, use of market and consumer intelligence and regular engagements with external stakeholders who can provide early insights into potential conduct problems. Through this and through firm-specific and thematic work, the FCA will aim to identify the root cause of problems and intervene promptly to address these in the most effective way. The effective use of data will improve the FCA's supervisory approach and to that end it will look at measures to ensure the accuracy of the data it receives from authorised firms.

- Regulatory contact: The FCA will aim to have direct regulatory contact with all firms through an approach that will be differentiated according to how the FCA categorises firms but with elements of consistency across them. Overall, the number of firms supervised on a 'relationship mandated basis' will be significantly reduced; the FCA will build on the FSA's small firms supervisory approach and apply it across a wider range of firms. This approach will use regulatory returns, thematic work and generic (sector-focused) profiles. At the larger end of the firm spectrum, the FCA will build on recent work that focused on using business model analysis to identify drivers of conduct risk for firms and sector. This, again, will be supplemented by a greater use of thematic work around regulatory priorities."[132]

112. We have received evidence from market participants expressing concerns that, for many firms, their existing contact with the FSA is unsatisfactory. We have heard that it "does not pay" for a firm to contact the regulator. While the experience of individual

130 Ev 70

131 Financial Services Authority, *The Financial conduct Authority: approach to regulation*, June 2011, para 5.2

132 *Ibid*, para 5.12

concerns may often be motivated by vested or commercial interests, it is not easy entirely to dismiss the weight of concerns expressed. Among many concerns, a number of witnesses have told us that there is no incentive for close communication with the regulator. The regulator may take a high-handed approach or respond very slowly. Brewin Dolphin, Cazenove and Rathbones posed the question:

> Why would a firm call the FCA contact centre to discuss an issue (in the knowledge that there is a strong chance that the FCA staff member will not understand the firm, its sector and the context) given that there is a higher likelihood of being referred to enforcement and the issuance of a public statement prior to an investigation?[133]

113. There also appears to be some frustration across the industry that there are too many new rules and communications from the FSA with little clarity as to their relative importance. The difficulty of communication and obtaining guidance may only get worse as the FCA moves to a more centralised approach and the level of regulatory contact is diluted further. Brewin Dolphin, Cazenove and Rathbones went on to say:

> It seems that the interpretation by the FSA of the Treasury's proposed principle are tending towards a rather aggressive, one size fits all structure that will replace face to face regulation with call centres and an academic and mechanical approach. We think this is unlikely to offer an improvement on the status quo or better outcomes for investors.[134]

Killik and Co wrote:

> We would like to see the FCA developing a deeper understanding of the firms it regulates and were curious as to how this would be achieved within a programme to reduce direct contact. Perhaps an element of self-regulation could be considered here to bridge the knowledge gap. If a way could be found to bring about greater involvement of recently retired professionals, for example, these would be people with the knowledge and experience to comment meaningfully on new proposals and products. If such a panel of advisers to the FCA could be created, it may mean that FCA can obtain an increased understanding of the firms it regulates without as much direct contact.[135]

114. It is proposed that a large proportion of the regulatory analysis will be conducted by the business and market analysis team. This team will be crucial to the thematic work of the FCA, especially given the proposal to reduce the number of "relationship-managed" firms.[136] It is proposed that:

> Central to the FCA's decision-making process will be a senior level, high quality, business and market analysis team. This team will provide the thorough analysis required to understand how markets work and how they interact with consumer behaviour. It will identify the features of industry economics (such as very high

133 Ev w39

134 Ev w38

135 Ev 70

136 Financial Services Authority, *The Financial conduct Authority: approach to regulation*, June 2011, para 5.12

returns on particular products) which may indicate or create incentives for actions detrimental to consumer interests. Its analysis will underpin decisions on where and when to intervene and how an intervention will affect the market as a whole, including competition.[137]

Despite the concerns raised by some respondents, Philip Warland of Fidelity Worldwide told us that an increased focus on thematic work through the business and analytics group was "not a bad way to go".[138]

115. **The FSA's proposals for the FCA to build up a central business and market analysis team present an opportunity to enhance the quality of regulation in a cost effective manner. The FCA must ensure that, in adopting this model, those developing policy are not divorced from the reality of the industry. We recommend that the FCA maintain a proportionate level of contact across all industry sectors, not just the largest ones or those from a particular sector, and that the FCA consult the industry on how it can improve its relationship with non-relationship-managed firms in a cost-effective manner. We also recommend that the FCA take steps to enhance the level of support available to firms to understand and implement new rules**.

Balancing benefits and costs and the regulatory ratchet

116. During our inquiry into the Government's initial proposals it became apparent to us that the cost of regulation was a major concern for the financial sector.[139] During the course of this inquiry firms reiterated their concerns and several wrote to outline the scale of the cost of regulation. A number requested that evidence relating to a particular firm be kept confidential.

117. While many of those giving evidence to us have focused on the cost of regulation, it is also important to remember its benefits. The recent banking crisis illustrates the need for strong micro-prudential supervision of financial institutions, as well as the shortcomings of FSMA. Similarly the widespread consumer detriment (for example from mis-selling of endowments, Payment Protection Insurance (PPI) etc.) and compensation costs to the Treasury (e.g., Equitable Life) starkly illustrates the need for strong conduct regulation.

118. There are broadly two types of cost of regulation to a firm—direct and indirect. Direct costs are the fees and levies paid by the industry, such as the fees to the FSA and the levies for running the Financial Ombudsman Service (FOS), Money Advice Service (MAS) and the Financial Services Compensation Scheme (FSCS). Indirect costs are much more difficult to define and quantify. These include the incremental costs of compliance: running compliance functions and monitoring programmes, costs of training and the hard to quantify but often substantial cost of diverting management and employee time from other productive activities. There are also the demands on senior management time, both in engaging with supervisory authorities as part of their continuing relationship and

137 *Ibid.*, para 1.19

138 Q 34

139 Treasury Committee, Seventh Report of Session 2010–12, *Financial Regulation: a preliminary consideration of the Government's proposals*, HC 430–I

significantly over recent years in engaging with regulatory authorities on a plethora of new discussion papers, consultation papers and other initiatives.

119. In our previous report we recommended that the regulatory bodies revisit the issue of cost of regulation, in the light of the financial crisis and the changes in regulatory structure.[140] A recent report on a survey of both industry and regulatory bodies by Charles River Associates (CRA) for the International Regulatory Strategy Group found that:

> During the course of interviews, the industry has been very clear about the importance of high quality impact assessments and effective consultation processes [...] the fact that the industry has raised these issues is a reflection of their anxiety that these elements are being downplayed within the new UK bodies. While industry and regulators are agreed that there is little advantage in consultations that produce mountains of paper but little strategic content, the continued use of the "judgement-based" phrase was interpreted as implying that regulators would increasingly decide on issues without conducting consultations.[141]

Earlier in its report CRA cited concerns of "a 'water-bed' effect in which a pushing down on rule-making flexibility simply leads to an increase in supervisory activity" and of the "relative opaqueness" of the supervisory approach. They noted that "no cost benefit analysis was conducted on the change in approach to be more 'judgement based'".[142] APCIMS agreed that the FSA had failed to conduct sufficient analysis of the costs or benefits of new regulation, relying on firms to complete an inappropriate questionnaire:

> The current approach often results in the FSA drafting a questionnaire which is sent to firms to complete. In drafting the questionnaire the FSA appears not to have visited any firms to gain an understanding of the cost base of different business models, gauge whether such data requests are achievable and to check whether data is relevant for the different business models subject to the proposals. The explanatory notes are often inadequate, the timescale to submit data is often too short and there is no point of contact for firms who have queries; consequently the level of responses to such questionnaires is low.[143]

120. The Smaller Businesses Practitioner Panel set out a number of concerns about the growing cost of regulation and the lack of effective cost control both within the regulatory bodies and in terms of the cost of regulation to firms:

> There is a danger that any increase in regulatory cost and burden, along with other current changes in the regulatory landscape taking place as a result of European requirements and the RDR, will undermine the viability of many smaller financial firms going forward.[144]

140 *Ibid.*, paras 140–141

141 The implications of the New Financial Regulatory Architecture: Prepared for the International Regulatory Strategy Group by Charles River Associates, Section 2.4

142 *Ibid.*, section 2.3

143 Association of Private Client Investment Managers and Stockbrokers, *APCIMS Response to The Financial Conduct Authority: Approach to Regulation*, section 9

144 Ev w25

Brewin Dolphin, Cazenove Capital Management and Rathbones told us:

> In recent years, the cost and complexity of regulation and red tape has increased substantially. It now represents around 5 per cent of our turnovers.[145]

The Association of Independent Financial Advisors added:

> The costs of coping with FSA regulation appear to keep rising. Furthermore, regulation under the FSA has been characterised by a considerable number of waves of different requirements with the result that a degree of regulatory fatigue has set in. The combined effect of these two factors is to drive members out of the market which acts to the detriment of consumers. [...] more weight should be placed upon the overall cost burden on firms.[146]

121. APCIMS gave us a worrying description of the current cost-benefit analysis process undertaken by the FSA:

> APCIMS has identified key policy initiatives where the FSA has, in our view, failed to meet their obligations to conduct a proper cost benefit analysis and have not adhered to their own published guidance. [...] The FSA consistently fails to identify IT costs associated with their proposals.[147]

122. Too often the FSA's current approach to cost benefit analysis has appeared to industry participants to be an afterthought perceived as being an ex-post exercise to justify a policy decision already made rather than a meaningful dialogue to elicit an understanding of the true cost and benefits of a proposed regulation. The impact of regulatory costs ratcheting ever higher is more expensive products and increased financial exclusion. Brewin Dolphin, Cazenove Capital Management and Rathbones told us that "in reality the barest minimum investment for the services and investment advice we provide is now well over £100,000".[148] Philip Warland, Head of Public Policy, Fidelity told us:

> The FSA has always treated us as an investment bank when we are not. We are an agency business. So our cost of capital has gone up 10 times in the last three years and our total costs of internal compliance have gone up 70%. We think that is wholly unnecessary and we don't believe they understand our business model.[149]

123. It is an inherent risk that a regulator will feel incentivised to focus on minimising the risk of regulatory failure without due regard to cost. The consequence may be to create a large body of onerous regulation. The cost of regulation is a major issue for many firms and ultimately becomes a cost for the consumer both in terms of price and impaired innovation and competition.

145 Ev w37

146 Ev w54

147 Association of Private Client Investment Managers and Stockbrokers (APCIMS), *Response to the Financial Conduct Authority: Approach to Regulation*, August 2011, section 9

148 Ev w37

149 Q 19

124. **We reiterate the recommendation in our report on the Government's initial proposals that, once the new regulatory architecture has been set up, the PRA and the FCA should revisit the tools it uses to examine the cost and benefits of regulation.[150] In doing this the FCA will need to challenge current FSA practices. It should consider how it ensures that the cost of regulation is examined at an early stage in policy development. Subsequent reassessment should not be treated as a tick-box exercise or afterthought. The FCA should design cost-benefit assessments that increase the level of engagement between the regulator and the regulated and improves the quality of the information that the FCA receives in undertaking their cost-benefit analyses. The Government should include in the Bill requirements for far more extensive cost-benefit analysis and consultation with firms, representative bodies and panels prior to the introduction of new regulation.**

Staffing the FCA

125. To be an effective regulator, the FCA will need to recruit and retain effective staff. Lord Turner told us that the FSA (and the FCA in the future) was not dependent upon the Government for funding, but used its levying powers over the industry. He stressed the importance, therefore, of "striking the balance between the clear desire to have a cost-efficient organisation and the fact that we need to pay appropriate salaries to attract good people". [151] Lord Turner said that currently the FSA is able to attract "good quality [staff] from outside" the FSA.[152] Hector Sants, however, told us that while the pinch-point for "retention through pay is not for the more senior people", the FSA's "area of challenge is people who have been with us for three to five years who have then used that experience to get a higher salary in the private sector". [153]

126. The Financial Services Practitioner Panel did not agree that all was well at the top of the regulator:

> Our main area of concern has been with the loss of senior staff from the FSA during the transition period and we have raised this recently with the Chief Executive and Chairman of the FSA. It will be crucial to the success of the FCA that it is able to recruit high calibre and effective people to its senior management positions.[154]

127. We heard evidence that staff retention was a problem at the FSA. Lord Turner told us that "it is also true that while complaining about the quality, they [regulated firms] also sometimes nick them". As we said at the time, we are aware that 'poaching' of the highest quality of staff is an enduring problem for all Government agencies. However, we accept that, at the FSA, this is more or less inevitable because of the potential for severe reputational risk, with no redress, which may result from making a mistake with the regulator. There is significant incentive, therefore, for firms to attract experienced regulators to reduce this risk. This is often held to be an intractable problem, to some

150 HC (2010–12) 430–I, para 140

151 Q 131

152 *Ibid.*

153 *Ibid.*

154 Ev w7

degree assuaged by the thought that it is desirable for firms to have high quality compliance departments and internal regulatory practices.

128. However Sir Mervyn King, Governor of the Bank of England, gave evidence to the Joint Committee on the Financial Services Bill on the subject of attracting quality staff to the public sector. When talking about prudential regulation, he told the Committee:

> People often say that you will have to pay vast sums of money to get people to come and be regulators. I do not believe that is true, and if you do pay vast sums of money you get the wrong people. We want to demonstrate that in the Bank of England it is possible to have a public service career where you specialise in being an effective regulator. [...] It is very striking that in other industries the regulators are not people who take secondments from the industry or have had a career working in the industry; they have expertise as regulators. That is the kind of people we need in the Bank of England.[155]

129. Several industry representatives told us that lack of staff retention at the FSA affected the quality and cost-effectiveness of regulation. The Investment Management Association told us that this had been the case in the past:

> High turnover of FSA review teams was seen as adding substantial cost to the process in terms of re-educating new teams and providing documentation.[156]

130. Brewin Dolphin plc, Cazenove Capital Management Limited and Rathbone Brothers plc told us that they were also concerned about the quality of FCA staff in the future:

> We have concerns about cost control at present within the FSA and fear that the focus is too much on reorganisation rather than effective regulation and restructuring, which risks further regulatory failure. There is some evidence that the best staff are leaving the FSA to join the private sector and that some joining the PRA leaving the FCA with the 'rump'.[157]

131. **The evidence we have received from industry highlights concerns regarding staff turnover and the problems of staff retention. While the Governor of the Bank of England has expressed a high-minded view of the motivation of public service this appears to be at odds with the evidence from both Lord Turner and Hectors Sants as to the problems the FSA faces with retention of key staff at certain levels. This is concerning. The Committee recognises the inevitable risk of poaching: the reputational risk of being the wrong side of the regulator is so great for many firms that they will be prepared to bid up the market price to recruit the best regulatory staff. No solution has been provided to us, but some action may help. The FCA should produce and publish a coherent and sustainable plan for attracting and retaining the brightest and the best staff.**

155 Oral evidence taken before the Joint Committee for the Draft Financial Services Bill on 3 November 2011, Q 846 [Baroness Wheatcroft]

156 Ev w115

157 Ev w40

Communication between the regulator and firms

132. As discussed in paragraph 79, effective communication between the regulator and the regulated firms is crucial. The FSA's document outlining the FCA's approach to regulation states that:

> [The FCA will] be more outward-looking and engaged with consumers than the FSA has been, (providing more consumer-oriented and more effective communications) and better informed about their concerns and behaviour where this is relevant to regulatory action.

133. Several representatives from industry agreed that the FSA's dialogue with industry has been unclear in the past. Aviva told us that the manner of communication of regulatory material was important, as was consistency and stability in the regulatory field:

> A very important way in which a regulator can be effective is by acting consistently and valuing stability. This consistency enables firms to comply with relevant rules in an efficient manner. We understand that the FCA will need to change rules to tackle emerging risks, but these changes must be done in an orderly way, with advanced notice, as uncertainty can lead to unnecessary costs.[158]

Other representatives from industry agreed. Paul Killik, of Killik & Co, told us that good analysis depended on good dialogue:

> Analysis doesn't work at one level unless you are actually working with the industry itself in understanding it, and they have shown a distinct lack of interest in having a dialogue with the industry; at least that has been our experience.[159]

134. The Building Societies Association told us of the ineffective culture of "regulation by speech", saying:

> Currently, speeches by senior FSA staff, although explicitly not binding, may nevertheless be taken into account in enforcement actions. While regulated firms should of course read and digest relevant speeches by the regulator as far as practicable, speeches are not an appropriate medium for delivery of binding regulatory material or even formal guidance. [160]

135. **We note that the proposed approach of the FCA that the number of firms supervised on a "relationship managed basis" will be significantly reduced. We heard from some representatives of industry that the lines of communication between the regulator and regulated firms, in the past, have not been effective. It is essential that the FCA improves this, as far as its resources allow.**

136. **We recommend that greater steps be taken to ensure that when formal regulatory material is released by the FCA it is clear to firms what is expected of them. The culture of "regulation by speech" should be discouraged and if regulatory material is released**

158 Ev 78

159 Q 2

160 Ev w84

in this way the regulations concerned should also be clarified at the time, and in adequate detail, to all firms affected. Regulated firms need to engage positively and constructively with the FCA. It is also important that, where firms consider unreasonable or disproportionate requests have been persistently made, they notify their trade bodies and, in serious cases, be able to inform the practitioner panels and the FCA's non-executive directors. Ultimately firms would be able to bring the behaviour of the FCA to the attention of Parliament via this Committee.

137. **In general we were disappointed by the FSA's document outlining the proposed approach for the FCA. We are concerned that the document outlines an inappropriate culture for the FCA, one that may allow some old and inappropriate practices and culture from the FSA to be replicated. The FSA's *Approach to Regulation* document is, in effect, a charter for the FCA's future approach. Its lack of detail and substance demonstrates the amount of work required to get the legislation right. We welcome the scope for a fresh approach to be taken implied by Mr Wheatley's evidence. We recommend that the FSA/FCA publish a much more detailed consultation paper setting out its intended approach, together with full supporting explanations. Further formal public consultation is also required.**

6 New powers

New Powers over conduct regulation

138. In the preface to the draft Bill the Government states:

> At the heart of the Government's proposals will be a more proactive approach to conduct regulation, with a clear focus on consumer outcomes. The Government welcomes the significant progress recently made by the FSA towards a more pre-emptive and intrusive model of conduct regulation, and looks forward to the publication of the FSA's launch document for the FCA in June.[161]

139. The Bill goes on to set out specific powers in relation to: product intervention, financial promotions powers and the early publication of disciplinary action (early warning notices). We consider these in more detail below.

Product intervention

140. It is proposed that the FCA have power "in product intervention [and] to direct firms to withdraw or amend mis-leading financial promotions with immediate effect".[162] The FSA has said that the product intervention and financial promotion powers are intended to "enable the FCA to act, and be seen to act, more swiftly to prevent retail consumer detriment".[163]

141. We have received mixed evidence on this proposal. Some industry representatives told us that for the FCA to take a more interventionist approach was not appropriate. For example, the Confederation of British Industry believed that such an approach would result in reduced innovation, although they did concede that:

> There might in theory be circumstances in which product regulation could be effective if used selectively, but they would be extremely limited. [...]
>
> Product regulation powers otherwise have the potential to reduce the availability and variety of products for consumers as firms become less likely to invest in developing innovative products or believe they will be penalised or restricted from developing products which do not align with criteria imposed by the regulator.[164]

This was echoed by AXA, who told us that:

> We are not in favour of the regulator being involved in product design or stipulating mandatory minimum standards. We think this should be reached through industry level agreement and codes of practice. Regulatory involvement in product design could also stifle innovation and the competitive market place. We are also concerned

161 HM Treasury, *A new approach to financial regulation: the blueprint for reform*, June 2011, p 30

162 Financial Services Authority, *The Financial conduct Authority: approach to regulation*, June 2011, para 1.9

163 *Ibid.*, para 4.1

164 Ev w43

> this power may create an uneven playing field where products are being sold in the UK by an EU entity on a cross border basis.[165]

142. Other industry representatives, however, were more supportive of intervention by the regulator. Philip Warland, of Fidelity Worldwide, told us:

> We in Fidelity do believe that strong intervention is needed. I think that the litany that the Chairman of the FSA talked about last week at the Mansion House dinner—£15 billion of redress over a period—just suggests that something isn't working. What they have done up until now is largely looked at how products are sold, how they are advised, and never really got involved in the governance of the product, what the product was aiming to do and was it aimed at the right target market.[166]

143. Consumer groups were generally supportive of the proposed interventionist approach to regulation. Peter Vicary-Smith, of Which?, told us the product intervention was necessary because of market-failure in financial services. He said:

> If we had a well-functioning market, we would not need to intervene against products in this way, because we don't recommend that kind of intervention in other marketplaces. It is because products are often poorly designed and then poorly marketed that we think these powers are necessary here.[167]

144. Consumer Focus largely agreed, but argued that the proposals do not go far enough:

> We strongly support extended powers to ban or place conditions on products, ban misleading advertisements, and publish warning notices. [...]
>
> But we think the proposed powers could, and should, be enhanced further still. [...]
>
> The areas where we believe stronger or clearer FCA powers could further reduce the chance of consumer detriment [include]: [...]
>
> - Stronger powers on disclosure of enforcement action
> - The removal of the regulatory principle of consumer responsibility which attempts to transfer responsibility from firms to consumers
> - The powers to undertake market studies where it does not believe markets are functioning in the consumer interest or where effective competition could be improved. [...].[168]

145. **It is crucial that the potential risks and benefits of products are properly understood. The case has not been made that the FCA will necessarily understand a new product better than a firm. We are mindful of the risks that product intervention can pose to competition and innovation. The FSA has been criticised in the past for**

165 Ev w33

166 Q 1

167 Q 178

168 Ev 74

being too slow to intervene and we welcome the FCA's willingness to respond quickly to issues of consumer detriment. We support the need for judgement-led product intervention by the regulator. We recommend that clear guidance be issued to firms when such powers are used. Their use should be sparing and the merits of each case very carefully considered before intervention. We reiterate our recommendation about the need for greater communication between the regulator and the firm concerned. This should reduce the need for such intervention.

The need for more intervention?

146. The rationale for a stronger conduct regulator has been made in response to a number of spectacular regulatory failures over recent years, including the mis-selling of pensions and mortgage endowment policies in the 1970s, '80s and '90s and the recent scandal concerning PPI. The Government's intention is to create a conduct regulator that will be more proactive and have powers to take early action to stop consumer detriment.

147. During our inquiry the consumer groups have emphasised the need for a more proactive and empowered conduct regulator. The Citizens Advice Bureau said:

> There is an explicit recognition in the draft Bill and supporting documents that persistent and widespread consumer problems in the financial services sector are rooted, at least in part, in regulatory failure. This is illustrated in the FSA's Approach to regulation document that starts by recognising the low level of confidence in the financial services sector and how "conduct issues since 1990 have been a major factor in this". The FSA also reflects that it has not always been quick enough or tough enough to prevent or control consumer detriment. For instance, the regulator concludes on PPI mis-selling that "stronger action sooner could have limited the growth of the problem."[169]

148. There is a clear need for a greater level of proactive intervention by a consumer focused financial services regulator. The ICAEW summarised the current situation as one where:

> Trust in the sector needs to be improved given the history of mis-selling and poor service standards. The volume of complaints received by UK financial services firms amounted to over 1.8 million in 2011, half of which were upheld. These outcomes are profoundly disappointing after around 25 years of formal regulation. They are bad for consumers, but also the many firms in financial services which are run on sound lines yet become grouped with those which are not.[170]

149. A number of submissions from industry groups offered qualified support for the additional powers. The Financial Services Practitioner Panel wrote:

> We acknowledge that it will be useful for the FCA to have tighter powers to control any product that can and does do harm.[171]

169 Ev 49

170 Ev w63

171 Ev w7

Philip Warland, Head of Public Policy, Fidelity agreed that:

> We in Fidelity do believe that strong intervention is needed. I think that the litany that the Chairman of the FSA talked about last week at the Mansion House dinner—£15billion of redress over a period—just suggests that something isn't working.[172]

150. **We recommend that the FSA place its more detailed proposals in the public domain and facilitate proper public scrutiny of its plans.**

Early Warning Notices

151. The Government proposes to give the FCA the power (but not the duty) to disclose the fact that a warning notice has been issued to a firm—an *early warning notice*. The draft Bill sets out amendments to FSMA section 391 and makes is subject to a safeguard that the FCA can only publish a warning notice "after consulting the persons to whom the notice is given or copied" and stipulates that "The FCA may not publish information under this section if, in its opinion, publication would be [...] unfair to the person with respect to whom the action was taken (or was proposed to be taken)".[173] The FSA set out in its paper that:

> The FCA will also intervene where the product may be well known and of utility to consumers but the sales and distribution process of a firm does not meet regulatory standards and consumer detriment is occurring. Where the FSA has typically allowed firms to continue to market and sell products alongside programmes to remedy poor practices, the FCA may not. When the firm is a major supplier of a product which is commonly sold to consumers, the consequences of such action, which could disrupt consumer choice or access, will be weighed against the benefits of preventing further consumer detriment. [...]
>
> If this provision is enacted, the FCA will need to balance the advantages of openness with the need to respect private rights and due process. In this context, the government has indicated that there will be a requirement to consult the person concerned before issuing any information about the warning notice. This should ensure that account will be taken of, for example, any reputational damage which could occur as a result of publication of the information.[174]

152. When we asked the FSA about this Margaret Cole indicated that the FSA view on this as:

> A rather small move on what I will call the transparency dial, if you like—the balance between fairness to individuals and firms and the public policy considerations around protection of consumers and putting as much information as possible into the public domain.[175]

172 Q 1

173 Draft Financial Services Bill – Schedule 8, Part 6, Paragraph 24

174 Financial Services Authority, *The Financial conduct Authority: approach to regulation*, June 2011,paras 4.15 & 4.5

175 Q 136

But she went on to tell us that the FSA would prefer to remove the requirement to consult:

> the proposal at the moment is that we should consult with the party that we are bringing the case against in every case where we might be going to publish a warning notice. We think that effectively undermines the power, because in each case there will be an argument and satellite litigation over whether we can publish the warning notice—arguments being to do with reputation.[176]

153. This position received support from the Financial Services Consumer Panel who wrote to us that:

> We support the new power to enable the FCA to disclose the fact that a warning notice has been issued in relation to proposed disciplinary action, but we believe the requirement for the FCA to consult those involved—implying that the subject's consent could be required for publication—should be clarified to allow immediate publication without consultation where it considers there is a risk of consumer detriment. Without such a change the requirement to consult and allow representations could slow the entire process and lead to consumers continuing to make potentially irreversible decisions based on unsuitable or incomplete information, depending on the nature of the disciplinary issue.[177]

154. The consumer groups were clear in setting out that it was important that the FCA could issue an early warning notice in relation to an investigation which may take many years to take through the later stages of enforcement when meanwhile there may be considerable ongoing consumer detriment. Gillian Guy, Chief Executive of the Citizens Advice Bureau, told us:

> It is not seen as, "Well, let's wait and see what happens." It is actually that there needs to be a warning out there to stop the product going further.[178]

155. We received a considerable amount of written evidence from industry expressing significant concerns. Objections to the proposals were principally raised in respect of the potential reputational impact of an early warning notice on the firm concerned which could lead to lasting damage to a firm with no ability to seek redress from the FSA. There were also worries about consistency with natural justice. The Building Societies Association told us:

> Advance publication of *proposed* enforcement action risks a new presumption of "guilty until proven innocent" in respect of regulated firms, which is unlikely to improve confidence in the regulatory system. The planned safeguards are inadequate; the reputational damage having already been done. As we understand it, the FSA often begins investigations that lead to no disciplinary action.

176 Q 136

177 Ev w15

178 Q 179

> Our concern is that, once information about proposed enforcement action is published, reputational damage will be done to the firm, irrespective of the outcome of the action and without the firm having had recourse to an appeal process.[179]

156. The Financial Service Practitioner Panel told us:

> We also continue to be concerned about the Government's proposals for early publication of disciplinary action. We acknowledge that there will not be a duty on the regulator to publish, and the power will be subject to certain safeguards. However, we are nevertheless sceptical of how the safeguards will be operated, and whether all the implications will be considered. It may be that the publication of a warning notice may mislead consumers and result in detriment if they decide to exit a firm's product or service early, when in fact no issues are proved to exist. There is also the possibility of legal hazards for the regulator if the publication of a warning notice has led to losses for consumers, shareholders and staff. One example is the publication in 2010 of the FSA investigation into the activities of Gartmore fund manager Guillame Rambourg. There was a resultant outflow of assets and reduction in the share price of Gartmore, following which it was acquired at a lower price by the rival asset manager Henderson.
>
> It will be essential that at the very least, the safeguards on consultation and fairness on the publication of warning notices are complied with fully by the regulators. We would also like to see a commitment to a public review of the use of this power by the regulator, after a number of cases have been publicised.[180]

157. The example of the Gartmore case was raised by a number of respondents. Margaret Cole told us "we did not announce our investigation at all. It was the firm doing that".[181] However, even if the FSA did not publicise the existence of the investigation, the Gartmore episode illustrates the potentially calamitous impact that an early warning notice might have on a firm given the market response in this case once the existence of an investigation had been made public. Margaret Cole told us that they would not be seeking to publish notice that an investigation had commenced but that this would be:

> [...] quite some significant way down our process for holding people accountable. It is a moment when we have looked at the case in detail, taken it to an internal committee and reached a conclusion that there is a case to answer.[182]

She argued further that:

> By publishing brief information at that moment, we are not doing anything more than putting that into alignment with the criminal process or with the civil process or with the process that other regulators employ, like the OFT and Ofgem.[183]

179 Ev w84

180 Ev w7

181 Q 136

182 Q 136

183 *Ibid.*

158. However we remain concerned that this analogy does not take into account the sensitive nature of the finance services market place and potential for an extreme reaction to be triggered by the publication of an early warning notice. Angus Eaton of Aviva, told us:

> Our fear [...] would be that that could be a tool that was used to publicise potential investigations and not used in a measured way. That itself could undermine the overall reputation of the industry as a whole [...] if this is a tool that is used in an unfettered way then we do have a fear that it is going to undermine the confidence in this industry that, of course, is already very delicate.[184]

159. We note that many of the most egregious examples of such detriment in the past have related not to firm-specific issues but products. The issues around pensions mis-selling and PPI were industry wide not firm specific. Asked about the FCA being a regulator which would intervene on the basis of its judgement, Martin Wheatley, CEO designate FCA, told the Joint Committee on the Draft Financial Services Bill that "We will get it wrong and the test will be whether [...] overall we are being seen as delivering the objectives for the organisation".[185] The inability for a firm to obtain redress against the regulator further exacerbates the problem of limiting the incentives to ensure that the regulator is fair to firms as well as consumers.

160. **We support giving to the FCA the existing ability of the FSA to issue public warning notices about specific products. However we are concerned that a general rule permitting the FCA to publish early warning notices in respect of specific firms, which in some cases could subsequently prove to be unfounded, risks unreasonable reputational damage to which there may be inadequate redress. We are also mindful of the risk to natural justice, given that in such a case the regulator may be investigator, judge and jury. We therefore recommend that the Government continue to consult on its proposed power for the FCA to issue early warning notices in respect of investigations into specific firms.**

Pre-approval of simple products

161. The pre-approval of some products was discussed during this inquiry. Brewin Dolphin plc, Cazenove Capital Management Limited and Rathbone Brothers plc have told the FSA that:

> We would like to see enhanced protection for retail consumers in a simplified product range of the key building blocks which should make up the core, or in many cases all, of the savings of the vast majority of savers.
>
> [...] The product range could include simple cash products, personal pension plans, index linked and other savings bonds, gilts and ISAs holding some very basic equity funds.

184 Q 46

185 Oral evidence taken before the Joint Committee on the Draft Financial Services Bill on 10 November 2011, HC 1447–xiii, Q 999 [Baroness Wheatcroft]

> We suggest that National Savings can be used as a benchmark for these products, in terms of performance, price and the issuers' willingness to stand behind their products should they fail to do "what they say on the tin" or lose value below prescribed benchmarks. This will reduce chances of mis-selling or inappropriate product engineering for an audience which is likely to be lacking in financial education and financial resources.
>
> All such products would be developed to a prescribed formula and require pre approval from the FCA. The organisations providing such products will all have the financial strength to stand behind their products. They will not have hidden risks or hidden charges and where possible should be tax advantaged.
>
> [...] The more sophisticated requirements of private investors will principally be catered for by wealth managers, stockbrokers, and private banks, larger IFAs and fund managers, most of whom will be members of APCIMS, BBA [(British Bankers' Association)] and/or IMA [(Investment Management Association)].
>
> [...] The companies providing product or services to this group of investors should be vetted and approved by a joint body of FCA and practitioners (not unlike the old Stock Exchange membership) to limit the chances of failure or rogue operators.[186]

162. We asked Martin Wheatley why the FCA had not adopted a system of pre-approving safe financial products. He told us that it was a question of resources:

> Pre-approval would place a large burden, so we would need a larger number of staff to do it, and a process between us and the market. I had experience of pre-approval of products in Hong Kong and the effect is that products get brought to you half-baked, because the industry wants to rush the products out. The regulator ends as up as the spellcheck for the industry, because they bring such poorly thought through products in the hope that they will have a place in the window. I think pre-approval is quite a difficult process and has many more negatives.[187]

163. The Financial Secretary told us that he was not in favour of pre-approving financial products because it would stifle innovation. He also told us that it would risk creating consumer detriment as a result:

> Because you would end up in a situation where you have some huge organisation based in the FCA that would have to vet every single product that came on to the market. In the heyday of mortgage markets, I think there were something like 6,000 different products. Each one of those would have to be approved, and there would be a process of approving them, so that would potentially act to the detriment of consumers who want to shop around for a good fixed-rate mortgage or a tracker mortgage. I think the bureaucracy that would impose would be quite significant and there would be some consumer detriment to that.[188]

186 Ev w135

187 Q 134

188 Q 257

164. Despite this, the British Bankers Association argued that "when considered in the round with the FCA's other more proactive intervention powers, the lack of any 'kite-marking' or similar may lead to very risk-averse behaviours which in themselves can under-serve consumers generally".[189] Christine Farnish, of Consumer Focus agreed, telling us that there would be a definite benefit to certain consumers of a pre-approval scheme:

> For mass market consumers we think it would be well worth exploring some sort of new arrangement. [...] We would very much like to see an attempt to try and produce some standard terms and conditions—minimum standards—for a suite of mass market products that most ordinary families and consumers need during their working lives, that could then be identified through some sort of mark or trusted brand, and that people could buy cheaply, easily, safely.[190]

165. It has been reported that the FSA was considering the pre-approval of simple financial products as recently as September 2011 and has decided not to pursue it as a policy because of resource constraints.[191] We have seen no evidence to justify this decision. Given the evidence cited above from consumers and producers alike we would expect a much fuller explanation of any decision together with supporting data.

166. **We recommend that the FCA conduct a review of the merits and costs of a pre-approval scheme for financial products, and publish its findings. We also recommend that the FCA reconsider the scope for distinguishing in regulation between simple products which can be pre-approved for basic needs and more complex products, generally but not always more suited to sophisticated investors, which cannot.**

Price Intervention

167. Measures in the Government's draft Bill will grant product regulation powers to the FCA as we considered above. One area that is not explicitly covered in the *Policy Overview* published with the draft Bill is the question of price intervention or regulation. Currently this would be a competition issue and so fall within the ambit of the Office of Fair Trading as the competent competition authority. The FSA set out in its paper regarding the FCA that:

> Where competition is impaired, price intervention by the FCA may be one of a number of tools necessary to protect consumers. This would involve the FCA making judgements about the value for money of products.[192]

168. The Financial Secretary to the Treasury told us that:

> The Government has been clear that the FCA will not prescribe prices in the manner of some utilities regulators. In the financial services industry, in the absence of natural or granted monopolies, such an approach would not be proportionate or

189 Ev w74

190 Q 181

191 Chris Pond, Speech to Social Market Foundation, September 2011

192 Financial Services Authority, *The Financial conduct Authority: approach to regulation*, June 2011, box 2

> consistent with the FCA's competition remit. However, the FCA should be looking at comparative prices and other possible indicators of where competition is flawed.[193]

169. The lack of clarity as to whether the FCA is intended to be a price regulator or indeed whether the legislation as proposed in the draft Bill grants it this power was highlighted to us by Which? who quoted their barrister, John Odgers, as follows:

> It is not clear whether, by not including in the Bill any specific provisions relating to price intervention, the Government intends the regulators to enjoy no such powers or whether it considers that price intervention is permissible under these rule-making powers.
>
> It seems to me to be desirable that a power of price intervention should be spelled out, if it is intended. Financial services regulators have not in this jurisdiction previously exercised that type of power, and might in future be loath to do so without a specific statutory authority, as the use of such a power would be particularly likely to attract a challenge.
>
> We would therefore welcome clarification from the Government on this matter.[194]

170. **There remains confusion about the role of the FCA in price regulation. We recommend that the Government clarifies whether it intends the FCA to play a role as a price regulator, the case for which has yet to be made. There should be adequate public consultation prior to any legislation on the role of the FCA as a price regulator.**

Consumer education

171. There is great concern that consumers are not able to make informed decisions. Consumer focus told us:

> Consumers in the UK are among those most likely to describe themselves as 'knowledgeable' in theoretical market research polls but research show that they are among those least likely to know their rights across a range of markets. Meanwhile empirically levels of financial capability, functional literacy and numeracy remain extremely poor. [...]
>
> Compounding this lack of basic understanding is the complex nature of many financial product contracts despite years of effort by regulators to improve disclosure. [...]
>
> - the consumer documentation from a major high street bank for a personal loan requires degree level education to understand
> - the standard text describing a PPI product requires PhD level education to comprehend

193 Ev 87

194 Ev 64

- it takes 55 minutes to read a standard consumer credit agreement, let alone understand it.[195]

172. Some industry representatives told us of the benefits to firms of having a financially capable consumer base. The Institute of Chartered Accountants in England and Wales told us that this would become more important in the future as the financial requirements of consumers change:

> Demographic developments, together with the fiscal implications of the possibility of growth remaining low in the West for some years to come, suggest that Governments are likely increasingly to look to individuals to make greater personal provision for retirement and possibly other requirements, such as aspects of health care. That implies a need to raise the financial capability of the general population. Financial education will be an important part of this.[196]

The Share Centre Ltd said that consumer education should focus on young people:

> If we have better educated consumers we will need less regulation. In this respect it is unfortunate that the resources available for financial education for young people have been so severely cut. It is in the interest of the financial services industry to see a small mandatory levy—probably totalling no more than £10m p.a., so that *caveat emptor* can reasonably resume its place in our industry.

173. The role of financial education in schools and the national curriculum was the topic for a recent debate in the House of Commons. During this the Minister of State, Department for Education, Mr Nick Gibb said that "Young people need to be confident and competent consumers":

> We all agree about the importance of good-quality personal finance education and the critical role played by a sound grasp of basic mathematical skills. Support from the finance industry and a range of good resources play their part in supporting schools to teach pupils how to manage their money well.[197]

174. Mr Gibb told the House that "the Government are currently conducting two reviews—that of the national curriculum [...] and that of personal, social, health and economic education, which includes financial capability".[198] We look forward to the results of these reviews.

175. Outside the school system, the Money Advice Service (MAS) is an independent body, set up by the Government and funded by fees raised from financial services firms regulated by the FSA. It has two core strategic objectives:

- To enhance the understanding and knowledge of members of the public of financial matters (including the UK financial system);

195 Ev 72

196 Ev w63

197 HC Deb, 15 December 2011, col 995

198 *Ibid.*, col 992

- To enhance the ability of members of the public to manage their own affairs. [199]

176. The FSA told us that the work of the MAS is valuable to consumers, firms and the regulator:

> We support measures included in the draft Bill that require the FCA to agree and publish a MoU with the Money Advice Service, replacing the current voluntary arrangement. We believe the Service will be a further useful source of intelligence and early warnings for the FCA on potential problems in retail markets.[200]

177. However, we received evidence outlining concerns that about the funding, expenditure and strategy of the MAS. Smaller industry practitioners in particular were keen to avoid duplicating costs. The smaller business practitioner panel told us:

> The industry is already funding the Money Advice Service (MAS), so it seems that the FCA should be doing less than the FSA has done to engage directly with consumers, as much of the role should now be undertaken by MAS. As it is, we are also concerned about the lack of cost control and accountability of MAS.[201]

178. The Financial Secretary said that he supported the MAS as the organisation to educate consumers on financial matters:

> I think there is a challenge here about how we make sure we equip consumers to buy products and services, and that is why I am a very big supporter of the Money Advice Service, which helps there.[202]

179. We support the aims and objectives of the Money Advice Service to provide generic advice. Wider understanding of financial services will benefit the economy as well as consumers. As with all public bodies, it is important that the MAS is seen to be providing value for money. This is especially important as the MAS is funded by industry levy, the burden of which is likely to be ultimately passed to consumers. **It is important that the work of the MAS is not duplicated but complemented by any work of the FCA in the area of consumer responsibility. We recommend that the MoU between the FCA and MAS be published in time for the introduction of the Financial Services Bill. The FCA and the MAS should work with the Department for Education to help ensure that young people receive at school the basic learning tools and skills required to make sense of financial advice later in life.**

199 Further information about the Money Advice Service may be found at: http://www.moneyadviceservice.org.uk/about/corporateinformation/default.aspx

200 Ev 61

201 Ev w27

202 Q 232

Conclusions and recommendations

Introduction

1. Given the evidence criticising the FSA, and following the perceived failure of regulation during the financial crisis, it was necessary for all concerned to make full use of the opportunity created by the split of the FSA into the FCA and PRA to ensure that the new bodies did not carry over the FSA's shortcomings through the new legislation. (Paragraph 4)

How the FCA fits into the proposed new regulatory structure

2. We have been encouraged by the willingness of the Financial Secretary to reconsider the objectives as set out in the draft Bill and by the Chancellor's assurances that competition would be an objective of the FCA. Competition should be central to the culture of the FCA. This is not for competition's own sake, but because effective competition benefits consumers. We agree with the substance of the recommendation of the Joint Committee, and recommend that it is best achieved by giving the FCA an additional primary objective "to promote effective competition for the benefit of consumers". (Paragraph 28)

3. We agree with the concerns put to us that the strategic objective as set out in the draft Bill risks creating the conditions for the FCA to pursue a course of seeking to enhance confidence in markets when that confidence may, at times, be misplaced. There is also a risk of confusion created by multiple tiers of objectives and duties. We agree that the FSA's own suggestion for the strategic objective "to ensure fair, efficient and transparent markets in financial services" is an improvement. We welcome the Government's open mindedness in relation to the strategic objective, but urge the Government to re-examine the need for it. The revised strategic objective is already largely embodied in the current operational objectives. With the addition of the proposed competition objective, the objectives would cover all that is required. The absence of a further strategic objective would avoid the problems inherent in creating a complex hierarchy of purposes, and would more closely reflect the Government's original aim of simplicity. (Paragraph 34)

4. While we recommend that the FCA be given a formal competition objective, requiring it to consider where financial services and markets are operating in a way which is consistent with competition, we were not convinced of the need to transfer the OFT's powers with respect to competition law to the FCA. We were, on balance, persuaded of the merits of the approach whereby the FCA can refer issues of competition law to the OFT. The staff at both the FCA and the OFT are already adjusting to rapid institutional change. We recommend that this issue be revisited once the FCA has bedded down, and with a track record both of the use of its powers and its ability to refer cases to the OFT on which to draw. The effectiveness of these arrangements, which would be less disruptive than transfer to the FCA, can then be reassessed. (Paragraph 38)

5. We recommend that the Government examine the scope for differentiating between retail consumers and wholesale consumers in the Bill, and clarify the balance of protection and consumer responsibilities that attach to these different groups. (Paragraph 45)

6. We sympathise with the need for balance as reflected in the recommendation of the Joint Committee and believe that the lack of clarity about the principle of consumer responsibility needs to be rectified in good time to allow for further scrutiny of the proposals. (Paragraph 52)

7. Recognising that an effective regulatory system can attract business, it is important that the new regulatory bodies established by the Government do not ignore the impact of their actions on the competitiveness of the UK. The relationship between competitiveness and the means by which the Chancellor's assurances that competition will be an objective of the FCA will need to be carefully scrutinised. We may return to this **issue.** (Paragraph 56)

8. We recommend that the Government reach a conclusion soon to give an early indication of its thinking and in good time to include any changes in the forthcoming Financial Services Bill. (Paragraph 62)

Accountability

9. the FCA's accountability to industry should be supported by a duty on both parties to a high level of engagement and exchange of information. (Paragraph 78)

10. it is incumbent on the industry to provide the evidence that different regulatory behaviour is in the public and consumer interest. The regulated industry, and particularly the trade bodies, should be more forthcoming about their concerns. A new regulator, led by a new Chief Executive, provides an opportunity for a better relationship—it should be seized. (Paragraph 79)

11. The Current legislative proposals do not provide adequate accountability, nor the framework for sufficient scrutiny of, and explanation by, the regulator. We therefore recommend:

    - That the board of the FCA publish full minutes of each meeting.
    - That the legislation provide that the Chief Executive of the FCA be subject to pre appointment scrutiny by this committee.
    - That the legislation provide that the FCA Board be responsible for responding to requests for factual information and papers from Parliament.
    - That the legislation provide that Parliament may request retrospective views of the FCA's work. (Paragraph 80)

The FCA's place in the wider regulatory architecture

12. Given previous unsatisfactory experience of regulators operating within a Memorandum of Understanding, we recommend that the relationship between the

FCA, PRA and FPC be set out more explicitly in primary legislation and in as much detail as possible in secondary legislation. This can help to avoid regulatory gaps or overlap. This will also provide greater clarity and should limit the scope for institutional bickering about obligations under the MoU, although with the risk of some loss of flexibility. With that in mind, and given that the shape of the financial services industry and the market conditions is fast-moving, the relationship between the regulators needs to be kept under constant review. It is also important that full consultation takes place. We recommend that the Government's proposals be aired early for scrutiny, and certainly in time for the Committee stage of the Financial Services Bill. (Paragraph 90)

13. We do not believe that the case for a veto over the FCA's powers has yet been made. The Government should publish persuasive evidence to support the need for it if it wishes to proceed with the proposal. If it were to persist with this proposal, we recommend that the Government set out in more detail in legislation the circumstances in which a veto could be used. The veto's use, or threat of use, would be appropriate candidates for retrospective review under the arrangements we recommend in paragraph 78. (Paragraph 95)

14. The Financial Policy Committee will have an overall mandate to consider systemic issues and powers to direct both the PRA and FCA, so it is logical for the FPC rather than the PRA to hold such a veto power which aligns to the existing proposals with its right to direct the FCA on systemic issues. We recommend **that if the Government were to maintain its commitment to a veto, it amend the draft Bill to ensure that the veto power lies with the FPC and may only be used in exceptional circumstances. We also recommend that the Government make provision for the PRA to make referrals in this area to the FPC.** (Paragraph 97)

15. A Memorandum of Understanding is unlikely to be the appropriate method to establish the basis of co-ordination between the PRA and FCA in respect of their seats at the EBA, ESMA and EIOPA. We recommend that the Government consult on the appropriate level of co-ordination and set this out in secondary legislation in order to ensure both adequate scrutiny of the basis on which the two regulatory authorities will co-ordinate, and legal clarity about how they should do this. We further recommend that the Treasury take steps to ensure that the impending change to the FSA does not lead to a fragmentation of UK representation in the EU, and that the UK's market position in the provision of European financial services be given an appropriate level of consideration within each of the ESAs. (Paragraph 106)

How the FCA should approach its work

16. While it would be impracticable and inefficient to seek to legislate for the detailed regulation for every subsector, there is an opportunity to consider a more explicitly differentiated regulatory approach between the broad classes of regulated activity and specifically between retail, professional and wholesale financial services. We recommend that the Government examine the scope for differentiating between classes of financial services activity, for example by distinguishing between the FCA's mandate and powers for retail financial services, services for professional clients and wholesale financial services. (Paragraph 110)

17. The FSA's proposals for the FCA to build up a central business and market analysis team present an opportunity to enhance the quality of regulation in a cost effective manner. The FCA must ensure that, in adopting this model, those developing policy are not divorced from the reality of the industry. We recommend that the FCA maintain a proportionate level of contact across all industry sectors, not just the largest ones or those from a particular sector, and that the FCA consult the industry on how it can improve its relationship with non-relationship-managed firms in a cost-effective manner. We also recommend that the FCA take steps to enhance the level of support available to firms to understand and implement new rules. (Paragraph 115)

18. We reiterate the recommendation in our report on the Government's initial proposals that, once the new regulatory architecture has been set up, the PRA and the FCA should revisit the tools it uses to examine the cost and benefits of regulation. In doing this the FCA will need to challenge current FSA practices. It should consider how it ensures that the cost of regulation is examined at an early stage in policy development. Subsequent reassessment should not be treated as a tick-box exercise or afterthought. The FCA should design cost-benefit assessments that increase the level of engagement between the regulator and the regulated and improves the quality of the information that the FCA receives in undertaking their cost-benefit analyses. The Government should include in the Bill requirements for far more extensive cost-benefit analysis and consultation with firms, representative bodies and panels prior to the introduction of new regulation**.** (Paragraph 124)

19. The evidence we have received from industry highlights concerns regarding staff turnover and the problems of staff retention. While the Governor of the Bank of England has expressed a high-minded view of the motivation of public service this appears to be at odds with the evidence from both Lord Turner and Hectors Sants as to the problems the FSA faces with retention of key staff at certain levels. This is concerning. The Committee recognises the inevitable risk of poaching: the reputational risk of being the wrong side of the regulator is so great for many firms that they will be prepared to bid up the market price to recruit the best regulatory staff. No solution has been provided to us, but some action may help. The FCA should produce and publish a coherent and sustainable plan for attracting and retaining the brightest and the best staff. (Paragraph 131)

20. We note that the proposed approach of the FCA that the number of firms supervised on a "relationship managed basis" will be significantly reduced. We heard from some representatives of industry that the lines of communication between the regulator and regulated firms, in the past, have not been effective. It is essential that the FCA improves this, as far as its resources allow. (Paragraph 135)

21. We recommend that greater steps be taken to ensure that when formal regulatory material is released by the FCA it is clear to firms what is expected of them. The culture of "regulation by speech" should be discouraged and if regulatory material is released in this way the regulations concerned should also be clarified at the time, and in adequate detail, to all firms affected. Regulated firms need to engage positively and constructively with the FCA. It is also important that, where firms consider unreasonable or disproportionate requests have been persistently made, they notify

their trade bodies and, in serious cases, be able to inform the practitioner panels and the FCA's non-executive directors. Ultimately firms would be able to bring the behaviour of the FCA to the attention of Parliament via this Committee. (Paragraph 136)

22. In general we were disappointed by the FSA's document outlining the proposed approach for the FCA. We are concerned that the document outlines an inappropriate culture for the FCA, one that may allow some old and inappropriate practices and culture from the FSA to be replicated. The FSA's Approach to Regulation document is, in effect, a charter for the FCA's future approach. Its lack of detail and substance demonstrates the amount of work required to get the legislation right. We welcome the scope for a fresh approach to be taken implied by Mr Wheatley's evidence. We recommend that the FSA/FCA publish a much more detailed consultation paper setting out its intended approach, together with full supporting explanations. Further formal public consultation is also required. (Paragraph 137)

New powers

23. It is crucial that the potential risks and benefits of products are properly understood. The case has not been made that the FCA will necessarily understand a new product better than a firm. We are mindful of the risks that product intervention can pose to competition and innovation. The FSA has been criticised in the past for being too slow to intervene and we welcome the FCA's willingness to respond quickly to issues of consumer detriment. We support the need for judgement-led product intervention by the regulator. We recommend that clear guidance be issued to firms when such powers are used. Their use should be sparing and the merits of each case very carefully considered before intervention. We reiterate our recommendation about the need for greater communication between the regulator and the firm concerned. This should reduce the need for such intervention. (Paragraph 145)

24. We recommend that the FSA place its more detailed proposals in the public domain and facilitate proper public scrutiny of its plans. (Paragraph 150)

25. We support giving to the FCA the existing ability of the FSA to issue public warning notices about specific products. However we are concerned that a general rule permitting the FCA to publish early warning notices in respect of specific firms, which in some cases could subsequently prove to be unfounded, risks unreasonable reputational damage to which there may be inadequate redress. We are also mindful of the risk to natural justice, given that in such a case the regulator may be investigator, judge and jury. We therefore recommend that the Government continue to consult on its proposed power for the FCA to issue early warning notices in respect of investigations into specific firms. (Paragraph 160)

26. We recommend that the FCA conduct a review of the merits and costs of a pre-approval scheme for financial products, and publish its findings. We also recommend that the FCA reconsider the scope for distinguishing in regulation between simple products which can be pre-approved for basic needs and more

complex products, generally but not always more suited to sophisticated investors, which cannot. (Paragraph 166)

27. There remains confusion about the role of the FCA in price regulation. We recommend that the Government clarifies whether it intends the FCA to play a role as a price regulator, the case for which has yet to be made. There should be adequate public consultation prior to any legislation on the role of the FCA as a price regulator. (Paragraph 170)

28. It is important that the work of the MAS is not duplicated but complemented by any work of the FCA in the area of consumer responsibility. We recommend that the MoU between the FCA and MAS be published in time for the introduction of the Financial Services Bill. The FCA and the MAS should work with the Department for Education to help ensure that young people receive at school the basic learning tools and skills required to make sense of financial advice later in life. (Paragraph 179)

Formal Minutes

Tuesday 10 January 2012

Members present:

Mr Andrew Tyrie, in the Chair

Michael Fallon	John Mann
Jesse Norman	Mr George Mudie
Mark Garnier	Mr Pat McFadden
Mr Andrew Love	John Thurso

Draft Report (*Financial Conduct Authority*), proposed by the Chair, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 179 read and agreed to.

Resolved, That the Report be the Twenty-sixth Report of the Committee to the House.

Ordered, That the Chair make the Report to the House.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

Written evidence was ordered to be reported to the House for publishing with the Report (in addition to that ordered to be reported for publishing on 25 October, 8 November, 23 November 2011).

[Adjourned till Wednesday 11 January at 2.00 pm

Witnesses

Tuesday 25 October 2011

Page

Tuesday 1 November 2011

Wednesday 2 November 2011

Tuesday 8 November 2011

List of printed written evidence

List of additional written evidence

List of Reports from the Committee during the current Parliament

Session 2010–12

First Report	June 2010 Budget	HC 350
Second Report	Appointment of Dr Martin Weale to the Monetary Policy Committee of the Bank of England	HC 195
Third Report	Appointment of Robert Chote as Chair of the Office for Budget Responsibility	HC 476
Fourth Report	Office for Budget Responsibility	HC 385
Fifth Report	Appointments to the Budget Responsibility Committee	HC 545
Sixth Report	Spending Review 2010	HC 544
Seventh Report	Financial Regulation: a preliminary consideration of the Government's proposals	HC 430
Eighth Report	Principles of tax policy	HC 753
Ninth Report	Competition and Choice in Retail Banking	HC 612
Tenth Report	Budget 2011	HC 897
Eleventh Report	Finance (No.3) Bill	HC 497
Twelfth Report	Appointment of Dr Ben Broadbent to the monetary Policy Committee of the Bank of England	HC 1051
Thirteenth Report	Appointment of Dr Donald Kohn to the interim Financial Policy Committee	HC 1052
Fourteenth Report	Appointments of Michael Cohrs and Alastair Clark to the interim Financial Policy Committee	HC 1125
Fifteenth Report	Retail Distribution Review	HC 857
Sixteenth Report	Administration and effectiveness of HM Revenue and Customs	HC 731
Seventeenth Report	Private Finance Initiative	HC 1146
Eighteenth Report	The future of cheques	HC 1147
Nineteenth Report	Independent Commission on Banking	HC 1069
Twentieth Report	Retail Distribution Review: Government and FSA Responses	HC 1533
Twenty-first Report	Accountability of the Bank of England	HC 874
Twenty-second Report	Appointment of Robert Jenkins to the interim Financial Policy Committee	HC 1575
Twenty-third Report	The future of cheques: Government and Payments Council Responses	HC 1645
Twenty-fourth Report	Appointments to the Office of Tax Simplification	HC 1637
Twenty-fifth Report	Private Finance Initiative: Government, OBR and NAO Responses	HC 1725

Oral evidence

Taken before the Treasury Committee

on Tuesday 25 October 2011

Members present:

Mr Andrew Tyrie (Chair)

Michael Fallon	John Mann
Mark Garnier	Mr George Mudie
Stewart Hosie	Jesse Norman
Andrea Leadsom	Mr David Ruffley
Mr Andy Love	John Thurso

Examination of Witnesses

Witnesses: **Angus Eaton,** Operational and Regulatory Risk Director, Aviva Plc, **Paul Killik**, Senior Executive Officer and Partner, Killik & Co, and **Philip Warland,** Head of Public Policy, Fidelity, gave evidence.

Q1 Chair: Let us begin. Thank you very much for coming in this morning. As you can see, we have already had quite a busy morning on this, clearly. I don't know how much of what we have just been exchanging you were here for.

Can I begin by asking each of you to comment on the FSA's consultative document on how the FCA would be organised? I am quoting what they said in June: "The Government expects the FCA to intervene more strongly in retail financial service markets". Do you think that more intervention is what is needed and, if so, what type of intervention? Why don't I start on the right-hand side as I look and move leftwards?

Philip Warland: Thank you very much, Mr Chairman. We in Fidelity do believe that strong intervention is needed. I think that the litany that the Chairman of the FSA talked about last week at the Mansion House dinner—£15 billion of redress over a period—just suggests that something isn't working. What they have done up until now is largely looked at how products are sold, how they are advised, and never really got involved in the governance of the product, what the product was aiming to do and was it aimed at the right target market. To the extent that the FCA say, "That is where we think we would go," in principle, we think obviously they could get it seriously wrong and there are issues with openness of markets and competition, but in principle we think that is probably the next step they ought to be thinking about.

Angus Eaton: I think we can understand that intervention is an appropriate step to take now, although we would urge it to be approached in a measured way, in that there is always a danger that the regulator could take an over-protectionist approach without acknowledging the slightly wider public policy issue of ensuring that customers continue to have access to products in the market.

Paul Killik: I differ slightly with Philip on the intervention issue, I must admit. I do feel that the paper was too confrontational. The spirit of the February paper from the Treasury was much less confrontational, and I would like to see the regulator working much more closely with the industry than it is doing today.

Q2 Chair: Can you just explain what you mean by working closely as opposed to intervening?

Paul Killik: I think there is a sense, isn't there, that indeed, in part of the paper they are referring to the amount of analysis that they are doing of the industry. Analysis doesn't work at one level unless you are actually working with the industry itself in understanding it, and they have shown a distinct lack of interest in having a dialogue with the industry; at least that has been our experience.

Q3 Chair: This intervention, you are all confident that in practice this will have the desired effect or is likely to have a desired effect. We can all devise theoretical explanations for the need for intervention, but the crucial question is whether it is going to work. I just want to be clear on that.

Philip Warland: I don't think that you can prove in advance that it is going to work, but, as Angus has said, it seems to us to be a sensible next step. The way we see it working is although they do ask for powers to go out and ban products or withdraw them from the market, and so on and do forth, and—

Chair: We will be coming on to that in a minute.

Philip Warland: Okay. What we think is much more important—and they have already begun to do it a bit in their supervisory practice—is to look at what we would call product governance. If we produce a new product, do we understand the features of it, how it is likely to behave in stressed conditions? Do we take the view as to what part of the market it would be suitable to sell it into, and do we take a view that the advisers who are allowed to handle this product understand the features of the product and where it should end up? If that is the majority of what their "product intervention" is, we think it would be wholly beneficial.

Chair: Anything anybody wants to add before I move on? We are going to come back in some detail to a number of aspects.

Paul Killik: I think product intervention I certainly would agree with. I think there has to be more work done in that area.

Q4 Stewart Hosie: Mr Killik, you said in your written submission that there was little detail of how the FCA would be accountable. They will be required to be accountable to us, producing an annual report, holding an annual public meeting and so on. But you have said it wasn't yet clear who would follow up what was in the annual report or conduct ongoing scrutiny of whether or not the FCA was meeting its objectives or operating in a reasonable or proportionate way. What would you have done? How would you like to see the FCA scrutinised in this regard?
Paul Killik: We have had subsequent conversations on this matter since we submitted our written evidence, but I think we are increasingly of the view that the PRA probably could play a role as a superior regulator here in some senses. At least there would be more of a peer group analysis of the FCA if it was undertaken by PRA.

Q5 Stewart Hosie: That is interesting because obviously the PRA are doing the prudential and the FCA are doing the conduct of business. That twin-peaks approach was designed with a particular reason. Would you then have the FCA as a subsidiary or underneath the PRA in that regard or would it simply be a peer assessment of the way they operate, how they behave?
Paul Killik: I think it makes some sense to do that, yes, because there are going to be probably some turf wars as between what is prudential and what is conduct of business.

Q6 Stewart Hosie: So, am I sensing that we could already begin to have an overlap of regulatory function to replace the underlap and the cracks we had under the old regime?
Paul Killik: I would not necessarily go that far, but I think that there has to be some sense in having a superior regulator, but this is a personal opinion. I am not speaking on behalf of my industry.

Q7 Stewart Hosie: Just one final question then. The Government did say in terms of accountability—and you have said you have had some discussions since—the process for the FCA replicates arrangements for the FSA where appropriate and strengthens them where possible. Do you think, given your experience with the FSA, that this is a good starting point for accountability?
Paul Killik: Do I think it is a starting point?
Stewart Hosie: Yes, is it a good starting point or would you have simply taken a clean sheet of paper and said, "Look, here's how we think you should behave."?
Paul Killik: I probably would have taken a clean sheet of paper on this. Yes, I do, I feel that this paper, from this consultative document on the FCA, was written by the FSA and therefore I am afraid it carries a lot of the baggage of the FSA with it.

Q8 Stewart Hosie: So the discussions you have had more recently then, have you suggested to them how they might change the way in which they operate or scrutinise and what has the response been?
Paul Killik: I have not been consulted in the matter at all. We put our own submissions in, but there has been no further consultation.
Stewart Hosie: Right, okay.

Q9 Michael Fallon: This Committee has previously recommended that competition should be a central objective. There seem to be mixed views in the industry about that. Would you agree with the Committee on that?
Paul Killik: Are you directing that to me?
Michael Fallon: Any of you.
Angus Eaton: We would certainly support competitiveness. We think the recommendation goes as far as it needs to in these circumstances. Speaking from the insurance markets' perspective, we consider the markets are competitive and I don't think we need to go any further.
Paul Killik: Yes, again, but I think there was a slight difference in emphasis between the Treasury paper of February and the FCA paper of June, where a more general discussion on the competition was referred to in the Treasury paper, which I would totally endorse. But it was very heavily consumer-weighted that the competition was only provided it was in the benefit of the consumer in the FCA paper.

Q10 Michael Fallon: How do you see the competition objective? It seems to be a catch-all duty now. How do you see it working in practice?
Philip Warland: If I could just say that we disagree with the view of this Committee. It is been argued over since 1984 when much of this was first legislated for. We think it is better to externalise the conflicts between investor protection and competition and to leave the competition where it is at the moment. I think, as I am sure you will when you get the FSA/FCA in front of you, they will set out some of the difficulties that they will have implementing a competition objective.

Q11 Michael Fallon: So you don't think the regulator should be bothered with competition?
Philip Warland: I don't think they should have anything stronger that they have regard to. I certainly don't think they should be considered a competition authority. They don't have the skills. I think they find it difficult to recruit the skills, which are very, very particular.

Q12 Michael Fallon: That is not because you think previous regulation has restricted or promoted competition; it is simply because you think they are the wrong people who are doing it?
Philip Warland: Yes. As I say, I think that the conflict is best handled externally—that is between the FSA and the OFT and the competition authorities. I think later on you are going to talk to witnesses who have the ability to make a super-complaint. That seems to me to be quite a good way to move ahead.

Q13 Michael Fallon: Do either of the other two of you think the competition objective should be more explicit?

Paul Killik: I would agree that it should be more explicit, yes. We have to balance commercial interests, but at the end of the day we are competitive businesses and I have seen examples of it recently where the playing field has been made unlevel by the regulator.
Angus Eaton: I would reinforce what I said earlier, in the sense that it is important for a regulator to have regard to competition in the decisions they make in delivering regulation into an industry. For instance, in the Retail Distribution Review some of the actions that have been taken, one could say, have restricted the number of advisers, for instance, in the market. So I think it is appropriate for a regulator to have regard to competition.
Michael Fallon: Thank you.

Q14 Mark Garnier: I shall start with Philip Warland, if I may, Mr Chairman, and then move to your right. In the draft Bill there is a table making it pretty clear how the regulatory system is going to work and how it is accountable to Parliament through the Chancellor. Do you think that that is a reasonable way of doing it? Do you have any comments on it and also what role do you think this Committee should play in the accountability?
Philip Warland: Broadly, we think that the accountability structure is far too weak and then there is the question as to whom it should be accountable to. Adair Turner has gone on the record—I think I am right in saying—that it should not be accountable to the industry, and in most respects that is true. I do think there should be more accountability to us in terms of their costs, and the NAO audits may have a look at that. But it is quite difficult to look at efficiency and costs without also taking a view on are they meeting their objectives correctly, which I tend to agree. I don't think we should be the arbiters of that. So some mechanism, which allowed a discussion, other than the Practitioner Committee that does not seem to work, between the industry and the regulator—not on a firm-by-firm basis, but on a genuine industry basis—we think would be very helpful and we could point to some places where we think it has gone wrong. We say in our paper that we think that the FCA should make an annual report to yourselves, rather like you have just had the Governor here talking about MPC decisions. I think what the FCA does is not on a quarterly round, but if they had to justify themselves against their objectives to you and you were to hold hearings, we would take considerable comfort from that.
Angus Eaton: We certainly support this Committee being engaged in the scrutiny of this regulator. From an accountability perspective, we would also add that it is important that the board itself that runs the FCA has been appointed in a transparent way and has a broad representation from the industry and consumers.
Paul Killik: Yes, and I would certainly very much support the broad representation from the industry. One of the weaknesses of the current system is that—as I alluded to earlier on—there is far too little inter-exchange between the regulator and the industry. Indeed, when we are going further away from that with the greater use of call centres and fewer relationship-managed businesses, it just means the regulator gets further and further away from the industry that they are regulating. But coming back to the point of accountability, I would certainly support that the regulator should be accountable to this group, but I also believe that there is some merit in making it accountable to PRA initially.

Q15 Mark Garnier: Fresh in many people's mind is the regulator's response to this Committee's *Report on the Retail Distribution Review.* Many people have said in the press, and just anecdotally, that this shows a huge amount of contempt for Parliament by the FSA. Do you think that is a fair comment?
Paul Killik: I do, yes.
Mark Garnier: Do you?
Angus Eaton: As I said, I think it is appropriate that is accountable to this Committee. If that gets hard-coded into the process, then I think they will respond appropriately.

Q16 Mark Garnier: But if they sort of suck their teeth and say, "Yeah, well so what, we will just do whatever we want," how do you think this Committee should be able to come back and make them accountable?
Angus Eaton: I think the key is transparency. It is important that these issues are raised publicly and the regulator itself is not given the opportunity to operate in quite a closed way.

Q17 Mark Garnier: So there is an argument that they have been transparently contemptuous of the views of this Committee?
Angus Eaton: That might be an argument, but I still think the transparency is important.
Philip Warland: I agree. I think you have done the world a service in some of the investigations you have had, and I don't know whether you have done it or not, but you might consider having not only the executives here, but actually some of the independent board members. I don't know whether you have done that, but that might just raise the ante a bit.

Q18 Mark Garnier: Can I just very briefly return to the costs? We have two large organisations and one, with great respect, small organisation. You all pay fees to the FSA and you also all have to dedicate resources, in terms of maintaining your compliance function and all the rest of it. Paul Killik, speaking as somebody from a smaller firm—your two colleagues—do you think the cost of the regulatory system disadvantages smaller firms and, as you get smaller, it becomes more of a disadvantage or do you think that is an irrelevant argument?
Paul Killik: Yes, I do. I think it would have been very difficult. I set my business up in 1989. I think it would be a very, very difficult job to start that business up today, to be perfectly honest, I really do. We were helped in starting up business by the regulator of the day, the TSA, who were enormously supportive and helped us with the whole formal completion process. You don't get any of that today from the regulator. So it is a very different world in that sense. As for costs, yes, if you look at the FSA's bill for this year of £500

million and you put that into context, and I know the figure of £15 billion that has been paid out over 20 years is a big number, but simple maths tells you that is £750 million a year. Well, already, we are spending two-thirds of what we are paying in compensation in running a regulator. Then, of course, you have the regulatory cost to all the individual firms, which is a multiplier of the cost of running the FSA. So the cost to the consumer of regulation, in its present form, is huge and I do not think people really recognise how big it is.

Q19 Mark Garnier: To the other two witnesses. That is an incredibly important point. As two big organisations, presumably you have to push the cost of your regulatory departments and the cost of your membership of the FSA down to the consumer. So effectively what you are saying is the cost of regulation, be it direct fees to the FSA or compensation fees or the cost of compliance actually is detracting from the savings culture of this country, ultimately?

Philip Warland: Certainly in our case—and although we are larger than Paul's firm we have a similar business model—the problem we have is the FSA has always treated us as an investment bank when we are not. We are an agency business. So our cost of capital has gone up 10 times in the last three years and our total costs of internal compliance have gone up 70%. We think that is wholly unnecessary and we don't believe they understand our business model. The good news is that early discussions with the proto FCA suggest they do understand that, in a fortuitous way, what they have created with the FCA is a regulator for whom prudential capital is not the key issue, and they are already beginning to think, "How do we have a supervisory practice that deals with agency firms?" where, frankly, if a parent goes down—you can see that from Barings; Barings went down over the weekend. On the Tuesday, the unit trust business was working again. That is our business model and they have never paid attention to that. But yes, those costs that they have inflicted on us will lower the savings rate.

Angus Eaton: I think you are right. The costs are perpetual in the industry, and in fact we would urge stability, if anything, to be honest with you. They manifest themselves in many ways. It is not just regulatory departments. It is clearly big-change initiatives as well. Solvency II costs £100 million per insurance company, for instance. So we would urge that stability. To your question; yes, ultimately, I think the customer will carry it. Hence the reason why we think the regulator should have regard to the ultimate impact on the customer.

Q20 Mark Garnier: Just finally, do you all agree that regulatory stability is key to keeping costs down?

Paul Killik: Absolutely.

Mark Garnier: Okay, thank you for that.

Q21 Chair: Mr Warland, in your submission you said that you were perplexed by the objectives of the Bill, but from what I could tell you were broadly supportive in your opening remarks, or not too critical anyway, and I would be grateful if you could tell me which bits are perplexing you.

Philip Warland: Mainly it is the overlap. If you look at the objectives of the FPC, then the PRA and then the FCA, they all have elements that seem to us to be coterminous. That seems pretty well a recipe for argument and dissent, and so on and so forth. I suppose we would prefer to see something that is much clearer, which is a reference to market integrity, which is one side of the FCA, and a reference to consumer protection that in a sense is the other side of the FCA. Then, as we have set out in the paper, we actually think having regard to international competitiveness is very important too.

Q22 Chair: You have said that you support product regulation. The regulators themselves have said that this will cost more overall. A moment ago I thought I understood you to say you weren't happy about this rise in regulatory cost. Do you think that the type of product regulation you envisage can be delivered for less or the same that is spent at the moment on regulation?

Philip Warland: I made those remarks, and can try and square the circle by saying that I believe the FCA should and, I think, is thinking of a completely different supervisory approach. At the moment, when they come and visit us they do an ARROW visit, and the ARROW visit was based on, "How the banks go wrong and let's stop it". The supervisory approach I believe that they should use for a firm like ours should be completely different. It will not start, or it should not start, with prudential capital and complicated policy-adjusted stress tests of how you get there because, as I have described, prudential capital is not where we are most likely to cause detriment to customers. But if a lot of that is stripped away that is what will push back our compliance costs and if there is a little more on product governance. Frankly, we think we have it in there anyway without being told to do it. So we believe there would be a way to protect the public and yet lower the overall cost base.

Chair: Just one other point just for clarity. There was a general nodding of agreement when the suggestion was made—I think by you, Mr Warland—that independent board members might be given a greater role. Maybe not now, but if you have suggestions on how they may be engaged to secure greater accountability to the FCA, this Committee is interested in hearing your views.

Q23 David Ruffley: Mr Killik, the paper that you submitted to us was interesting where you talk about, "Engagement with industry bodies could help a more segmented approach". You also draw our attention to the fact that in the FSA June paper they were actively talking about reducing the number of relationship-managed firms, and you propose to remedy that. An element of self-regulation and a key part of that would be putting together a panel of professionals, retired professionals, who could give knowledge and advice, I am assuming, to the FCA staff. I just wondered what reaction you have had from policymakers, either at the Treasury or the FSA, to that proposal.

Paul Killik: I have not had any. I have not had consultations with them, so I have not had a response.

Q24 David Ruffley: You have not floated it at all?
Paul Killik: I have in papers, but I had no particular response to them.

Q25 David Ruffley: Did you expect a response?
Paul Killik: It would have been nice to have had a response, but in some senses I am not altogether surprised.

Q26 David Ruffley: I just wondered, because it seems an interesting idea. It is a contribution to the debate. Would you have support from the rest of your industry for that?
Paul Killik: Without a shred of a doubt. I think by putting it forward as people at the latter end of their careers, nobody could accuse practitioners of looking after their own interests, but they are coming with a lifetime's experience. We are currently seeing people being retired out of businesses, at 60, 65 these days, who have probably got another 10 years or at least five years of work within them and they would like to contribute in that way, I am quite sure. It would be beneficial for the whole industry and certainly, I believe, useful for the regulator to have that sort of resource internally.

Q27 David Ruffley: I infer from what you just said in your proposals that you don't entirely have faith in the likely expertise of staff on the FCA, because in your submission you made clear that in terms of products, the understanding of products, it would be sensible to have some retired practitioners who have been involved in the market for these products and services. You presumably do not believe, or have much faith, that the FCA will be able to recruit such expertise, hence the need for your panel?
Paul Killik: Absolutely. I have been in one small sector of financial services for 40 years, and I can't claim to be an expert in all aspects of my small segment. It is hugely complex, the whole gamut of the financial services industries. Therefore, to recruit people and believe that you can then train them internally, without any interface with the businesses that they are regulating, strikes me as a bizarre concept. I know how long it takes me to train chaps up before I put them on the telephone to talk to clients. That is a very long process. We are wasting resource when we have people who would happily contribute, I believe, and not using that level of experience.

Q28 David Ruffley: You did not propose this; the June FSA paper proposed that the number of relationship-managed firms be—and I quote—"significantly reduced". To the layman, this seems to be the opposite of what we—
Paul Killik: You are absolutely correct, and since that paper was written by us we have actually been notified that we are now going on to a call centre. As you have rightly observed, we are not a big business, but we are a very particular niche of our industry and I think the FCA are going to be poorer by not having contact with us and understanding where we believe our industry is going.

Q29 David Ruffley: Your views have been given by yourself as an individual. What I am quite keen to understand is, are there other serious concerns of the kind you have identified prevalent in the rest of the industry?
Paul Killik: Yes, there are. I would add that I am a director. I am on the board of APCIMS, which is a trade association for our industry. I have been on that board now for about 15 years, so I am pretty well plugged into the thinking of the industry.

Q30 Mr Ruffley: Of course, APCIMS is a very important trade body. Are they going to make a fuss about this?
Paul Killik: They have made submissions both to the Treasury Select Committee, and also to the Financial Services Group, Peter Lilley's group, as well as, obviously, having dialogue with the FSA. I am not sure yet whether they are in a dialogue with anyone at the FCA.

Q31 Mr Ruffley: Would you think that the idea of a single supervisor across many different product areas is a bad idea?
Paul Killik: What I think is a bad idea is a one-size-fits-all concept. To take a very high-level view of regulation, from a rather analytical approach to it, without understanding the business models of the various companies underneath it, you end up with the regulator effectively designing the business model for our industry. That is not healthy because we are all being shoehorned into a one-size-fits-all regime.

Q32 Mr Ruffley: On that important point, can I ask Mr Eaton and Mr Warland what their comments would be on that issue?
Angus Eaton: I think from our perspective the—
Mr Ruffley: That is, essentially civil servants putting together a model with perhaps limited experience of the products and the industry that they are designing this regime for?
Angus Eaton: We would certainly support the view that it is essential that the regulator has the capability to do what it is set up to do. I endorse Paul's comments, in the sense of that it is not an easy thing to do. I would say my fear is these recommendations are predicated on the assumption that the industry itself isn't taking this seriously and not taking consumers seriously. We have invested an enormous amount in product development and have engaged regulators through our product development processes in a positive way. The danger is that if they separately try and analyse the industry in a way that is the broad brush approach, which I think was suggested, that could give rise to issues.

Q33 Mr Ruffley: This could potentially be quite calamitous for your business—not just your business, but for the industry. Would you go that far?
Angus Eaton: I would say the key for us is in understanding the consumer and the regulator needs to have the capability to do that. If we don't

understand the end consumer then I think there are issues.
Mr Ruffley: Mr Warland?
Philip Warland: A number of points. First on experience, in general I agree absolutely. I have been in the asset management industry now for 20 years and I can only think of one person who has ever been in the FSA who actually had business experience of the asset management industry. That is the first thing. The second thing I have to confess is that the FSA does have senior advisers who used to be called, "Grey Panthers". The predecessor in my job here in Fidelity is actually an old Grey Panther in the FSA. So they do have that experience in the FSA. But the biggest thing we suffer from is precisely what Paul has described: they do not understand our business model and they throw a whole series of regulations at us, which are really irrelevant and just add to cost. One big one is they talk about governance. They think governance is the way they govern the FSA, which is committee after committee after committee after committee, and we do not think that is a good way to run a business.
Mr Ruffley: Thank you.

Q34 Chair: I am suddenly curious about a witness who says they don't understand your business model but you want them to do product regulation.
Philip Warland: I absolutely agree. There is a whole list of things in where the FCA is going where they don't have the skills. So, they don't have the skills in the business model, therefore they won't have the skills in the product, they won't have the skills in competition. We have discussed it with the proto FCA and they absolutely admit that the thing they are designing—I think it is called the Business Analysis Unit—they don't have at the moment, and I am not sure they know where they are going to get their people. But as an aspiration we think it is not a bad way to go.

Q35 Chair: But it sounds as if the aspiration is already likely to be a triumph of hope over experience?
Philip Warland: You might think that.
Chair: No, I am only drawing on your own evidence that they don't understand the business models.
Philip Warland: Absolutely; no, I agree with that. But I should say that I think they are beginning to understand that they do not understand it.
Chair: He who doesn't know and knows he doesn't know.
Philip Warland: Yes, slightly listening.
Chair: I forget, or at least I won't repeat ,the end of that line, because it is a little bit too impolite to the FSA.

Q36 John Thurso: The PRA is seen by some as kind of the big brother in this supposed twin peak; it has the veto, it has the big voice. What is the danger that, instead of it being a true twin peak, it is more of a mountain and a foothill and of the FCA becoming very much the kind of second cousin in the arrangement? Do you see that as a danger? Perhaps we will start with, Mr Killik.
Paul Killik: No, I actually think that would be positive to be perfectly honest.

Q37 John Thurso: You think it will happen or it won't happen and you think it is a danger or not a danger?
Paul Killik: I don't see it as a danger. It is difficult to predict whether it will or won't happen, but I think there is certain merit. Certainly, looking at the accountability of the conduct of business side, I feel that is the area that I am most nervous about. Therefore, having the regulator answerable to a peer group at the PRA I think would make me feel a lot more comfortable.

Q38 John Thurso: That assumes that they would be answerable to them.
Paul Killik: Or accountable.
John Thurso: Or accountable to them. Whereas the system as it is currently designed is that they both have equal accountability, so that the danger would be that they become much more aggressive and difficult, because they are trying to compete with the big brother, or indeed more relaxed because big brother is doing it, but you don't see those as dangers?
Paul Killik: I don't.
John Thurso: Does anybody else want to add to that?
Angus Eaton: I am happy to speak on that as an organisation that would be regulated by both regulators. The double regulation issue is one that we are concerned about, in the sense that our experience is while the structure of regulation is important, it is actually its operational effectiveness that is essential. We would urge the recommendation to go further and ensure that both regulators share services where it is appropriate to do so, and indeed interact from a single point, because the danger of two regulators coming in from different angles can only drive some confusion, and indeed costs, coming back to the comments earlier.

Q39 John Thurso: So your concern would be they would each go off and do their own thing and you end up having two sets of compliance, two sets of regulation and a double load of bureaucracy?
Angus Eaton: We can see that as a potential risk, yes.

Q40 John Thurso: What other impact would it have on a firm such as yours, which is going to be dual regulated? Are there any other areas of concern?
Angus Eaton: I think it is the co-ordination, ostensibly, which is the heart of our concern, from experience in truth. We completely respect the fact that conduct regulation is important and needs to have the appropriate airtime, and indeed we see that as a very important component of our business. With two regulators, and indeed other regulators, balancing that is a challenge for us.

Q41 John Thurso: For example, on compliance, do you see this as being double the amount of compliance required by you, because you will have to be doing two sets of compliance, or should it be one set of compliance that satisfies both?

Angus Eaton: Ideally, we would like one set of compliance if that was possible.
John Thurso: There's a surprise.
Angus Eaton: We should not lose sight of the fact that clearly there is a prudential regulator and a conduct regulator, so by their nature they are different topics. But there are some specifics—for instance, approved individuals with the regulators. There is the danger that the regulators could come in. We would be approving individuals by two different regulators, which, you know—

Q42 John Thurso: You will be regulated for conduct of business only by the FCA and you will be regulated for the prudential side by the PRA. By contrast, Mr Killik's firm will be regulated for both conduct of business and the prudential by the FCA. So he will only have one person to deal with; you will have two.
Angus Eaton: That is right.
John Thurso: However hard one tries with architecture, we nearly always get it wrong. Is there not a danger that actually you are going to end up—sorry, it is a fact of life, isn't it?—with two masters or two people to satisfy, while Mr Killik only has one? It is really trying to understand the risks in that and of giving you the opportunity to tell us what we should be looking for, and I will come to Mr Warland next on this.
Angus Eaton: Yes, there is clearly that danger. I think we would just add we do have a fund manager as well who, in theory, could be regulated by one regulator so we have that added complication as well. I would reinforce the point that double regulation could drive costs to consumers, and anything that can be done to drive the efficiency in the process between the regulators is something that we would support.

Q43 John Thurso: Mr Warland, if you would like to address that as well, but also, particularly around the question of the PRA's veto, because we can have a situation where the FCA might take a decision on product and the PRA would then veto it. To what extent is that going to get us into difficult territory?
Philip Warland: We think there is a danger there, and I think we gave an example in our paper where, had the PRA and the FCA existed when PPI came forward, the FCA might say, "This is very, very bad, that conduct of business," and the PRA might say, "But we really don't want to take any million, billion pounds out of banks' capital at the moment," and you can see that sort of tension arising. So I think there will have to be very close co-ordination, as Angus and others have said. We are slightly schizophrenic I have to say, because one of the problems with asset management and securities prudential capital is that, in Europe, and only in Europe anywhere in the world, our capital is actually set by a banking directive. There was a reason for that many years ago when CRD first came in, but that reason has gone away. Again, our early discussion with the proto FCA has made it clear that they understand that if you were to define anew what a capital regime looks like for a firm like ours, which is almost 100% FCA agency business, you would not start with the banking model. We think that is a very hopeful idea and we just hope that the PRA don't get in the way of it.

Q44 John Thurso: But as you pointed out in your paper, you clearly see that danger that, as with PPI, you can have a situation where the clear consumer interest might be to do something but a prudential authority might take a different view, and is that not an area that really needs to be fleshed out in legislation? For example, in the Crown Estates there is a veto reserved for Ministers that is never used. It is described as a nuclear option, but it never, ever gets used. I mean that is one possibility: you end up with no veto ever being used so it is pointless. Or the other is it is used too often, which completely takes away from the conduct regulation?
Philip Warland: I think you understand these matters in terms of legislation better than I do, but where you are headed I would agree with you.
John Thurso: Thank you.

Q45 Andy Love: Can I come back to the issue of intervention, which we touched upon at the beginning? I am interpreting now, but my interpretation of what you said was that for all the reasons that we know about—mis-selling and other issues in the marketplace—there is the recognition of the need for greater intervention. But of course the FCA envisages having a power to ban products and issue public warning notices. Is that going too far? Perhaps I will start with you, Mr Warland. You were the most sympathetic, if I could say that? Is it going too far?
Philip Warland: Maybe I should say why, I suppose, we are sympathetic is that our product—the one we use the most—which is the mutual fund, is of course totally regulated. So we are not scared about product regulation and that makes us different, probably, from Mr Eaton. We suspect and believe that the FCA would use the power to ban a product only in the most extreme circumstances, and there have been recent cases, Keydata being the most obvious one, or the Lifemark Bond, where, had they seen it coming and had they had the powers, they might either have said, "You can't do that," which would have been difficult because it was an overseas product, but they could have stopped the advisers selling it. If they had those powers, that would have been both for the good of individuals who bought the stuff and for us who have paid the compensation, or the redress. So, if it is used rarely, then as a reserve power we think that probably could be quite a good idea.

Q46 Andy Love: Mr Eaton, as seductive the argument that PPI could have been stopped in its tracks if they had had these powers, what is the other side of that equation? We understand what it might do and what it might achieve by intervening, but from your perspective what is the downside to that?
Angus Eaton: I think I will start at a macro level, in the sense that there are a number of actors in this industry who have a responsibility to build the confidence back into this industry—one of those actors is the regulator—including ourselves as well. The regulator should exercise its powers in a

measured way. I think our fear, for instance, on the warning notice that you cited would be that that could be a tool that was used to publicise potential investigations and not used in a measured way. That itself could undermine the overall reputation of the industry as a whole. So, echoing Philip's comment, it is all about measured, proportionate approach. But if this is a tool that is used in an unfettered way then we do have a fear that it is going to undermine the confidence in this industry that, of course, is already very delicate.

Q47 Andy Love: Mr Killik, guilty without being able to prove your innocence. Do you think that is a real danger and how can we protect firms against an overweening regulator?

Paul Killik: I come at it in a slightly different way. I think there is a lot of sense coming out of Brussels in the concept of simple and complex products. Again, going back a number of years, I remember the days when a unit trust was a unit trust, which was a long-only fund; it could not short, there was no leverage involved and it was basically what it said on the can. These days we all talk about funds, which can be anything from a hedge fund—a very complicated, structured product—to a very simple old-fashioned-style unit trust. I do think that, rather than banning products, probably it is a matter of ensuring that the person purchasing a product can understand what is in the product. Therefore, I think the concept of having a simple product, which can be bought widely by everybody, but keeping complicated products for those who can demonstrate that they have some knowledge and experience and can understand the risks of the product they are buying, has quite a lot of merit and bears further investigation.

Q48 Andy Love: Early-warning notices, what would be the impact? I am thinking about Mr Warland and Mr Eaton primarily here. What would be the impact on your firm if an early-warning notice was issued, in terms of your investors and your employees?

Philip Warland: The first thing to say is that we hope it would not happen. I went back through the records and I can't find a reference to the Ombudsmen that has been upheld for quite some time back. We, as Angus says, start with the consumer. In extreme cases, if the regulator sees that there is likely to be further damage if they do not say, "We think there is something going wrong here," again, as a reserve power, one can see the point or one can see that it could be very helpful. But I also agree with Angus that if you get a constant stream of these things, some of which will turn out not to stand up, then what it will do is it will damage confidence, and one idea we have is to perhaps involve the RDC and make the RDC a statutory body and let them make the judgment as to whether this is in the public interest. So, as a reserve power it is difficult to argue against, but how it is used is the issue.

Q49 Andy Love: Taking that up, Mr Eaton, the fact of issuing such a notice would have an impact, particularly on your investors, so how do you presume that we can protect against that happening? What protections need to be in the legislation to ensure that that will only be done in extreme cases, and when it is done it will be done in consultation with the affected parties?

Angus Eaton: Certainly speaking from experience, my experience of a regulator is to work in a constructive and open way with them as we build products, which is what we do now. I think that will mitigate the risk. I would echo Philip's words. We certainly hope we don't receive such a notice, but it would mitigate us ever getting to that point because we have built products that ultimately service the consumer and are demonstrated to service the consumer and—to Paul's point—the consumer understands what they are buying. So, I think that is where one should start. When it comes to a regulator actually deciding to issue such a notice, then I think the regulator should be accountable, perhaps to a tribunal or a higher body, or higher up, before they decide to take that action. I think the concern as well is that because it is connected with publicity and publicising that notice, that in itself is a big step to take for a regulator, which is not the way they exercise it at present.

Q50 Andy Love: Can I come onto a different issue. Mr Killik, you talked in your submission to us about a heavy-handed regulator, and you mentioned in the initial questions from the Chairman the confrontational attitude that you detected. In your paper, you talked about stifling innovation as a result of heavy-handed regulation. Can you expand on that for us?

Paul Killik: This is a combination both of heavy-handed regulation and also the one-size-fits-all concept. We all have to change our business models to fit with the regulator. That, per se, reduces the ability to innovate. You are being occupied with having to change the business model and not with the further development of the business.

Andy Love: Any of the other two want to comment on that?

Philip Warland: I think in our case it is their not understanding the business model and so they get their supervisory practice pretty well wrong.

Q51 Andy Love: Can I ask all three of you a final question. We are seeing here a more interventionist Financial Conduct Authority. We talked about dual regulation and the consequences of dual regulation with the PRA. There has also been quite a lot of comment about the lack of skills and the need for, particularly, the FCA to up-skill its employees, and you mentioned in particular not understanding the business model. Does all that add up, if we are going to have an effective regulator that it is actually going to cost the industry more? We are being told at the moment that it won't cost the industry more, but in effect all these things, if they are addressed, will actually lead to an increase in costs. What is your view? Mr Warland?

Philip Warland: Certainly that is a potential danger, and if they have to recruit a number of new skills, which I think they do, but if they also alter the way they carry out regulation and make it more appropriate

to our business, then we believe actually the costs could drop, so it would be more appropriate. In certain areas it might be more intrusive. That would be pretty difficult these days. But we do think that they can get better investor protection at a lower cost if they are clever.

Andy Love: So you believe in interventionist light-touch regulation?

Philip Warland: No, I don't think I said that. I think they should intervene and be intrusive where that protects the investor. They do it at the moment where it is totally irrelevant.

Andy Love: Mr Eaton, what is your view?

Angus Eaton: I think there is clearly the risk that you have articulated. I think one area that there ought to be some focus on is the regulator demonstrating, from a cost-benefit perspective, the actions that they are taking and being transparent about that, and then retrospectively assessing the impact of what they have done. I think they are attempting to build some capability that could do that, so it is a case of learning and mitigating that cost because, as we said earlier, ultimately it could be the consumer that carries that cost.

Andy Love: Mr Killik?

Paul Killik: I don't think I have anything to add to either Philip or Angus, bar one point. It is often referred to as a cost to the industry. It is actually a cost to the consumer. Ultimately, it is only the consumer who can pay and that is often lost sight of.

Andy Love: I thought you would be less worried about the consumer and more worried about your own cost structures, but I take your point.

Chair: Thank you very much for coming before us today. You have given us a lot of interesting evidence. If you have more thoughts as a consequence of the hearing, please come back to us in writing. We certainly have one regulatory optimist at least among us. It is something of a surprise. I would be very grateful in particular if the point that you just made, Mr Eaton, were fleshed out more. You have argued for greater transparency in almost every reply you have given—transparency for costs and benefits. A cost-benefit analysis is manifestly lacking and we need the industry to supply it to us, of which regulatory costs, obviously, is an important part of the equation. Thank you very much for giving evidence today.

Tuesday 1 November 2011

Members present:

Mr Andrew Tyrie (Chair)

Michael Fallon
Mark Garnier
Andrea Leadsom
Mr Andy Love
John Mann
Mr George Mudie
Jesse Norman
Mr David Ruffley
John Thurso

Examination of Witnesses

Witnesses: **Lord Turner**, Chairman, FSA, **Hector Sants**, Chief Executive, FSA, **Martin Wheatley**, Managing Director, Conduct Business Unit, FSA, and **Margaret Cole**, Managing Director, Enforcement, Financial Crime and Markets, FSA, gave evidence.

Q52 Chair: Good morning. Thank you very much for coming before us and helping us with our inquiry into the new institution, the FCA, and a particular welcome to Martin Wheatley, who is coming aboard to look after the FCA. Could I begin with a question to you, Mr Wheatley? I am sure you have read this document very carefully. Do you agree with everything in it?
Martin Wheatley: I think it is fair to say that the document is setting out our early stage thinking as to how we think the FCA will operate, and clearly it is setting that out with some idea of the legislative framework but without absolute certainty of it. It was a document to promote debate, and I think we have had a very good discussion with the industry. It is not a final blueprint.

Q53 Chair: But are you part of that debate or do you have firm views, as expressed in this document?
Martin Wheatley: I have a number of views and I am sure we can discuss them as we go on. I was part of the production of the document—even though I had not taken up post I very much spent my time talking to Hector and Margaret about what should go into the document—but I do stress it is a discussion document to promote a discussion and I am very much having that debate with industry and stakeholders now.

Q54 Chair: I am just trying to clarify whether you are signed up to the proposals in here.
Martin Wheatley: Yes.
Chair: You are, in their entirety?
Martin Wheatley: I am sure you will find some that I can question, but in a broad sense the document is the vision of the FCA but it is something that we are consulting on.

Q55 Chair: Obviously you are consulting, but if I, which I am not going to, were to ask Hector Sants these questions he will tell me, "Of course I support the proposals in the document." I am asking you, new to the job, whether you support them.
Martin Wheatley: And the answer is yes.

Q56 Chair: Mr Sants, we have had a lot of regulatory failure over the last few years, not least PPI. Are you confident that all of those failures were caused by structure—after all, we are changing the structure here—or was some of it caused by people?
Hector Sants: Some of it was caused by the people, both the regulators and the firms and to some degree the consumers. Some of it was caused by the structure, some of that structure being the micro-prudential structure and the powers that go with the micro-prudential regulators, and some of that, of course, in the prudential side—which I know is not the purpose of this inquiry—by the rules that were set in Basel and various international European forums. As we all know, I think we all agree, the causes of the failures over the last decade, both conduct and prudential, come from a variety of different sources, but I am confident that if we took forward the broad agenda, as set out in this document—I do agree with Martin, we were trying here to set out a broad agenda, not the detail of how we carry it forward and we did so with the intention of stimulating discussion and debate, not with the intention of reaching a conclusion—I do believe that if we carried out the broad agenda as set out here, we would significantly reduce the amount of consumer detriment in the future relative to that which we have seen in the past.

Q57 Chair: Are you responsible for any of these failures?
Hector Sants: In respect of the consumer issues that we highlight in the document, broadly no, because these have occurred over the past decade and have been built up, and some of them have crystallised, notably PPI during my tenure as the chief executive. But I think in relation to the principal issues that you are talking about, they all had their origins pre my time as chief executive, and I was not responsible for conduct issues at that time, and they also have their origins in some issues pertaining to the mandate of the FSA, both in respect of FSMA and the way it carried it out. Obviously part of this process now, which I am very much looking forward to, is to try to ensure that the future FCA is better equipped than the FSA was and also that there is a better common understanding between Parliament and the regulator as to exactly what the regulator is trying to do. I think one of the things that I find upsetting—
Chair: That is what we are looking at now.
Hector Sants:—in the last few years is coming quite regularly before parliamentarians and realising that

there is a huge gulf between what the regulator is doing and what many parliamentarians think the regulator is doing. That is a profoundly unsatisfactory position to be in.

Q58 Chair: We are going to be trying to close that gap as part of this inquiry. But the answer to my question is partly the mandate, partly the structure and partly the people who were in charge before your time?
Hector Sants: Yes.

Q59 Mr Mudie: Mr Sants, in view of yesterday, we are clearly in a potential pre-crisis period. If a crisis does develop, which body will deal with it? Is it the tripartite system or is it this embryonic system that we are discussing?
Hector Sants: We are still working under the current FSMA-based powers and the previous Finance Bill. Therefore the responsibilities for dealing with current regulatory issues, both conduct and prudential, lie with those authorities that currently have the power, so micro-prudential regulation is the responsibility of the Financial Services Authority. Having said that, we have, as you know, reorganised the FSA over the last 12 months into a prudential and a conduct business unit, therefore we have, as far as we can within the current legislation, anticipated the outline proposal in the current proposed legislation and therefore are working to some degree to the new model, in the sense of having a focused prudential micro-regulator.
The second point I would make is that the degree of co-ordination on micro-prudential matters between the FSA and the Bank of England is at a totally different level than it was in the 2007–08 period. I have regular meetings with the Governor directly myself, in which I brief him on micro-prudential matters, but I should be very clear that my responsibility for micro-prudential regulation is to the board of the FSA and my Chairman.

Q60 Mr Mudie: This is under the heading in the Chairman's questions, "Learning from the past". One of the things that alarmed us when we went through the last crisis was that the tripartite system rarely met. Is it meeting now?
Hector Sants: Yes, regularly. I am very satisfied, and again Adair may want to come in here, that the degree of co-ordination from top to bottom between HMT, the Bank of England and the FSA is at the required level of intensity. We now have a whole new process that has been put in place over the last few years, which did not exist pre 2007. As you well know, to my knowledge anyway, there were no regular meetings at all between senior FSA officials and Ministers pre the crisis. We now have regular meetings with the Chancellor, with HMT. I have regular meetings with the Bank of England. Of course Andrew Bailey—

Q61 Mr Mudie: When was the last meeting of the tripartite body? The Chancellor in the chair, the Bank of England and yourselves—when was the last time?
Hector Sants: This is not your question, but just to reassure you, the deputies, which are myself, Paul Tucker and the relevant senior official at HMT, normally Tom Scholar, took place yesterday afternoon and the last principals' meeting was three weeks ago.

Q62 Mr Mudie: Did the Chancellor attend yesterday's meeting?
Hector Sants: No, that was a deputies' meeting.

Q63 Mr Mudie: When did the full tripartite—
Hector Sants: As I was saying, three weeks ago.
Mr Mudie: When?
Hector Sants: I would have to check my diary but about three weeks ago; I cannot remember the precise date. If you want me to look at my BlackBerry, I can produce it.

Q64 Mr Mudie: That is interesting. They will be the body that handles most of the crisis. Learning from the past, we were all ill-prepared and a lot of that was due to the banks not being forthcoming about their real financial position. Even when the real crisis erupted and they were in real danger they were still telling the Chancellor that they did not need money. Assure the Committee that you have been all over the banks, that there are no surprises in store, that you know their full exposure rating for Greece, but if it moves on to Ireland and Portugal you have got that covered and that, as we sit, you do not foresee any public money being required?
Hector Sants: We have full transparency from all our major banks as to their positions. That was certainly not the case, as you rightly say, back in 2007–08. I do not wish to sound like I am hedging because I am not. I think the short answer to your question is yes, but nevertheless I should draw to the Committee's attention a couple of points. First of all, of course, it is possible for fraud—rogue trading—to occur within an institution, which will mean that its position turns out to be different to that which the institution has reported to us. But I believe we have full transparency of those positions. We also have the capability, which we did not have pre 2007, to make our own judgments on the quality of those positions, in the sense that we have hired 200 or so risk specialists. The FSA, as you know, had no risk specialist capability pre 2007; it was not set up to do that. And we now employ multiples of individuals on supervising individual banks compared with that period. So we do have full visibility.
The second part of the question, which is can we assure the Committee that there is no scenario under which UK banks will—

Q65 Mr Mudie: Obviously you cannot answer that question but it was within the context of first Greece and then it moving on to a second wave of Ireland and Portugal.
Hector Sants: Yes. The answer, broadly speaking, is yes.
Mr Mudie: It would only be fair to ask you again.
Hector Sants: Clearly you can construct scenarios of a more cataclysmic nature that go beyond those peripheral European countries where you could envisage there would be circumstances where there might be difficulties.

Q66 Mr Mudie: I have not, so you can assure us with the full transparency, which you have taken advantage of, you do not perceive public money going into anything arising from a Greek default and it moving on to Ireland and Portugal?
Hector Sants: Yes. I do not envisage that happening.

Q67 Mr Mudie: This question only requires a short answer—just a yes, if you wish. You say the banks have been transparent; have you, as an organisation, taken full advantage of that transparency and have the banks at any time refused to give you information or access?
Hector Sants: Yes and no. Yes, we have taken full advantage. No, on prudential matters all the major UK banks have been fully open and transparent with us.

Q68 Mr Mudie: So, bringing in today's exercise, there are no additional powers, Mr Wheatley, you feel you might need or want to be able to get information? It is forthcoming on request?
Martin Wheatley: Yes, I think that is true.

Q69 Chair: Mr Sants, when the FPC makes a recommendation with which you, sitting on the FPC, disagree, what are you going to do about it when you get back to the FSA prior to the enactment of this legislation?
Hector Sants: I think the process we would adopt is clear. So far that has not happened, may I just say, but nevertheless I understand—

Q70 Chair: But it is in the nature of things that it will one day?
Hector Sants: Yes, it could do. If I disagreed, I would express my view in the committee. As I think you have heard from Bob Jenkins and others, certainly on my experiences so far, it has been a very good quality discussion in the FPC. There seems to be no hesitancy from committee members in speaking up and expressing their views, though I can assure you if I—

Q71 Chair: That is not my question. My question is if the FPC are asking you, you at the moment a separate institution set up under current statute, to do something with which you disagree, what are you going to do then?
Hector Sants: Once the FPC had made its decision then the Executive of the FSA have said as long as they can see no bar to executing that mandate in relation to the powers of the FSA that they will comply with the interim FPC's request. We have made clear we will comply with all the current requests made and I would comply with future requests as long as there was no issue with complying with that request in regard to our powers. In the event—

Q72 Chair: You mean that you did not have the power to implement it, so they were asking you to do something you are physically incapable of doing?
Hector Sants: Yes. So in the event that there was a problem of that nature we have agreed—again, Adair may wish to come in—that the Executive would take that problem to the FSA board and then the FSA board would consider the issue and, if necessary, revert to the FPC. But assuming that we are able to comply, we will comply.

Q73 Chair: Where is this all set down?
Hector Sants: The procedure within the FSA, so the commitment by the FSA Executive to operate in the way I have described, was agreed by the FSA board, so I made the proposal with paper.
Chair: When was that?
Hector Sants: I am sorry?
Chair: When was that?
Hector Sants: We agreed this set of procedures prior to the first interim FPC meeting, so we were sure how we were going to operate when we went into the meeting, and the Executive—

Q74 Chair: Is that in the public domain?
Hector Sants: I think the actual executive paper isn't currently but I am sure we could put a summary of it—

Q75 Chair: I think it would be very helpful if this were put in the public domain. It is an issue that I have raised, as you know, both with Lord Turner and you, and also with the Governor, and I think it is extremely important that we have clarity before we have a crisis.
Hector Sants: Will do. I should also say that we have also agreed a set of procedures, which the Governor signed off on, which I agreed with Paul Tucker, as to ensure how we would then subsequently monitor the FSA's compliance with the FPC's requests, and how we would report the progress. Obviously some of these issues arrive over time.
Chair: Rather than waste more time on this it seems that you have given quite a bit of thought to it. It is very helpful and I think what the Committee would like to see is the papers supporting all this in full and any relevant minutes about the discussion of it. Thank you.

Q76 John Mann: I want to follow up Mr Mudie's question, just to clarify with you, Mr Sants, on your answer because you were suggesting that British banks were robust enough to deal with scenarios relating to, in Mr Mudie's words, Greece and other peripheral economies, which I take to be Portugal and Ireland. Does that extend to Italy?
Hector Sants: I think that is where I was making my rider, that as the Governor indeed has said in a number of press conferences, there are always concerns about what we don't know about interconnectivity in the financial system, particularly in relation to the interaction between the UK banks and continental Europe. I remind you that we are not the lead supervisor in the continental banks so I am not asserting that I have full visibility of the state of soundness in large continental banks, and therefore we cannot be absolutely certain of the implications of significant disruption to large eurozone economies and the consequence of that on their banks and the subsequent interconnectivity between those banks and the rest of the system, and therefore ultimately the UK banks.

I believe we monitor this very closely. We have done substantial analysis and work on potential scenarios that could arise from further disruption in the wider eurozone, but it would be wrong for me to give absolute certainty to this Committee. What I can assure the Committee of, categorically, is that we are very, very alert to the problem. I believe that we are addressing you with the greatest possible focus and we are doing it through the tripartite structure.

Lord Turner: Could I add one other thing? The direct exposure of the UK banks to Italy is not all that large. Indeed, in terms of the total exposure to the economy it is considerably less than to Ireland, where there is large exposure, not to the sovereign debt but, for instance, real estate loans. Italy, as a direct exposure, is not very large and that was part of the disclosures in the stress tests earlier this year. The bigger issues arise if problems in Italy had consequences for other banks throughout Europe and were part of the wider problem. But to Italy in itself the exposures are not terribly large.

Q77 John Mann: Let me perhaps ask a different question as a follow-up to that. Are you more concerned in your scenario planning with the economic situation in Italy because of the level of debt and the size of the economy than of those peripheral countries? Perhaps more pertinently, should we be more concerned about Italy than about the much publicised problems of Greece?

Hector Sants: Relative to its impact on UK banks and therefore possibly on taxpayers' money, which I think was the original question, yes but only in the way that Adair has already outlined, in the sense that the interconnectivity in the system between Italian financial institutions and the rest of Europe carries greater risk than the interconnectivity between Greece, Portugal and Ireland and the rest of the system. So in that sense, yes. But as Adair has said, and it is in the EBA data, the direct exposure to Italy is also not particularly significant.

Lord Turner: But I do think you would be absolutely right to focus on the fact that within the present stresses on the eurozone Italy is the most concerning, simply because of the sheer size of its public debt relative to GDP in absolute terms. So I think that is the most important thing in terms of the overall dynamics of the eurozone for us to focus on.

Q78 John Mann: Thank you for that; that is clear. Two questions on the purposes and objectives of the FCA. One of them is protecting and enhancing confidence in financial services and markets. Of course, at the heart of the problems three and four years ago was over-confidence, so how is over-confidence and, in that case, mispriced risk going to be balanced against confidence?

Lord Turner: We have suggested in our letter to you that we are not convinced that the most appropriate statement of the top-line objective of the FCA is enhanced confidence in the system. That seems to us something that more logically fits with the PRA, where the concept of confidence is important, although I take the point that it would be incredibly important then that that does not mean false confidence; it means confidence which is really based on good resilience.

When we switch to the FCA we have suggested that we should more clearly than under the present proposals say at the top what the fundamental focus is, which we think in some way should refer to fair, efficient, transparent markets, and so on. We think at the moment there has not been a clear enough distinction in the top-line heading objectives between the core focus of a prudential regulator, which is to do with the system and confidence in the system, and the core focus of a conduct regulator, which should be about efficiency, fairness, consumer protection.

Q79 John Mann: On the issue of consumer protection, Consumer Protection Objective F is the general principle that consumers should take responsibility for their decisions. Mr Sants, you talked about you having "full visibility" but consumers have opaqueness when it comes to the decisions made by the financial institutions. How can this catch-all, some would say cop-out, of consumers taking responsibility for their own decisions be managed by consumers when they have so little visibility of decisions and processes that lie behind the financial institutions?

Hector Sants: I agree with you. I think the question of what we mean by consumer responsibility has not been adequately teased out and there is not an accepted view as to what we mean by consumer responsibility, and I think it would be very helpful to the FSA going forward if we could get—we will probably never achieve entirely—a much greater consensus on what we mean by that.

Two points, as you say, are apparent from the past, and I might ask Martin to expand on how one might take it forward. The two points that I think are apparent from the past are, I think, there are certain decisions which consumers are being asked to make where it is not reasonable for them to take full responsibility for that decision because it would not be reasonable for them to have a full understanding of the information on which they need to make that decision. An example of one that I have mentioned in the past some time back is that I think it would have been unreasonable to have expected a consumer to have worked out what the risks were inherent in Northern Rock's business model, which is why there should be an effective FSCS deposit protection scheme, and expecting consumers to know how banks fund themselves is not reasonable.

The other fact, of course, we do know, and that obviously very much lies behind the thinking in the FCA document. That is that historically it has been believed that if you give consumers plenty of information at the point of sale on individual products, it would then be reasonable for them to take full responsibility for the decision, assuming the information had been properly presented to them at the point of sale. Unfortunately, research undoubtedly demonstrates that, for a variety of reasons, consumers do not read that information properly at the point of sale and that is not a very effective way of mitigating risk.

We also know, sadly, that many consumers are not equipped to make those types of judgment, given the

degree of education they have had in relation to financial matters and mathematical skills. That is just a matter of record, which is why there is a need to raise significantly the understanding of consumers generally on finance.
We have three elements, which tell us literally that full responsibility is going to be very problematic, and I think Martin has already begun to give thought as to how we tackle this conundrum.

Q80 John Mann: Perhaps I could throw in one final question for Mr Wheatley. With these new arrangements, in your view, is it more or less likely that bankers and other financiers who do wrong will go to prison?
Martin Wheatley: That largely relates to the penalties for particular offences within the system and clearly at the most egregious end they will and should. In the past penalties at the egregious end have been linked to market risk conduct, insider trading of various descriptions. The original point that we started on, which is—

Q81 Chair: Before we move off that, how many are in prison at the minute?
Martin Wheatley: I don't know the answer to that.
Lord Turner: Perhaps you could ask Margaret, I would suggest.
Margaret Cole: None, because currently there isn't a criminal offence that is pertinent to the behaviour of bankers. Some may say it should be, but it is not a criminal offence to be incompetent—

Q82 Chair: How many have been found guilty of offences which, under your proposals, would be likely to lead to a prison term?
Margaret Cole: There is nothing in here that changes the criminal law aspects of this. That would be a matter for Parliament. If there were to be a criminal offence relative to behaviour of bankers and the running of banks, that would require new legislation. It is not framed in this current draft legislation.

Q83 Chair: This is certainly a point to come back to and I can imagine what the public are thinking listening to this, but I do not want to interrupt Mr Wheatley's train of thought on the earlier point.
Martin Wheatley: If we go back to this question about consumer responsibility, individual responsibility, I think the global world of regulation has moved from a belief that providing information to people combined with some conduct rules over the people selling products will lead to good outcomes. That was the broad philosophy that was adopted everywhere and it just has not worked, and so we have seen the detrimental outcomes all over the world; that process did not work. So the heart of the FCA going forward will be the extent to which we can look through products, look through conduct, look through business models of institutions and act at an earlier stage than the detriment occurring—so, rather than going in after large losses, take an earlier judgment as to which products are unsuitable in which circumstances.

Q84 Andrea Leadsom: Lord Turner, under the tripartite arrangement over the last 10 years, how many women were at the top of a bank or a regulator or the Bank of England that presided over this financial crisis?
Lord Turner: Not many, but the institution that scored best on that parameter I have to say would be the FSA.

Q85 Andrea Leadsom: How many women were at the top of the FSA?
Lord Turner: How many women are at the top of the FSA?
Hector Sants: 50% of my executive committee I think over the time of my chief executiveship have been women.
Lord Turner: When I joined the managing directors were Jon Pain and Sally Dewar. You are quite right that overall—

Q86 Andrea Leadsom: In terms of accountability, how many women were directly accountable—as chief executives, as senior executives of regulators, banks and the Bank of England—for presiding over the financial crisis?
Hector Sants: In the case of the FSA, 50% of the Executive.
Andrea Leadsom: Can you give me a number?
Hector Sants: Yes, 4 or 5 out of 8, depending on size.
Lord Turner: In the case of the FSA, 4 or 5 out of 8. In the case of most of the other institutions, absolutely minimal. That is what the factors are.

Q87 Andrea Leadsom: In terms of now, the restructure of the new financial regulatory organisations, of the Bank of England and all of those new bodies, how much effort have you made to ensure that the sex that got it wrong last time are not going to get it wrong this time? Is this jobs for the boys? Did you divvy them up between you?
Lord Turner: We do not appoint either the senior people at the Bank of England or the senior people at any individual bank. We don't have the right to do that. Nor have we set it as an objective, and it is not part of our statutory objectives to, as it were, influence a gender balance in the belief that decisions—
Andrea Leadsom: Okay, so nothing.
Lord Turner: In relation to our own internal situation, I would say that the FSA is as good as you get in terms of an exemplary approach to the fair treatment of women. We do have a requirement statutorily when we produce a new rule to think about whether that has some diversity impact, but that is quite different from us having an overall aim of trying to change the gender balance in positions of responsibility.

Q88 Andrea Leadsom: So you would agree then that the leadership of the PRA, the FCA, the FPC, the Bank of England, and all of the UK top banks remains men?
Lord Turner: No.
Hector Sants: No. It does not in the case of the FSA.
Lord Turner: In the case of the FSA I would say that we are somewhat of an exception to your general proposition.

Q89 Andrea Leadsom: Which of Martin and Hector Sants is a woman, then?
Hector Sants: I thought you were talking about the senior executives. Unless I have missed a point, there is one lady sitting on this bench. I think you will be familiar with Sally Dewar and other senior members of the FSA community, so no, I am sorry, I don't agree with you. The FSA, under my leadership, has had a balanced, effective Executive committee, which has reflected properly a gender balance.
Andrea Leadsom: But under your leadership?
Hector Sants: Yes, I am sorry; I am a man.
Andrea Leadsom: Not the leadership of a woman. That is fine, thank you.

Q90 Andrea Leadsom: I just wanted to talk to you a bit about competition. You have rejected the idea of a primary role for the FCA in competition and it has been watered down in spite of the efforts of this Committee and the ICB to require that the FCA has a specific primary objective of competition. Could you explain, Mr Wheatley, how the balance is between competition and regulation? Does more of one lead to less of the other and vice versa?
Martin Wheatley: Can I just clarify the position that we have taken on competition, because I think it is quite important? As the draft Bill currently stands we have a set of three operational objectives, which don't include competition, and then a duty relating to the objective, which is to have regard to competition in discharging those objectives. What we have said is that that is an uncomfortable position to be in. We would rather have a clearer competition objective so that we would have the ability to step into cartels, price, areas that we felt were unfair—so that we would not only have to take regard of competition once we fear one of our other objectives is not being met. So our view is we want a stronger role in competition than the original draft had suggested.

Q91 Andrea Leadsom: But you have suggested, have you not, in your submission, that you think you should simply refer to the OFT?
Martin Wheatley: No. Our current position is that there is a confused structure, that we would prefer to have a stronger position on competition and a clearer objective on competition.

Q92 Andrea Leadsom: "We do not believe it would be appropriate for the FCA to have responsibility for further specific competition acts of enforcement. The OFT has the relevant technical lead in economic expertise and experience." So in terms of firm, specific competition you do not think that the FCA should have requirements to enforce competition?
Martin Wheatley: Competition is an industry-wide issue, and what we would like to have is the powers to look at industry-wide issues. Within that context there will clearly be firms that we have concerns about, but our view is that we have to start from an industry-wide position and that the original drafting did not give us the ability to do that.

Q93 Andrea Leadsom: Sorry, that is still not clear to me. If you are not going to be responsible for firm-specific competition, so you are not responsible for Lloyds HBOS's 42% of the UK mortgage market, but you are responsible for the overall competitiveness of the mortgage market, isn't that contradictory?
Martin Wheatley: I think it is a starting point. It tells you where the starting point is and the starting point—

Q94 Andrea Leadsom: But where is your responsibility? Where would you like your responsibility to be?
Martin Wheatley: We would like a responsibility that had as a clear operational objective responsibility for promoting effective competition in the markets for the benefit of consumers.

Q95 Andrea Leadsom: So if Lloyds HBOS has 42% of the mortgage market you are not going to do anything about that?
Martin Wheatley: We would have to first form a judgment that the mortgage market was either over-concentrated or that that over-concentration was leading to detriment for consumers, and if we concluded that we'd then have to conclude what actions could be taken that would remove that redress. Some of that power would still sit in the Competition Commission to which we would have to make a reference.

Q96 Andrea Leadsom: But could you imagine a scenario where one organisation having 42% of the UK mortgage market could possibly be perfectly fine and perfectly competitive? Am I missing something? It just seems to me that you do not need even an O-level in economics to realise that a 42% market share is completely anti-competitive.
Martin Wheatley: It depends what the rest of the market looks like and so you have to look at the market as a whole.
Andrea Leadsom: So it could be perfectly fine?
Martin Wheatley: Depending on the characteristics and you would have to look at the facts.

Q97 Andrea Leadsom: Will you be considering that 42% market share? And if you decide that it is anti-competitive what will you as the FCA be doing about it?
Martin Wheatley: Partly this relates back to the debate we are having about the powers that we are given. If we have a clear objective—

Q98 Andrea Leadsom: What powers would you like to have? What I am trying to get at is, what competitive powers do you want to have as the FCA in regard to this specific example I am giving you, which to most people would be a clear example of lack of competition?
Martin Wheatley: It is very difficult because it always depends on facts. We would like to move from a situation where we have a set of operational objectives and then a duty that in discharging those objectives we take account of competition. To me that feels uncomfortable and it feels like a constraint. We would like to move to a position where we have a

competitive operational objective—effectively promoting competition within our objectives.
If, subject to the parliamentary process, we end up with that, then we come back to your question of looking at the different industry sectors and forming judgments as to whether there are anti-competitive features of those markets. I cannot prejudge whether 42% on its own would represent an anti-competitive position, which would need action.
Hector Sants: The simple answer to your question is yes.

Q99 Andrea Leadsom: Let me ask you in another way, Mr Wheatley. If you do have those powers, so now you do have the powers to look at anti-competitive practices, and if you do conclude that 42% is anti-competitive, what would you then like to be able to do about it?
Martin Wheatley: There were two things we would like to be able to do. If that led to conduct abuses, which were broadly in the space where we have sufficient powers, we would seek redress and we would seek actions to respond to our concerns.
Andrea Leadsom: What sort of actions?
Martin Wheatley: It could be abuse of pricing power, it could be abuse of cross-selling. It could be a product structure that created unfair product terms, it could be promotion of products—there is a suite of actions that we might be able to take—or it might be a reference to the Competition Commission. Again, we would have to judge based on the specific circumstances.
Hector Sants: What we are trying to do is remove the overlap, in simple terms, between us and the OFT, which we tried to use worked examples of in the last paper. That does not mean removing the Competition Commission from the process. What it does mean is removing the overlap and, in our view, potential confused structure that currently exists between us and the OFT. The current drafting of the Bill does not do that, so in relation to the current drafting we would like more powers, not less powers, to ensure we have clarity as to who is responsible for addressing exactly the sort of question you have raised. We are in favour of having more power in the Bill, not less.

Q100 Andrea Leadsom: So more power to force that market share to be reduced?
Hector Sants: Yes.
Chair: Why don't you send us something with some worked up examples, developing what you have already put in the public domain on how you think this competition structure will operate? I think that will be very helpful to the Committee as part of this inquiry.

Q101 Mr Ruffley: A question for Mr Wheatley. The consumer protection objective specifies that the FCA must have regard to "the differing degrees of experience and expertise that different consumers may have". How on earth, in practice, do you envisage the FCA achieving regulation having regard to those distinctions? It is quite a tricky one, isn't it?
Martin Wheatley: It is quite a tricky one. That partly derives from the broad legal definition of consumer, which is different from the common man test of a consumer, so the broad legal definition has consumers including everything from retail consumers through to hedge funds, through to major parts of the infrastructure like stock exchanges or clearing houses. In that sense, what we are saying is it is not that within retail consumers we are going to try to judge the responsibility and the duties that we owe to different groups. It is more reflecting that institutional consumers, corporate large wholesale consumers, have the ability to take more responsibility and they have the legal powers to read the 200-page document and understand exactly what it means. That is the sense in which that was in the document.

Q102 Mr Ruffley: Do you think under the new arrangements there will be more protection for the consumer than under the old system?
Martin Wheatley: Yes, I do.
Mr Ruffley: More protection for the consumer?
Martin Wheatley: More protection and because it comes back to this philosophy as to whether you can trust a combination of disclosure and conduct to deliver good outcomes, and what has happened in history is it has not, and therefore we are moving along the value chain to an earlier part of product design to try to ensure that good outcomes are designed into the corporate governance process of the people creating products. It is designed into the features of the product. I think it will lead to more protection for consumers.

Q103 Mr Ruffley: Can you finally give an example of how the new regime with these enhanced protections for the consumer, which you have just described—which will relate to product design among other things—would have prevented one of the failures in the last 10 years from a consumer's point of view.
Martin Wheatley: A couple of examples and it is easy with the hindsight of history so—
Mr Ruffley: No, but I am inviting you to frame that judgment.
Martin Wheatley: PPI is, as you know, one of the big areas where we have had significant concerns and they have ultimately ended up with a major redress issue with all of the banks selling PPI. With that product we would have been looking at the product production governance within firms, we would have been asking firms to show us how they have demonstrated to themselves, to their risk committees, to their board, that the product met our reasonable standards of care and fairness and we would have analysed the product profitability for firms, and if we saw products that were generating a margin of 70% or 80%, we would have been very intrusive in asking those firms whether that product and those features were properly explained to their clients.

Q104 Mr Ruffley: You do not believe the old system gave the regulator the power to ask those very pertinent questions? You are saying it is only under the new arrangements that those questions could be asked; is that right?

Martin Wheatley: PPI was a particular case in point because the FSA only took responsibility for insurance after some time.

Q105 Mr Ruffley: You said PPI but it was one example. Give me another example.
Martin Wheatley: Another example would be mortgages, where we look at the business model of a firm and look at its profitability—and here it might be the converse of PPI. In PPI we found products that were 80% margin. If we looked at the business model of some of the mortgage products, they are unprofitable under normal circumstances and they only become profitable when people start defaulting on their payments and banks start to impose higher charges based on those defaults. That is another example where we would have gone in and said, "You can't possibly launch a product that only works if it fails or you only make profits if it fails."
Hector Sants: It might be worth asking Margaret just to expand on the powers because I think in answer to the specific question: could we have done the analysis? Yes. We did not choose to because the FSA had adopted a different philosophy, which we have expanded on before. But where I think the new legislation is different and where we are very focused is, what are our powers of intervention? There we need different powers of intervention and Margaret might want to—
Margaret Cole: Yes. I think this also interlinks neatly with the competition point and where the boundaries are because in relation to PPI there were clearly anti-competitive aspects in the way the product was sold at the point of sale advantage. Yet the whole of the competition area was something that at that time we felt we had to refer across or work with the OFT and the Competition Commission on, and I think with the competition objective we are now proposing that will be much clearer and we can take earlier action. One of the earlier actions we could take would be to ban the sale of that product or ban it with the primary product that it is sold with.
There is a power to intervene earlier to ban a product on a summary basis and then to have a later consultation to make rules within a 12-month period. That is quite an important new power, we think, because that does enable us to intervene at an earlier moment, giving us the opportunity to have a look at the evidence and to justify our action in that 12-month period. That, I think, would have been pertinent in the PPI scenario. But I think giving us a competition mandate would have helped to get there and removing that confusion between the action that we could take and other authorities could take would have helped a lot.

Q106 Michael Fallon: Mr Wheatley, should it be the role of the Financial Conduct Authority to enhance the international competitiveness of UK financial services?
Martin Wheatley: That clearly was part of the FSMA responsibility that sat with the FSA. It creates a set of conflicts and I don't think it is part of the function of a regulator to have to take regard to that as well as consumer protection and intervention and the various other things. I think that creates too many conflicts.

Q107 Michael Fallon: So it is nothing to do with the domestic regulator whether or not the measures it adopts damage our competitiveness; is that right?
Martin Wheatley: There is a proportionality element, so let's separate these two things out. We clearly need to be proportionate in our responses. We need to be accountable to the effect of them and to the market, but to have a specific UK competitiveness competition point can only lead to compromises in regulation, and I don't think it would be a good thing.

Q108 Michael Fallon: All the evidence to this Committee is that it is the other way. Fidelity say it is a signal omission. AXA say they think that the regulatory principles should include the need for a regulator to recognise the international nature of financial services. Killik say it should be reviewed by an independent committee.
Martin Wheatley: As I say, I think proportionality is very important. We should do things that are sensible within the context of the industry that we are regulating, but to add on top of the proportionality requirement a requirement to have regard to the UK's international competitiveness can only lead you to say there are certain things that you might otherwise consider to be good regulation that you won't do. That would be a very strange outcome.

Q109 Michael Fallon: But nobody is suggesting they should have an override. All that is being suggested is that you should have regard to it. Do you think the regulatory system that you are inheriting will promote our international competitiveness, or leave it where it is, or damage it?
Martin Wheatley: I think it will promote it because people are attracted to a well-regulated structure. They are attracted to safe, secure, transparent markets that they can have confidence in. So I think all of that enhances the competitiveness of the UK system, but that is quite different from having a specific objective, which will be used to argue against certain things, which otherwise we consider to be sensible interventions.

Q110 Mr Love: Before we leave the issues related to objectives, can I ask you, Lord Turner, where you would rank diversity among the priorities of the regulator?
Lord Turner: I think diversity should probably be at the level of "have regard to" rather than up there in the top-line objectives because I think whereas diversity is a very important objective for society in general, it is not clear that it is the core function of a financial regulator to pursue diversity objectives. That would be my overall point of view.

Q111 Mr Love: Can I just press you a little on what "have regard to" would mean? There have been suggestions that, in some senses, you should measure complexity in the matter, monitor it. Others suggest, and I think you have already moved in this direction, setting up departmental structures that address some

of the diverse structures that exist in the marketplace. Which of those or what other things are you suggesting you should have regard to?

Lord Turner: Let me make sure we are clear about what we are talking about. There is, of course, a completely separate thing between the FSA and the FCA's internal commitment to diversity but leaving that aside, what should be the objective in relation to what happens within the provision of financial services to society in general? Where it has been interpreted so far is that, for instance, we have been supportive of creating regulations, which allow sharia-compliant products and that services a diversity requirement, an openness of access to people who have a different set of religious beliefs or moral values in relation to what a financial product should be. I think it is legitimate that in our activities as regulators we are making sure that there is a regulatory framework which is not to the disadvantage of diversity, but—although it would be for Parliament to debate this, and it could be debated—it has not been seen in the past and I could see some difficulties of us as being given the positive aim of creating a greater degree of diversity. I think it is defined and I think at the moment reasonably defined as being something that we have to take into account; we have to make sure that products are not discriminating, for instance, against different defined groups, but not a positive role, as Mrs Leadsom was suggesting, of pursuing a gender balance agenda. I think that is a reasonable balance, as is intended at the moment within the legislation.

Q112 Mr Love: Mr Wheatley, you are getting your feet under the table. May I ask about a couple of issues that you will have to deal with? The first is the Financial Services Compensation Scheme levy, where some concerns have been expressed, particularly by building societies, in relation to how that levy has fallen upon different diverse structures. There is also an interminable row going on about the definition of "with profits" related to mutual insurers. These will undoubtedly be resolved at some point, but there is a distinct feeling that there is not the recognition within the regulator of the diverse structures that exist out there in the marketplace. How will you seek to address that?

Martin Wheatley: First, there are a number of issues that are existing policy issues that will continue and will be picked up by the FCA in the future, and the comments you make about the levy and the way the levy falls and the "with profits" policy will be part of that. We will be starting the consultation process on the levy in February. We will have various European changes to compensation schemes to take into account and we will try to come to something that recognises the diverse business models that exist in the UK. It is a challenge that is there today. We won't shirk that challenge. It will be something that we grapple with.

Q113 Mark Garnier: Martin Wheatley, the draft Bill provides that the Treasury will be able to direct the FCA to conduct an inquiry where it considers certain triggers have been met. In practical terms, when do you think the Chancellor should invoke those powers?

Martin Wheatley: As you know, we would have a very difficult process in regard to the RBS report, and a difficult process in terms of trying to invoke those powers against our own legal processes—I am sure Margaret will comment on this—that mean we gather information for certain specific purposes and it cannot be used for other purposes, and that we have investigations on foot. I think we have to move to a situation where there is a very clear set of guidelines as to when those powers are invoked, a very clear hard and fast line, which does not mean to say it is the only case but we have clarity about it that respects the fact that we may have enforcement processes under way and allows us to, as far as possible, complete an investigation and enforcement process before we have to publish, because there is a trade-off between the transparency and publication and our ability to complete the process. But I do think that those powers are useful powers—I think this Committee should be interested in those powers—but we would like to have a more clearly defined structure as to when they are invoked.

Q114 Mark Garnier: In practical terms it is quite a big deal for the Chancellor to come along and say to you that you have got it wrong and that you need to—

Martin Wheatley: That is right. In practice, what we would like to be able to do is to agree with the Treasury a set of almost automatic criteria—I say automatic; it is not so that they cannot be overridden—that say, "Under these circumstances a report will be produced." I think that is a much cleaner system and it gets away from the big hurdle as to getting to a point when a report has to be produced, but subject to our ability to complete our normal processes. Maybe Margaret can comment.

Margaret Cole: It is obviously a primary duty of the regulator to pursue investigations into misconduct or mis-selling or wrongdoing and to bring appropriate disciplinary action, or in some cases we do have the option of bringing criminal action. I think that is a primary duty and it is important that individuals and firms are held to account and also that firms and individuals pay due attention to early redress of consumers who have been harmed.

I have to say there are real legal, practical and fairness implications of trying to run an investigation the purpose of which is external reporting, at the same time as running an enforcement investigation the purpose of which is discipline. I think all of those implications have to be fully considered and it is very much our strong preference that we are unable to complete our primary duty of enforcement ahead of commencing or pursuing separate investigations for reporting purposes.

Q115 Mark Garnier: Hector Sants, in your submission to this inquiry, you say that you believe that this Committee will play a key role in the accountability system. You will be well aware that the virtual indecent haste that you responded to our RDR report was seen by commentators as being the FSA holding this Committee, and indeed Parliament, in contempt. How would you respond to that?

Hector Sants: I am extremely sorry that that impression has arisen, but it is obviously for you to judge. Over the years that I have been in front of this Committee, I have very much been a proponent of accountability to Parliament as a whole and to this Committee, so it absolutely was not our intention to generate that impression, and I am very sorry that that impression was generated. I quite understand that.

Mark Garnier: You do accept that?

Hector Sants: Absolutely. And the reality, just being absolutely open about it, was that I think we felt under media pressure to respond to the report, which was in the media domain. We were concerned that during the summer period—if you recall, it was slightly unfortunate timing for releasing a report, in the sense that the summer was coming up—the press were going to report it as RDR delayed. That is why, while we were considering the issue—and we absolutely did consider the issue, should have considered the issue—we were concerned that the media were going to run stories that basically made it look like the RDR was killed, and that preparations would then be disrupted, and effectively the option of careful consideration of your recommendations would have been removed from us. The press release was somewhat clumsily worded but it was reacting to media pressure. It was one of those things that happen, I am afraid, in the world of instant media, but it does not in any way reflect my personal commitment, the FSA's commitment, to full accountability to this group.

I think we should put it, if I may, to one side as not what we intended, and in terms of debate going forward we absolutely want to see proper accountability to Parliament and this Committee.

Q116 Mark Garnier: I am very grateful for your apology; good man for doing it. But you do have to address this point. There is a perception that the FSA is not accountable. This has caused quite significant damage to your reputation in terms of the accountability to this Committee and Parliament. I would like to give you the opportunity now to explain how you are going to redress that damage and go forward so that when the FCA is created there will never be a charge laid against you again that you are holding Parliament in contempt.

Hector Sants: I will ask colleagues to come in, in a moment, but since you are looking directly at me, not to duck the question, I will make a couple of observations. But I am keen for Martin and Adair to join in because we have given considerable thought to this and the general point, which I have said here before, is I do feel one of the failings that occurred around the time of the creation of the FSA was that there was not sufficient alignment, as I have said before, between the FSA's intended philosophy and the understanding of that philosophy by Parliament and the media. That has been some of the cause of the difficulties that we have seen emerge since, so we certainly want to try to avoid that.

I think there are two issues to try to improve that accountability. I think the first point is that absolutely the regulator should be accountable for discharging its statutory duties, obligations, objectives, and should be clear and transparent in reporting on whether it has succeeded in achieving that to Parliament, to this Committee, and there should be a robust challenge to that process. But to get there requires clarity of objectives, which can be reasonably measured.

The first ingredient to improve the situation going forward is to have simpler and clearer objectives that can be more transparently and openly discussed, which is why we don't like "confidence"—back to the earlier point in relation to the FCA.

The second question, of course, is to make sure that other accountability mechanisms to hold the Executive to account are stronger, and Adair might want to comment on that, which would be a much stronger and more credible board oversight process than the FSA has achieved before. We then come on to a third question, which I think we have not fully bottomed out, and is maybe to some degree at the roots of some of the concerns that you are alluding to, which is, what exactly is the model we want for our regulator? Are we, as we currently are set up and the Bill proposes, operating with a model, which is the one proposed in the Basel framework and so forth, that essentially you have an independent regulator working to a set of objectives for which it is accountable, for which the individual rules are its own responsibility, and those rules are made at a distance from the parliamentary process, or does Parliament want to take responsibility for those individual rules? At the moment the new legislation is sticking with the former model and that is a model we have been working under, but that has undoubtedly at times introduced tension into the system where some Members of Parliament, quite unreasonably, have had a different view on what is the right rule to make. But of course that was not how we were set up, and I think we have experienced that tension and dissatisfaction; I think that is what you are referring to and I entirely agree with you. I think we need to bottom out which of those two models we are going with and there has to be a recognition of which of the models—I think my Chairman is keen to—

Lord Turner: Could I make a comment on this and also suggest some ways that might make this model work? I personally believe that the model should continue to be the independent regulator within broadly defined objectives; that is the model that we broadly apply across Ofgem, Ofcom and so on. You could change it; one can argue it either way. But I think if that is the model, the nature of the accountability and the transparency of the decision making is very important. One of the things that struck me when I became Chairman of the FSA is that the FSA had been given very significant delegated authority to legislate rules, and I was surprised how little attention there sometimes was to the nature of the debate that was going on within the FSA board about those rules. When we debate the RDR or the MMR—the mortgage market review—the FSA board is, on behalf of society, ending up making rules that have legal force, but the visibility of those debates to the external world is not very great.

What is interesting is that you can draw the analogy with, for instance, the independence of the Bank of England and the Monetary Policy Committee for setting the interest rate. The objective is set by

Parliament but it is the MPC that decides the interest rate. But the way in which they do that is very clear to the external world because there is a minute of the MPC, which sets out clearly, so that the world can understand, the arguments that were put forward on either side. It deliberately makes transparent those arguments. Indeed you then invite as an accountability, not merely the Governor, the equivalent of the Chairman, or the executive members of the Bank on the MPC but you invite the non-executives, the independent members, and quiz them to make sure that you believe there was an open debate about it.

We could extend that to the FCA. You could require that FCA board minutes, to a much greater extent than at the moment, where they deal with a direct public policy issue, are published and set out clearly the arguments for and against, in the way that the MPC minutes or the FPC minutes do. You could, as you have not done with the FSA in the past, ask along non-executive members of the board for you to say, "Well, tell me what the debate was about the RDR. Tell me what the debate was about the MMR. Did you receive good enough papers from the Executive to drive that decision?" and so on. So even within what I do think is the better model, which is not Parliament individually writing all of these rules because I think there would be disadvantages to that, but independence within objectives, I think there are particular ideas that could create a better sense of visibility of the nature of those decisions and of a clear sense of accountability. Thinking about what the FCA board should be relative to what we have already set up for the FPC and the MPC might be a fruitful area of thinking.

Mark Garnier: That is incredibly helpful; thank you very much.

Q117 Chair: That is very helpful, Lord Turner. You said that the visibility of your internal debates on MMR, for example, has been very limited. Do you think that there is merit in an approach of scrutiny by exception—that basically you should be able to get on with it and not be interfered with, but now and again there will be issues that are of considerable public interest where you will understand and respond constructively to demands from us for a much higher level of information—you have mentioned MMR—on something where there is a high degree of tension? Then we may ask you for far more by way of documentation, including possibly minutes.

Lord Turner: Yes, I would not exclude that. I think drawing the analogy with the MPC, because the MPC ultimately makes only a small number of decisions—it used to be one, the interest rate; they now have quantitative easing as well—as it were your insight is simply on what were the processes, what were the debates, what was the degree of independence on that one decision.

The FCA, like the FSA, will make many decisions, many of which are of a lower level of importance and quite technical and one would not want to set in process an immensely complicated reporting device to that, but there may be particular ones, like the mortgage market review or the RDR, where we should more explicitly think through whether there is a more intense form of reporting that, while still leaving it for the FCA board to make the ultimate decision, gives a much greater transparency as to what the debates were and indeed enables this Committee to participate in those debates.

Q118 Chair: There are two aspects to it. One is ex post review of how you came to the decisions, where I think the view of this Committee should be that the level of transparency if demanded of you should be very high, subject to anything that you may need to blank out for commercial confidentiality reasons, but probably virtually no other exclusions—security in theory, but that would be extremely rare—and secondly, there would be scrutiny by us while you were formulating those rules, where of necessity you will have to be somewhat more cautious in the exchanges.

Lord Turner: I think even within what there is at the moment one could do more. I do not think, for instance, you have asked us along in the past at the level where we have issued a discussion paper, which is a broadly stakeholder-consultative process, and quizzed us in detail at that point, in the development of the theory. There are documents that are put out into the public domain, but I don't think there has been a clear enough definition in the past as to what should be the interface of this Committee with that sequence of papers as they are developed.

Q119 Chair: But you are agreeing with me that we need a high level of availability of documentation ex post should we demand it?

Lord Turner: I think that is probably right. I think the crucial documents are probably available in any case because there are consultation papers and discussion papers, but there may be other papers, which—

Q120 Chair: But we are talking about the decision-making process by which you decided over half, for example.

Lord Turner: I would not exclude the possibility that we should write, in the future of the FCA, the minutes—

Chair: I am trying to get past "not exclude the possibility" to support—

Lord Turner: I am quite favourable to the idea that in relation to these major policy issues the minutes should in future be written in a different fashion, more like the fashion of the MPC and the FPC, where it is visible to the external world that one member of the committee said this, another said that, and on balance the conclusion was as follows. Apart from anything else, I think that would get away from the idea that there is one correct answer to these problems. These are trade-offs where whoever is the body is going to make arguments for and against, and that fact should be visible to the rest of society, that a trade-off has been struck.

Q121 Jesse Norman: Each of you has affirmed their belief in the importance of proper accountability, and that is something that has been gravely missing in the past few years as regards the management of major

financial institutions, which have in several regards—as we know—been scandalously mismanaged. One thinks of Halifax Bank of Scotland, which fired its head of risk before going bust, and similar concerns at the World Bank. These executives are very highly paid and they bear very large private and public responsibility, so my question for you, Mr Wheatley, is—returning to an earlier question and elaborating it—would you support making certain actions into criminal offences? For example, reckless mismanagement of a financial institution.

Martin Wheatley: I think we have to be very careful about what we consider to be criminal actions. The challenge that we all have is we want good people in those roles, and so we want good people to take on the roles of directors, to take on the role of chief executives.

Q122 Jesse Norman: You are not suggesting that Messrs Goodwin, Stevenson, Crosby, and so on, were successful exemplars of good management in banking?

Martin Wheatley: No, I am suggesting that we need some good people in banking and we may not have been able to achieve that in the past. Clearly, there is a trade-off as to whether the risk and reward of that role is worth the best people going into it. I think we have to have the appropriate level of penalties for the appropriate level of offences. I think that is something we just have to think very carefully about.

Q123 Jesse Norman: But would you, in principle, support the idea of making certain actions into criminal offences in this area?

Martin Wheatley: When you say "in this area", the principle of making certain actions criminal offences, yes. I think we need to be very specific.

Jesse Norman: In the area of management of financial institutions?

Martin Wheatley: Reckless or wilfully misleading, possibly. Genuine business mistakes—people make genuine business mistakes.

Q124 Jesse Norman: No, certainly not for that. For reckless mismanagement, that kind of category.

Martin Wheatley: Again, and maybe I could ask Margaret to comment as she has more experience of this, I think we just have to be quite cautious about where we push the criminal sanctions into.

Margaret Cole: Clearly where there is fraud, that is a clear issue. We also have a criminal offence of misstatements to the market, and that is already there. I think I would be extremely wary of introducing a criminal offence in connection with management or mismanagement of a financial institution. What I think we should do is look at extending the consequences of that through the regulatory structure and perhaps arriving at a solution where it is easier for us to make sure that people who have been involved in mismanagement of financial institutions before are very clearly kept out of practising or working in that industry in the future.

That is not as straightforward as it currently sounds, as we have to reconsider applications when people have left the industry and make fairness judgements based upon an application at the time, so I think we want to be in a world where we can be clearer that people who mismanage institutions will never be able to work in the financial services industry again. So I think there are adjustments we could make here.

Q125 Jesse Norman: Your view is a significant toughening up but not extra criminalisation?

Margaret Cole: That is my view, yes.

Hector Sants: I think realistically, without discussing individuals, which would be wrong—particularly given that we have ongoing investigations in some areas—and Adair may want to comment here as well, when you look back in the round over what has happened by far the greatest category of error is misjudgment. I would see it as a judgment on fundamental competency, but that is different from recklessness. Having clearer powers to ensure that there is a presumption that once incompetency is demonstrated, which means you cannot get back into the industry, is what Margaret is referring to. Clarity of powers for us to use demonstration of incompetence as grounds for barring people from the industry would be a major step forward in itself.

Lord Turner: I did want to add one point. If you try to go down the criminalisation route that any form of criminalisation that is still sticking to—as it would have to—reasonable human rights, presumptions of innocence, clear proof of recklessness, will only very occasionally produce a prosecution, because the burden of proof will be very significant.

Therefore, I think if we simply go down that route we do not address the core of the problem. To me the core of the problem is that people make business misjudgments in balancing risk and return, but that in banks, we want them to make a different balance of risk and return from other sectors of the economy. There are other sectors of the economy where, for instance, launching an aggressive takeover bid in a contested fashion where you can only do limited due diligence might be a reasonable thing for the management of the supermarket or hotel chain to do; taking a risk for its shareholders which may or may not pay off, and if it goes wrong, well, the shareholders suffer but society does not suffer and the shareholders will fire the management. I think the difficulty we have in banking is that when you take some of those risk/return trade-offs, which might be perfectly normal in other sectors of the economy, there is a disaster for the economy as well. Therefore, rather than through the criminalisation of it, we are more likely to make progress here by thinking about whether we should simply face people who are the directors of banks—whether non-exec or executive directors—with a sense of automatic non-criminal sanction, either because we go much further down the line than we have at the moment of requiring deferral of compensation and making clear that that will be lost in some circumstances, or we have much clearer mechanisms to say if a bank, for instance, fails, "You cannot have future employment in the financial services industry unless you positively prove to the regulator that you were the person who was putting up the red flags and trying to warn against the concerns". I think we are more likely to make

progress in ways that shift the risk/return balance in a non-criminal sense than criminality itself, but they are very important issues.

Jesse Norman: Well, I am grateful for those two comments. The idea that the FSA might be able to make judgments as to competence is good, and the idea that takeovers in the financial sector have such high externalities that they might be regarded, as it were, as prima facie evidence of mismanagement, if that was an implication of what you were suggesting, is a very interesting point.

Lord Turner: It is not directly what I—

Q126 Jesse Norman: I take your point. I will move on, if I may. The FSA itself operates under a standard of gross negligence from mismanagement having to be proved against it. Do you think that that is too high a burden given, for example, that you are funded by the industry? Should the burden be lower so that you yourselves can be held more accountable by the people you seek to regulate and by the public?

Lord Turner: Well, I think there are two issues. On the FSA as an institution—or the future body as an institution and the individuals when you get to the institution in itself—of course one has to be practical here, given that it has no money and no shareholders. If it was subject to suits against it that resulted in payments to particular groups of people, all that is going to happen is that another group of people in the industry will have a levy placed on them. In those circumstances one simply has to practically work out what the benefit would be.

There is a separate issue of the treatment of individuals. I think it is quite right that in general across the public sector there is an approach to the idea of negligence, where I think the phrase is that it requires bad faith—is that right, Margaret?—on the part of the individual for them to be liable for that. I think it is difficult to go beyond that—it is a general principle that we have applied across the public sector—without removing the fact that you have to empower people with the ability to make decisions. There is a trade-off here with their freedom to make sometimes judgmental decisions; we have talked about the need to get away from box ticking and give the regulators the ability to make more judgments. The more that you make them subject to an individual legal sanction, the more that the automatic response of a cautious individual will be just to stick to the box-ticking approach. I am not convinced that there is an appropriate change in the law in that respect.

Hector Sants: If I may just bring it back to the earlier discussion, I think if we had a more visible and more accountable board—back to our earlier point about independence, as Lord Turner said, appearing in front of Committees such as this and so forth—of course the performance of the individual executives is the responsibility of the board. I think I take the underlying point that you are driving at, "Do you feel the executives are being adequately held to account for their operating processes as well as for their results of their judgements?" A stronger board would be another way of putting an oversight mechanism in place. I think that would be welcome and I cannot emphasise enough my support for the comments about a much stronger and more visible board.

Q127 Jesse Norman: I don't want to cut you off, but I have one important final question. You will recall that at a previous hearing I raised the case of my constituents, the Hintons, who had a business that has essentially had to close, at a cost to them of some £350,000. That problem arose because of faulty information as to the classification of them as directors of a failed and dishonest trading company of representatives. When I met the FSA on this with the Hintons and with Sharon, the account director there, I was told that faulty information given to the FSA had led to faulty classification of the directors on the register. I was told by her that the system was too inflexible and could not be changed. There was no acknowledgement that the FSA had any responsibility to change this information, although it knew it was faulty, and she also refused to commit to any change to the status of those directors in the new register. Now, do you think that that is an appropriate exercise of public accountability for a firm whose value has been reduced by £350,000—that official response and no further support to be given from the senior executives of the FSA?

Hector Sants: No, but I am not convinced that is what she said. I do not want to take up too much of the Committee's time on this particular issue, I am conscious of that. The Hintons e-mailed me on the subject yesterday, and I read it last night. They made a number of points that seemed to be at variance with my understanding of what had happened in the meeting that took place in the summer. There are a number of unanswered questions, and I think I will be following up and having a further discussion and come back to it.

Chair: Come back to us, yes.

Hector Sants: I am happy to write back to you. Clearly, we have not yet arrived at a position in this unfortunate case where the facts are all agreed between all parties.

Chair: Well, let us come back to it. We won't deal with it now. Jesse, we won't deal with it now and we won't answer this answer.

Jesse Norman: But if the facts were as they have described, can I take it, Mr Sants, that you would be in agreement with the question I put?

Q128 Chair: You do not need to answer that question. We are moving on. I just wanted to get back to something you said, Adair: "The penalty for failure may be a very high hurdle for further employment for the people who were in the bank when it failed." I thought we were trying to create the conditions in which banks could fail.

Lord Turner: No, what I was suggesting, I think, is that we are trying to create conditions in which banks are able to fail. I think we would still accept probably—this relates to the issue of reports as well—that there is a level of failure beyond some size where it is an important event for society, and where we would like them to be very rare indeed. I think if in 15 years' time there is another failure of the level of RBS or HBOS, I am absolutely sure that society will

want some sort of report as to what occurred in those circumstances, and although we want to create the mechanisms where that failure can occur in a much smoother and less disruptive fashion than at the moment, failures of that size should not be considered part of the process.

Chair: So it is a society issue.

Lord Turner: I think we also want to create incentives which make them less likely. I don't—

Chair: This needs very careful thinking through, what you have said on this.

Q129 Mr Ruffley: Mr Wheatley, could I ask you about the new business and market analysis team that is going to be really rather important in the FCA set-up? What will that team be able to do that other senior managers and directors at the FSA haven't been doing?

Martin Wheatley: The broad supervisory philosophy that we have had to date has been relatively firm-specific, so we had teams split by industry sector who owned particular groups of firms and either knew a lot about those firms or visited those firms on an occasional basis. Our intelligence comes from information from those firms, and we group up to a level where we understand that if there is problem with the firm, there may be problems across a broader group, there may be problems across a broader product range. The objective of this new group is to act as a matrix check, looking from a different perspective, so not now starting from a firm perspective, but starting from a consumer or broader product perspective that cuts across the specific firm work. It is to give us an additional check that will make sure that we are surfacing problems at an early enough stage.

Q130 Mr Ruffley: Are you going to be recruiting a different kind of supervisor to man this team than the FSA?

Martin Wheatley: Well, I think we will need more business analysts and economists. I think they are the sort of people; we have some at the moment, but I think it is giving more emphasis to that.

Mr Ruffley: We have had evidence to the effect that one needs more practitioners who can be regulators who understand product design and the interstices of problems with financial service products. What is your view about the number of practitioners who should be part of this team? Do you think it should be 30% or 50%, or do you have no basic view at all on the practitioner recruitment level?

Martin Wheatley: No, I think it is very important. I mean, any regulator only gets a sensible balance if you can balance the long-term career supervisors with new blood coming in from the industry.

Mr Ruffley: Sure. So in particular relation to the business and market analysis team, what proportion will be practitioners? What are you aiming for, more or less than 50%?

Martin Wheatley: I think probably more than 50%.

Mr Ruffley: More than 50%?

Martin Wheatley: Yes, but do bear in mind that we have already within the organisation a number of people who we would call practitioners that have come in from the industry fairly recently, so it will be a combination of lawyers, accountants, product designers, people who have come in from the industry already and new recruits to the business.

Hector Sants: Yes. Since 2008, we probably hired something over 2,000 people from the outside world who are not graduates, so the majority of the frontline regulators already have external world experience, but of course that includes experience in law firms, management consultants, accountants as well as in actual regulated firms.

Q131 Mr Ruffley: A final question, Mr Chairman. We have had lots of evidence to the effect that the calibre and expertise of regulators in the new regime needs to be higher, to put it bluntly, than we have currently enjoyed hitherto. In order to attract the brightest and best, what kind of budget will be available to you for salary for top supervisors, in particular in the new business and market analysis team? Are you asking the Chancellor to give you a good spending settlement so you can attract the brightest and best? Is it going to be comparable—the wages you pay, the salaries you pay to the FSA—or is it going to be better or is it going to be worse?

Martin Wheatley: Well, we are going through a budgetary process at the moment, and maybe it is better if my Chairman comments.

Mr Ruffley: Perhaps Lord Turner might want to chip in, yes.

Martin Wheatley: Yes. But we are going through a process which is largely a bottom-up process, which is saying, "What do we think we need?" and then we will have a process of discussion with the board where we talk about what the overall costs of the new structure are likely to be.

Mr Ruffley: Yes. Lord Turner.

Lord Turner: The situation of course is that we are not dependent on a spending settlement from the Chancellor. Again, one of the degrees of autonomy we have is essentially to set our own budget and to have levying powers over the industry. Now, that places therefore the responsibility on the board of the FSA now—the FCA in the future—for striking the balance between the clear desire to have a cost-efficient organisation and the fact that we need to pay appropriate salaries to attract good people. I would say that at the moment our salary structures are reasonable in terms of our ability to attract people of good quality from outside, such as, if I may point out, Martin himself. We would be concerned if we were placed under any tighter controls and told to limit the amount.

You have regulators across the world, in particular in the US, where the salaries are set directly by government or parliament, which have had very major problems in getting people anywhere near as good as the people in the industry that they are regulating. We clearly do not pay salaries at the level of the private sector, we don't need to, but we need some freedom, and I would say that the freedom that we have had so far is about appropriate, and the board will continue to strike this balance between what is the level of pay required to attract people, while still focusing very strongly on the need for a cost-effective organisation.

Hector Sants: I feel I should say on behalf of my staff that I think the main pinch point in the regulation in terms of retention through pay is not for the more senior people, who may well come into the industry having had a successful career behind them, and they have the additional social value of the wider challenges and tasks that they have, and it is not at our graduate end, where we have worked incredibly hard to have a very good graduate scheme in the last few years, and we had some outstanding products from that. But in the middle, when people are looking to accumulate savings, hopefully, for retirement and in the longer term, if you look at the turnover in our staff, our main area of challenge is people who have been with us for three to five years who have then used that experience to get a higher salary in the private sector, and of course that is where the firms have the most contact. So you are absolutely right, the firms are concerned about the lack of expertise, but it is in that middle section where we need to hold people, and I think the secret to this is pay and terms and conditions. It is not whether you had two years' experience in the industry before you came in.

Lord Turner: It is also true that while complaining about the quality, they also sometimes nick them.

Chair: Poaching is an enduring problem for all Government agencies.

Q132 John Thurso: I want to ask Mr Wheatley some questions about product intervention, but before I do that, can I chance my arm, Adair, and ask you for a short answer to something you said earlier, which was about the differences between risk and reward, between business and banks. Is it not the case that the levels of return on capital that all the banks are currently targeting are automatically locking in a level of unacceptable risk for the future? In other words, we need to be anticipating lower returns on capital for the future if we are not to repeat the risk.

Lord Turner: Broadly, yes. The logical consequence of the higher equity requirements that we have imposed on banks is that they should accept lower return on equity. Investment in banks should not be a high risk, high return part of the stock market. It should in technical terms be a low beta stock, a lower risk, lower return. The banks have adjusted their expectations to some degree, but I would agree with you that they may not have adjusted it enough.

Q133 John Thurso: Thank you. That is what I thought you said, so thank you very much.

Can I come to the question, Mr Wheatley, about product intervention? The FCA is envisaged to have power to ban products, to issue public warning notices. Now, we have obviously seen the damage that can be done with mis-selling and toxic products, but what are the negative aspects of this approach? What are the things we should be concerned about?

Martin Wheatley: Well, I think the negative aspect—I'm sure the industry will have played this back to you—are the potential negative effects on innovation and choice. Either because we take the view that a certain product is not appropriate or has features that are undesirable, or that the firms themselves self-regulate and do not bring forward products that may fall foul of some of our guidance. So the negative will be that there will be fewer products, and potentially a less broad flavour of products in the market. Now, what we would argue is that the broad flavour of many of the products that have come forward over the last five years has not been good for consumers, in fact, has been very bad for consumers, but the industry has not found a way itself within our existing governance and rules not to sell those products.

Q134 John Thurso: Why not a system of pre-approval of products?

Martin Wheatley: It would probably have the downside I have described, but in even greater numbers. Products typically become more and more complex, and firms want to get their products to the market within a relatively short time frame to take account of the market conditions, interest rate conditions and so on. Pre-approval would place a large burden, so we would need a larger number of staff to do it, and a process between us and the market. I had experience of pre-approval of products in Hong Kong and the effect is that products get brought to you half-baked, because the industry wants to rush the products out. The regulator ends as up as the spellcheck for the industry, because they bring such poorly thought through products in the hope that they will have a place in the window. I think pre-approval is quite a difficult process and has many more negatives.

Q135 John Thurso: You paint a picture of a world where there is an infinite number of extraordinarily good potential products, in a way. Maybe I am just a simple soul, but it seems to me either that I want to borrow money or I want to insure something. I have maybe four or five things I want to achieve, and all the rest is flim-flam. Why can't we cut to the chase and get this right for the consumer?

Martin Wheatley: Well, it means determining what is the flim-flam, and I agree, there is a certain set of basic needs, long-term needs, housing needs, capital needs and earnings needs. The industry happens to have been quite innovative in producing products that meet those needs through very many different routes, many of which provide very little value.

John Thurso: Yes. I was sitting here through most of the last Parliament hearing about multiple whiz kids with a double first in computer games creating products in basements that brought the financial system to its knees, and here we are saying, "So what. Let's let them all get on with it again." In so many other areas of product where safety is involved, like aviation or cars or all sorts of things, if you want to do something that is not tried and tested, you have a duty to work it out entirely and then you go and get it licensed by the CAA or whoever it happens to be. I just do not understand the mindset that says you can go and take lots of funny little bits of formulae and create something that nobody knew they wanted, persuade them that they have to have it, then discover it doesn't do anything and it gets banned afterwards. I mean, why do we go through that tortuous regime? Why can't we just say, "Look, this doesn't make any sense to start with, so we will not do it"?

Martin Wheatley: We could, and it would be a very different model, so it is certainly possible to design a pre-approval process and to have some quite strict structures around pre-approval. I can guarantee that this Committee would be inundated with pressure from the industry saying, "No, no, we are destroying the competitiveness of the UK. We are destroying choice. We are destroying valuable opportunities", but it is certainly a choice that could be made.

John Thurso: So our answer back to all the people in the industry who are currently saying to us that this proposed system of product intervention has huge dangers is, "Well, it is better than pre-approval, it could be a lot worse"?

Martin Wheatley: Yes, from their perspective, it could be a lot worse.

Q136 John Thurso: Okay. One of the things that was put to us—perhaps I can put this question to Margaret Cole—is the risk that the power to issue early warnings creates people who are guilty until proven innocent, and the particular one that was put to us was of course the Gartmore case, where at the end of the day, no action was taken against the particular trader, but meanwhile Gartmore have gone basically broke and been bought by somebody else.

Margaret Cole: The Gartmore case is not the greatest example of this, because it is a case where we did not say anything; we did not announce our investigation at all. It was the firm doing that. We are not proposing a world in which we announce investigations. That is a situation where we do not know whether there is anything that we should be holding people or firms accountable for. What we are suggesting is what we see as a rather small move on what I will call the transparency dial, if you like—the balance between fairness to individuals and firms and the public policy considerations around protection of consumers and putting as much information as possible into the public domain. We think that balance can be struck by publishing brief details at the moment when we issue a warning notice. A warning notice is quite some significant way down our process for holding people accountable. It is a moment when we have looked at the case in detail, taken it to an internal committee and reached a conclusion that there is a case to answer. We believe that by publishing brief information at that moment, we are not doing anything more than putting that into alignment with the criminal process or with the civil process or with the process that other regulators employ, like the OFT and Ofgem. They also put out brief information at the equivalent moment to a warning notice. We do not see this as a significant risk.

Hector Sants: Margaret, can you explain that the current proposal, however, does not really work either way?

Margaret Cole: Yes. Well, the proposal at the moment is that we should consult with the party that we are bringing the case against in every case where we might be going to publish a warning notice. We think that effectively undermines the power, because in each case there will be an argument and satellite litigation over whether we can publish the warning notice—arguments being to do with reputation. What we were endeavouring to do was shift the presumption. We were saying that we are going to bring forward the moment when we can put the fact that we are pursuing an enforcement case forward as a general presumption, so the last thing we want to do is get involved in separate satellite litigation halfway through an enforcement process. So we feel the current proposal is not satisfactory.

Q137 John Thurso: This is my last point, and perhaps I will link back to Mr Wheatley for this one. The FCA—this has been touched on already as well—will operate under the general principle that consumers should take responsibility for their decisions, and in your earlier answer, you explained that the legal definition of "consumer" covers everything from the highly sophisticated fund manager right down to the man on the street. Can I ask you to think just about the man on the street, the average consumer? In their written submission to us, *Consumer Focus* pointed out that, "The documentation for any high street bank personal loan requires degree level education, the standard text describing a PPI product requires PhD level education, and it takes 55 minutes to read a standard consumer credit agreement, let alone understand it". I would add, having recently tried to transfer some M&G fund shares to my son that belonged to him, that trying to do that is a particularly frustrating, lengthy and multi-correspondence experience. But do you not think that we should get to a point where the consumer on the high street should be able to buy something that has a simple tin with a simple set of words on it that says what it does, and he or she can trust that what it says on the tin is what it does?

Martin Wheatley: Yes, I think we should, and I think we do need to get to a situation of having simple, understandable products for most people; although some people will want more complex products. It comes back to the fact that even products that are simple in broad concept, whether it be mortgages or certain types of trading products, can be quite complex in terms of legal structures, and so we rely not just on the individual to ask some sensible questions—we do want individuals to ask sensible questions—but we also rely on the intermediary, the distributor selling that product to make sure that they have understood the circumstances in which they are selling it. They are the qualified professionals, and we expect them to make sure that it is suitable in the circumstances. There are certain responsibilities that consumers have to take, but there are responsibilities that distributors have to take as well, and the banks producing the product. We are very much focused on the production and the distribution of the product as well as the individual's responsibilities.

John Thurso: The core point is that for most consumers in the high street, looking at the question of caveat emptor, it is about working out the difference between a range of products in which they can trust. Now, they may make the wrong choice for them, but the products will all do what they say on the tin. The point about due diligence, as to whether or not what it says it will do on the tin, cannot be the caveat emptor responsibility of the man in the high

street. Am I correct that that is the direction you will go in?
Hector Sants: Yes.
John Thurso: Thank you.

Q138 Chair: It is not only product intervention, is it? There is also price intervention you are considering. I am just looking at box 2—sorry, I am not quite sure what page it is—but in any case, it is close to paragraph 3.15 in the consultative document. You say, "Where competition is impaired, price intervention may be one of the tools necessary to protect consumers. This would involve the FCA making judgements about the value for money of products". How are you going to achieve that, Mr Wheatley?
Martin Wheatley: Again, this links back very much to the objective. If we have a clearer competition objective, falling out of that will be our ability to act in terms of price regulation. We will be able to do that by having discussions with firms about their own processes and whether they are delivering products that are fair to both parties, fair in terms of their own products and fair in terms of the value to consumers. It will be very hard to say that there is an explicit single return that a product should generate, because it will vary according to different products. The truth is that it will be a discussion very often with the senior management of an organisation, for them to assure themselves that they have considered the fairness to the buyer of the product as well as the supplier of the product.

Q139 Chair: Can you think of a large number of products where you might need to do this, and can you think of a large number of products where improving the competition, rather than leaving it impaired, is not the better solution?
Martin Wheatley: Well, that largely comes down to the transparency or otherwise of the product. If it is simple bank accounts where you can compare interest rates and the products that go with that, that is quite different from structured products that are sold by banks, which have a number of quite opaque components, and it is very hard to judge the price you are paying for the product.
Chair: My question though was aren't we better off operating on the transparency rather than intervening on the price?
Martin Wheatley: I think generally; but there are certain products, and I mentioned structured products, where almost no degree of transparency will give you a proper understanding of what you are paying for the product, and this comes back to Mr Thurso's comments about how we have moved away from simple products. There are a number of products now that are so complex it is very hard to see what you are paying.
Chair: It might be helpful if you could give us some more information so that we can put some flesh on what exactly it is, what type of structured product it is exactly that we need to have in mind when reading box 2. I think that would be helpful.

Q140 Mr Love: Can I turn to the European dimension? Mr Sants, to what extent is the ability of the FSA to represent UK interests at a European level hindered by the reforms that we are undertaking here at home?
Hector Sants: I think there are two parts to that question. In the short term, some of the turnover in our senior staff has undoubtedly affected our representation on some of the key regulatory committees, because those are elected roles by the European regulatory community and they are elected on a personal basis, so if they leave the organisation the FSA does not automatically have the right to reappoint somebody to those roles. So the process of splitting up the FSA, which has been the cause of some senior people leaving, has been somewhat disruptive to our representation ability. That is a short-term issue.
In the longer term, I am content that the Bill and the supporting documentation does have clarity of responsibility for who is leading the process of representation on the key European regulators; the PRA, as you know, in respect of insurance and banking, and the FCA in respect of securities. There obviously will be the need to co-ordinate between the PRA and the FCA, as indeed at the moment, for example, there is the need on the EIOPA, the insurance one, which I represent on the management board. I have to co-ordinate with the pension regulator, which I think we do pretty well, and there is a need for us already to co-ordinate with the FRC and so forth in respect of ESMA. So co-ordination within the UK regulatory community is nothing new. We will have to make sure we have set up the right processes to do that. We have not created a new problem here, we have always had that problem. By definition, if you have more than one regulator, you have a co-ordination problem in Europe.

Q141 Mr Love: I was trying to get an answer to the question of whether we have a peculiarly bad fit between the UK regulation and European regulation, but let me park that, and perhaps you could give us your view, Lord Turner. But going on, you are trying to address this with a memorandum of understanding now. Getting away from whether or not a memorandum of understanding of common deliverables has applied in recent years, there is quite a lot of comment that we have received that says this is a muddle, and there is real concern that we will not be as effective in representing UK interests as we could be just with a memorandum of understanding. So is it a peculiarly bad fit and is a memorandum of understanding the appropriate way to address it?
Lord Turner: Well, it is clearly the case that against all the advantages that I think we will get from this future separation of the prudential authority from conduct, which I think will enable a better focus on those particular challenges, it will create some complexities in some particular areas, so that as long as it was essentially the FSA, it would clearly be the authority which relates to the European Banking Authority. Whereas in the future, there will be an interest of both the FCA and the PRA in the activities of the European Banking Authority, primarily the PRA though, because the EBA does not do much conduct stuff; it will probably be a bit more

complicated in relation to ESMA, where there are both conduct and prudential activities. But I think that simply reflects the fact that whenever you change an organisational structure, you make some things better and you create some new things that you are going to have to manage, so against the advantages of the new set-up, we will have to find a way of managing effectively, for instance, the relationship with ESMA. I cannot see a better way of doing that than through having a memorandum of understanding, although the thing I would stress, and I think this is what comes out of the talks that we have had, for instance, with the Australians and the Dutch, who are running similar models—this would not surprise you—is that whatever you write down in the memorandum of understanding, what really matters is the degree of interface and working relationships between the individuals involved. I think it will be absolutely essential that the PRA and FCA, even when they have split up, are continually in a relationship where people know each other, talk to each other, and so on.

I think one of the surprising things, frankly, in retrospect, when banking supervision moved out of the Bank of England into the FSA is that although the FSA's banking supervisors were primarily people who had come from the bank, there was a great deal of, "Well, we are now a separate institution and we are not going to talk to you closely, except to the extent that we formally have to". We have to avoid that in the FCA/PRA relationship. We have to support whatever is in the MOU by the fact that people individually still feel that they are working in a common endeavour in a number of areas. For instance, in the area of authorisations we will have to have sensible co-operation, but particularly in relation to the representation in Europe.

Q142 Mr Love: I want to come to the issue of the people involved and the tasks that they will have to undertake, but let me just stick the memorandum of understanding. As I say, quite a lot of people are worried about muddle. They are also worried about whether that will achieve the objectives that we are trying to set ourselves. To take the example of the CBI suggesting an international co-ordinating committee—some executive body—I understand there will now be costs associated with that. Recognising the difficulties that have existed in the past with memoranda of understanding, you have gone into them in just a little detail, Mr Sants, do you think we need to beef up the co-ordination between all the people who will be involved at a European level?

Hector Sants: At the European level, we would definitely have to do more than just ensure that we have a memorandum of understanding for bilateral processes between the regulators, unequivocally. We have to do that not just because we have to make sure that the regulators are talking—I do not want to repeat Adair's point—but I can't emphasise enough when we are thinking about MOU, this is really important. The MOU is not really the important element of co-operation. The important element of co-operation is human relationships. That was where the tripartite failed, and we have to make sure that does not happen in the future.

But back to your European point, we need to remind ourselves of course that the European regulatory process—it somewhat touches on the earlier conversation—is rather fundamentally different from that which we are used to in the UK, in the sense that the substance of the rules are not made in the individual regulators, they are not made in the ESAs, they are made through the political process of the Parliament, the Council of Ministers and the Commission. Therefore the principal authority within the UK that influences those high-level regulatory rules is in fact Government, the Treasury primarily, and the relevant officials from Treasury. So it is vitally important that you have a wholly co-ordinated approach and sufficient resources committed in Government, both in the political sense and in the civil service sense, to working the full spectrum of the decision-making bodies in Europe. Government needs to take the lead in co-ordinating the regulators in order to make sure that we are all speaking with one voice and it is a co-ordinated process, because ultimately, the key regulatory decisions in Europe are political decisions. So I think yes, we do already have structures for co-ordination between Government and the regulators, but I would encourage more formality and far greater commitment of resources to those areas.

Q143 Mr Love: Well, perhaps we could have a paper on that, because I think that is an interesting issue relating to how it all merges with Government, because I think Government has a unique role at the European level.

Let me come back to the issue of people, because not only is there an enormous amount of new regulation coming out at a European level, and an importance that perhaps has not been there in the past, at the same time we have the change in regulatory structure, the ICB report and all the other things happening here. Some of the people representing us in Europe are going to be involved in all of the regulatory changes. Are you stretching the limited number of people too far to be able to address the really important things that might be happening at a European level that are going to be critical for our future?

Lord Turner: Well, the biggest challenge that the FSA has at the moment is that we are going through major structural change, which is always disruptive, while also dealing with not only this major set of new legislation and proposals from Europe, but also of course a financial system that is very fragile and which, as we discussed earlier, could produce future stresses. That is a major challenge, but it is a challenge that I am confident the Executive are thinking about very systematically. What one tries to do is make sure that there are particular people who have particular jobs who you carve out a bit from getting too much involved in the structural reform agenda. You say, "You concentrate on that and just get on with it". It requires systematic management, but this is an organisation of which a lot is being demanded at the moment. In an ideal world, you probably would not have decided to do major structural change amid the biggest financial crisis of the modern capitalist

system, but we are where we are, and we will manage through it.

Mr Love: Can I have just one last very quick question?

Chair: A very quick question, and there had better be a quick reply.

Q144 Mr Love: There is a lot of discussion about the importance of financial services to the UK in comparison with other European countries, yet we only get one of 27 votes in all of these structures. The EBA has been based in London. Is there an argument that perhaps others, ESMA, and looking at it particularly, might be based in London to satisfy the importance of this particular sector to our economy?

Lord Turner: It is a very good argument, but it is not one we are going to win.

Chair: Thank you very much for coming before us. We have found that evidence extremely useful. We are heartened by the fact that there is quite a lot of flexibility around this consultative document about which a good number of us have reservations, and I expect we will be returning to these issues before too long. Thank you again.

Wednesday 2 November 2011

Members present:

Mr Andrew Tyrie (Chair)

Michael Fallon	Jesse Norman
Andrea Leadsom	Mr David Ruffley
Mr Andy Love	John Thurso
Mr George Mudie	

Examination of Witnesses

Witnesses: **Peter Vicary-Smith**, Chief Executive, Which?, **Christine Farnish**, Chair, Consumer Focus, and **Gillian Guy**, Chief Executive, Citizens Advice Bureau, gave evidence.

Q145 Chair: Thank you all very much for coming in this afternoon and thank you for rearranging, which was inevitable as a consequence of the overload, itself triggered by the decision of the Governor and the Bank to do QE, and I will wish to hear from him on it. Could I begin by asking each of you whether you think that the proposal that the purpose of the FCA should be to "protect and enhance confidence in financial services and markets" is the right overarching objective for that organisation?
Peter Vicary-Smith: To kick off, no, it absolutely is not. Our view is that confidence is an outcome, not an input. If you think about it, the best way that you can maintain total confidence in the financial services system is by never telling anybody when anything goes wrong. Putting the regulator under a kind of burden of trying to promote confidence leaves us open to a lot of problems. Our argument has been that the objectives should be about a fair and transparent market in financial services—that should be the strategic objective—and confidence is then something that comes from people engaging in a market that they find to be transparent and fair. They will then have confidence in it.

Q146 Chair: Isn't transparency also not necessarily an end in itself but an objective to secure competition?
Peter Vicary-Smith: I think it can be, but the market is so untransparent at the moment that having a requirement to promote transparency would be a very good driver in this particular marketplace.

Q147 Chair: You have seen our recommendations on competition and the competition objective. Do you agree with them?
Peter Vicary-Smith: I would absolutely agree that competition needs to be promoted higher than it was, yes.

Q148 Chair: Than it is at the moment in the draft legislation? You are not happy with the draft legislation on that point?
Peter Vicary-Smith: No, we are happy with the position of—forgive me, I can't remember the term, the secondary—
Christine Farnish: Operational objective.
Peter Vicary-Smith: The operational objective, that is right. We would be happy there, but the key is what does competition mean? Competition can't just mean that loads and loads of services are provided and available, because it needs to have with it people's ability to compare products—which is where transparency comes in—ability to have confidence, and the technical ability to switch so they can make use of that competitive dynamic. So competition on its own is insufficient; it has to be supported by transparency and switching as well.

Q149 Chair: None the less, you are happy to see it as a secondary objective rather than a primary objective?
Peter Vicary-Smith: Yes, indeed.
Chair: Even though you want it surrounded by these other—
Peter Vicary-Smith: Fairness and transparency will create a market in which competition can thrive.
Christine Farnish: I think we would agree with much of what Which? has said to you. I am very pleased you have started with the strategic objective because it seems to us that getting the right strategic objective for the FCA is absolutely paramount. Everything flows from that. It is going to govern all the rest of the activity and the culture of this new body, which is so important, and we think, just as Which? does, that an objective that is narrowly about maintaining confidence could lead to the wrong sort of behaviour by the regulator. For example, it could lead to a rather risk-averse stance when one might prefer a more proactive interventionist stance to prevent problems from happening down the track. So we agree very much with what Which? has said, and also with what I believe the FSA said to you last week: that the primary objective—the strategic objective—should be about making the markets work properly, effectively and efficiently for consumers and for users of financial services.

Q150 Chair: Can that be done without competition?
Christine Farnish: No, it can't. Competition would be an essential part of that but we feel it should be one of the operational objectives. We are not happy with the way it is formulated in the Bill. The way it is formulated in the Bill would not allow the FSA to make rules using competition powers because it is not actually set out as a proper objective. It is slightly better than a "have regard" but it is not the same status as a statutory objective.

Q151 Chair: So you want it pushed up the hierarchy to become a statutory objective?
Christine Farnish: Yes, very much.

Chair: Okay, just to be clear.
Christine Farnish: Along the lines recommended by Sir John Vickers.
Chair: Which is pretty much what we say in our report.
Christine Farnish: Yes, absolutely.

Q152 Chair: So, unlike Mr Vicary-Smith, you are supporting what the Vickers report said and what we said in our report?
Christine Farnish: Yes, we are.
Chair: Okay, I think that is clear enough.
Gillian Guy: I think the important thing is to view the strategic objective within a context, and that has to be the culture of the FCA and also its governance. That said, we think that the strategic objective around confidence is not sufficient. It does not feature the consumer sufficiently highly, and we think that fairness and transparency should be the aim of the strategic objective for this organisation to make the market work well for consumers, yes, but for all consumers. Our difficulty is that there is not a clear mandate for financial inclusion in there. Because although we see the view about competition being high on the agenda, we also have the view that Which? have that it should not be a primary objective because it starts to kick into touch somewhat the necessary protection for consumers in this market. Also, in terms of how people are affected by it, we can see detriment at the margins very often from competition because good competition does not necessarily drive good behaviour
Chair: It strikes me there are not many takers for the Bill as drafted, even its first clauses. We will go on to have a look at the rest of it, but that is pretty condemnatory, from what I can gather so far.

Q153 Mr Mudie: You all seem to be united about lack of balance on consumer responsibilities. If so, why? Peter, in your submission you seem to say it is unbalanced, it is unnecessary and then concede to industry as, "However, as they want it, as long as it is toned down we'll go along with it." Is that misreading your position?
Peter Vicary-Smith: I think our position is that we would amend to remove the consumer responsibility principle completely because it creates an imbalance having a consumer responsibility and then not others. So not to leave it to the industry. The consumer responsibility is already established in common law, so consumers have responsibilities not to lie and so on already in there. To reinforce it in the ways envisaged, we think is over the top. With the imbalance of power and information that exists, it is very difficult for all consumers, in the place they are at the moment in terms of their financial education, to be able to engage on a level playing field with the industry. Thus, placing more responsibility on to the consumer without that being mirrored we think is just going way too far.

Q154 Mr Mudie: But am I wrong to think you are suggesting in here that you would be prepared to wear it because industry wants it?
Peter Vicary-Smith: That is very rarely my position. No, I don't think that this is the case. I don't think that is the position.
Mr Mudie: No, that is all right.
Christine Farnish: I wonder if I could make two comments. First, part of the problem here is the definition of consumer in the Bill. This is a unique set-up for a regulator that has consumer responsibilities as well as other public policy objectives. In all other sectors of the economy where you have sector-specific regulation, and indeed in Europe, consumer is defined normally as someone who is not a participant in the market activities, not doing it by way of business, who is usually either an ordinary domestic retail consumer or a small business. In this legislation, consumer is defined broadly to include everything from my mum to a hedge fund manager and that seems to us very odd. We think it would be far better and easier to focus the consumer protections where they are needed if the definition of consumer was narrowed to a more normal meaning of the term. Were that to be done, we think it is quite inappropriate to say the normal principle is that consumers should take responsibilities for their own decisions. As Peter says, there is a common law requirement for them to do that but the power in this market is so imbalanced between consumers and providers that that is one of the reasons why we have regulation in the first place.
Gillian Guy: We think the emphasis has to be on the market in this legislation because of the imbalance and the uneven power there is between the consumer and the operation of the market. There have to be safe products and good information in order to try to create that balance together but we have a long way to go—and I think a long way from buyer beware for consumers. I want to mention again particularly those vulnerable consumers who don't have the information and the wherewithal to make those kinds of choices; they don't need any more than their common law duty.

Q155 Mr Mudie: Have the three of you thought of getting together and rewriting it? It is in pre-leg down the other end of the building and it seems to me it would concentrate the minds of Members when they come to make decisions on pre-leg. It seems a very important point.
Peter Vicary-Smith: On that competition point, I think there is a principle in here that is quite important: I don't know another market where the producers seek to impose upon the purchaser, often uninformed purchasers, this kind of responsibility. If I buy a ready meal from Tesco, all I have to decide is, "Will I like the taste?" and "Can I afford it?" I don't have to work out whether it is going to poison me, but that is the kind of responsibility that they are aiming to transfer on to a consumer. It just does not exist elsewhere.
Christine Farnish: On top of that, 5 million consumers lack basic functional literacy and nearly 7 million adults lack basic numeracy.

Q156 Mr Mudie: Just on the point, you seemed to be enthusiastic about rewriting it but can I just temper your enthusiasm by saying it will have to be done very quickly because that Committee finishes, in terms of taking evidence, in the middle of the month and

produces the report in December, so it will have to be done in the next couple of weeks if it is possible. It would be very useful for Members.
Christine Farnish: We will have a go.
Peter Vicary-Smith: We would be very happy. The people sitting behind us are squirming at the moment.
Mr Mudie: They are all shaking their heads.
Chair: They looked very happy when you agreed so promptly to the suggestion.

Q157 Andrea Leadsom: I would like to return to competition. Clearly, in the financial services sector at the moment it is desirable that we create more competition. Post-financial crisis, the concentration is even greater than it was previously, particularly in the PCA and SME markets. I would like to ask you, first, do you think that there is a trade-off between competition and regulation, that is, if you have more competition would you require less regulation?
Christine Farnish: Perhaps I could have a go at that first. I think in some markets, that certainly is the case. I have worked in a number of regulatory organisations in the past in my career, some of which had both competition and consumer protection objectives, and there was an internal trade-off and balancing act that needed to be done. One of the great things about having a competition objective properly set out in the statutory remit of any regulatory body is that it tempers the temptation to do more regulation and write rules if that is not necessarily going to solve the problem. I think there is always a tendency for regulators to write more rules and be more intrusive. It actually forces them to pause and think about the impact on the way the market works.
It is also true that, generally speaking, effective competition is one of the most potent forces for delivering consumer benefits but, of course, we know there are lots of market imperfections with retail financial services markets, and indeed wholesale ones, and so competition by itself is not enough. We would like to see "effective competition" put on the face of the Bill rather than just competition, because competition gurus know that there is a subtle difference between competition and effective competition. Effective competition is a more subtle concept and is really about making sure that the demand side of the market is functioning well as well as the supply side. So it is not a narrow way of just looking at how many providers, how many suppliers, how many products. It is much more sophisticated than that. It is saying, "Do you have informed choice? Can consumers exercise their market power in the normal way to buy good stuff and put poor providers out of business?"
Peter Vicary-Smith: We agree entirely with that—effective competition. To give an illustration from the energy market where you have several thousand tariffs, the energy companies themselves don't understand their own tariffs. They certainly can't communicate them, as the Which? research we have just done shows, to their customers. Where is the real competition in there if no one understands the product and no one can compare it because of hidden charges and all the rest of it? So you have to have competition, yes, but that competition must be based on products that people can understand and compare and the ability to go and choose the product, so the whole process of switching, not just bank accounts, but switching your mortgage, your investments, your savings accounts and all the rest of it creates effective competition.
Gillian Guy: I think we have to look at where we are today as well and think about the imbalance in that market. Just putting competition into it would not be the magic bullet because it is about competition in the markets themselves but also about competition in conduct to some extent and that can have an adverse impact that we might not be aware of without protection and regulation. For example, something as exceedingly innocuous as free in-credit banking has had a knock-on effect on those people who are not in credit who have had to pick up the tab for that, because this is a profitable organisation and a market. We must have, I think, first and foremost, the objective straightened out as to where we are trying to get to with the market. Competition is part of that, but it is not the magic answer.

Q158 Andrea Leadsom: It is a very interesting point you raise about free-while-in-credit. Do you think that that in itself is a big barrier to competition? In our last session our witnesses were saying—I think it was Nationwide—that free-in-credit effectively creates enormous obstacles to establishing a new challenger bank because you have all these upfront costs of establishing the cheque guarantee cards, the chequebooks, the bank account itself, and it is only over time that you get the value of the credit balances to recoup your costs. Is free-in-credit in itself a limit to competition?
Christine Farnish: Perhaps I could have first stab at that. I don't think we have seen any new entrants or any banking entity in the UK that has been able to be profitable and offer a different business model, and I think that answers your question. Anyone who was the first mover out of the free-in-credit model would not do very good business and would soon probably go out of business. So it is a market imperfection. We are stuck in a place where there is a business model that has been arrived at for whatever reasons but which we do not think is truly sustainable. It is also unfair in many ways because, as Gillian says, it tends to penalise lower-income consumers.

Q159 Jesse Norman: I must say to the witnesses that I think you are making a very formidable case and I take your points very much on competition, effective competition and the different kinds of consumers involved. Thank you for those.
If I may, I want to turn the discussion to the issue of accountability of the FCA. The Government is suggesting that the FCA will replicate the accountability arrangements for the FSA where appropriate and strengthen them where it can. Can you just comment on that and say whether you think it is true, whether accountability could be better strengthened and how?
Peter Vicary-Smith: If I may kick off, I would say this is one area where we have had real trouble with the FSA in the past, so I think there are a couple of

dimensions. First, the internal governance structures that existed in the FSA where the board membership until post-crisis was so dominated by people in the industry—we have talked about the fact that at one point 10 of the 12 members of the board of the FSA were from the financial services industry, including someone, who in their day job was running HBOS, as deputy chairman of the FSA—were just wrong. The board should be able to represent many different interests and we were very pleased at the addition of, I think it was three individuals to spread that out a bit. The board itself of the FSA needs to be a bit of a broad church. It needs people from the industry, of course. It needs people from other types of groups and representing different interests so that it is not dragged into the minutiae of the detail but looks at the broader picture and spots the emperor having no clothes, which was so lacking during the recent crisis.

When you then ask to whom that body is responsible, we found with the FSA itself there was a real problem. If we had trouble with the FSA, where did we go? If we went to a Minister they would, at least when convenient, but generally most of the time, say, "Independent body, can't do anything about it." It was not responsible through the National Audit Office, the Parliamentary Ombudsman, and we said in the past that we thought that this Committee was the only real body that was exercising governance and accountability to Parliament over the FSA, and that does not feel like a very sustainable structure. So we would like to see the FCA have much more formal accountabilities and be brought within the remits of the like of the NAO, the Parliamentary Ombudsman and so on, in a much more explicit manner.

Q160 Jesse Norman: That is all very well, and I am grateful for that, but could you be more specific about the kinds of things you have in mind?

Peter Vicary-Smith: About the kind of accountability or the kinds of issues?

Jesse Norman: No, the ways of strengthening the accountability of the FCA that are covered by the phrases you have used.

Peter Vicary-Smith: For example, the agendas of the board meetings, the forward plans, the minutes of those board meetings, are quite untransparent as a way of trying to find out why positions were taken. I think in his evidence yesterday, Lord Turner, was it, referred to the nature of Monetary Policy Committee minutes and we think a lot can be done to say this body exercises enormous power on behalf of the public and it needs to be more open in the way it shows that power.

Q161 Jesse Norman: I certainly agree with you on the point of what you might call actual accountability, retail accountability rather than some nebulous phrase. Ms Farnish and Ms Guy, could you tell me what your views are on that? Would you support, as it were, strengthening the board, greater transparency, publication of minutes? You have kind of hinted at it in some of your replies.

Gillian Guy: I would certainly support something more formal and more rigorous along the lines that Peter Vicary-Smith has been talking about. I don't think you can divorce it from the other things we have been talking about. The culture of the organisation, the governance and the make-up of the board is particularly important. I think also duty—a duty to investigate, a duty to act when there is consumer detriment—is important to give accountability to consumers, and also the super complaint power, which we would support the organisation having.

Q162 Jesse Norman: Sorry, what is that? Could you explain that?

Gillian Guy: To take on board an issue that is broader than individual issues and actually pursue that through Government to have sanctions and changes to procedures and practice—that is a very important duty for accountability or power in that instance. I think it also links into our clear objectives. If there is not a clear objective around a fair and transparent market, the accountability is immediately watered down because it is only about confidence.

Christine Farnish: I have little to add to that. If you look around at accountability of other bodies that exercise significant power outside Government, statutory regulators, the FSA regime is not too bad because they have to consult on everything they do, they have to publish reasons for their decisions, they have to publish their annual plan, they have to account for themselves, and they have to come before this Committee. I think their accountability to this Committee could be strengthened. I also think that the board accountability could be strengthened in the ways that my colleagues have discussed.

Q163 Jesse Norman: How would the accountability of this Committee be strengthened?

Christine Farnish: Well, perhaps a more regular formal mechanism whereby you brought them in to account for their progress at six-monthly intervals or something like that on the basis of achieving the objectives and the things they have set out in their work programme, but possibly also an ability for other third parties like consumer groups to ask whether you would investigate a particular matter that they were concerned about.

Q164 Jesse Norman: I am grateful for that. With the Chairman's permission I will go on to one more question. In the introduction of the draft Bill, there is a table suggesting that the whole framework, through the Chancellor, is intended to be accountable to Parliament. Do you think that is likely to happen and, if so, how do you see it working in practice?

Christine Farnish: If you want to look at weaknesses in the accountability framework in the proposed new arrangements, I suggest you look to the Bank of England group rather than the FCA, because I think that is where the most weaknesses are. Clearly, particularly with the Financial Policy Committee, a new body is likely to be set up that is going to have enormous powers that will affect everybody in the UK, whether they are a consumer or a business, and the economic fortunes of this country without, it seems to us, effective accountability to democratically elected Government, Ministers and Parliamentarians.

So that is where the real weakness is in this arrangement.

Q165 Jesse Norman: In that table the thrust of your concern is on the Bank of England FPC side rather than the FCA?
Christine Farnish: Yes.
Jesse Norman: Other views?
Peter Vicary-Smith: For us there is a question about the relationship between the PRA and the FCA. In particular, we were concerned about the transfer of responsibility for with profits policies to the PRA, where there are huge amounts of consumers' money invested in these areas and there have been huge problems with with profits policies over the years and that, just overseen in a regulatory sense, feels it is ignoring the very real interest that consumers have in those policies.
Gillian Guy: I think in terms of accountability to Parliament, it is not for us to say whether that will work or not but there is always a bit of wry scepticism about these things and exactly how they will work, what the mechanism is and what the consequences are. If there aren't sanctions and consequences, there is no accountability.

Q166 Michael Fallon: How much of the cost of regulation and the cost of complying with it actually gets passed down to the consumer?
Peter Vicary-Smith: My view would be that the consumer pays for regulation, which is why in many markets we argue that, if it can be got to work, self-regulation is the cheapest form of regulation as a preferred option, then you regulate as much as you need to to create a fair market. The difficulty in this market is that it is so wrong that a less interventionist start just is not appropriate right now. I think Lord Turner in his Mansion House speech talked about £15 billion of mis-selling. Of course that didn't include PPI mis-selling, so over £20 billion as the cost of having got the regulation wrong. I can't remember who it was—wasn't it Stelios?—who said, "If you think safety is expensive, try having an accident." That is what I think we see here: that that is the cost of poor regulation, £20 billion having to be paid back because people mis-sold policies. So getting the regulation right upfront may seem like an expense initially but it should prevent mis-selling and other problems that end up in costs that hit the industry and therefore get passed on to consumers in the end.

Q167 Michael Fallon: It does not sound as if you are too bothered about the costs then.
Peter Vicary-Smith: I am absolutely bothered about the costs. What I want to see is, as Gillian said, a culture in firms that says, "We will not set up structures that encourage this form of mis-selling," so the industry is, if you like, playing by the same rules as many others. Then you can see over time that you don't have to have people checking up on them, but when you have an instance where just over the last few years you have had £7.5 billion of PPI products mis-sold, you can't at the moment trust the industry to do it properly.

Q168 Michael Fallon: Do you think consumers understand the cost of regulation?
Peter Vicary-Smith: I would say they understand that they pay for all things that happen, that firms are not charities so they end up picking up the cost, but I think they also understand that, without people fighting their corner for them, things happen that are wrong, and that is what payouts are about.

Q169 Michael Fallon: Yes, but the FSA told us they take very seriously the duty to be economic and efficient in the use of resources. How do we know consumers are getting value for money? You are just saying they should pay it because there have been all these scandals, but how do we know they are paying the right amount?
Peter Vicary-Smith: I think how you know consumers are getting good value for money is about how you know the FSA is spending its money wisely. That, to my mind, brings you to the accountability of the board, the accountability that may exist to the National Audit Office, the accountability here about how the FSA spends its money. If your question is about whether they are regulating too much or too little, I would say—

Q170 Michael Fallon: I am trying to get you interested in whether the cost of regulation is the right cost, whether consumers understand it, and how we can judge, you and I, whether that cost really is value for money. It is not enough just to say there have been all these scandals.
Gillian Guy: I doubt whether the consumers understand the full cost of regulation and they probably feel that competition helps deal with some of that and don't realise how fixed it might be, but the issue is whether they can afford not to have regulation. As Peter said, right now they probably can't because of the enormous cost. Take PPI—£9 billion. We therefore can't afford not to have someone keeping an eye on the conduct and the regulation. We are not ready, I think, for self-regulation, although that would be the ideal world. There are also layers of costs here. There is the cost of the FCA, which should be transparent, open to challenge and as efficient and effective as possible, and then there is the cost that the financial industry will pass on, which may bear no relation to that cost at all, and I think that is something that also ought to come under scrutiny, and dare I say, regulation.
Christine Farnish: May I pick up on that? I think cost is a very, very important issue for consumers but there is very little understanding and transparency about cost for retail market consumers right across financial services. So let me say that first of all. I would also say that as far as cost of regulation is concerned, the FCA or FSA's direct costs are one thing, but the indirect costs of all the compliance—and there is an industry of compliance out there some of which over-eggs the requirements, some of which is particularly risk-averse and gets an awful lot of lawyers' additional clauses put into things that are not necessarily required by the rules—all that cost, and it is expensive, ends up being paid for by consumers. In addition, there is the actual cost of the product, which

very often is completely opaque to people and they don't understand what they are paying. So I think there is a very big issue about cost.

Q171 Michael Fallon: Yes, but you have not given me an answer. How do we ensure that those compliance costs, for example, are the right costs?
Christine Farnish: More transparency about how costs are derived and made up would help.

Q172 Mr Ruffley: Christine Farnish, may I ask you about the business and market analysis team that will be the engine room, if you will, of the FCA? Are you attracted by that new concept and are you satisfied that the FSA officials, who are very likely to be passported over, have the right expertise to fulfil the objective of this new team?
Christine Farnish: To your first question, the answer is, yes, I am very attracted by the prospect of a horizontal team that can analyse the way in which a particular horizontal market works, because I think we have seen, particularly with mass-market retail products and some of the problems over the past 10, 15 years, that the problems are market-wide and it is not a question of one individual provider or firm doing something that is not right. It is a question of the whole market behaving in a particular way and selling products in a particular way that is causing detriment. So I think analysis of what is going on in the market, having your finger on the pulse in terms of up-to-date market intelligence of what is being sold by whom to whom on what terms and where the money is being made would be a huge step forward for the financial services regulator, and, indeed, it is done in many other regulatory regimes.
On the second question, I think this is aspirational for the FSA. They recognise that this is an important new step for them. I don't believe they have the necessary quality and quantity of skills they will need to do that, but these people exist in other regulatory regimes, and I think it could be very helpful to second some of the people who are used to working in this way to the new FCA to get things going.

Q173 Mr Ruffley: Could you give us an indication of which regulatory regimes you think these people might be drawn from?
Christine Farnish: All the economic regulators have people who think about the way markets work in economic terms. So that would be an obvious starting point.

Q174 Mr Ruffley: The existing UK regulators? Could I ask a question of Mr Vicary-Smith? You expressed concern in your written submission to us that the PRA veto could lead to a concept of too big to be forced to treat your customers fairly. How would you go about balancing the important job of preventing specific detriment in relation to certain products with that of more widespread consumer detriment if an intervention were to cause and trigger another crisis?
Peter Vicary-Smith: I think our view would be that we accept, albeit reluctantly, that there needs to be a veto of some kind in there. I remember during the financial crisis and the takeover of HBOS by Lloyds that I was the only person, I think, who stood up and said, "Only the Government can tell whether this is right or not right now. If they think it is right we will just have to kind of accept that." There are some things that have to go outside the normal frame for reasons of systemic market problems. But it is important that when that veto takes place, it should trigger an open inquiry and report into why it was exercised so that we can all see after the event that the thinking that went into it was correct, that there was a market problem that needed to be addressed, that it was being used appropriately and not being misused, so if you like it is that post-event accountability. I recognise that the veto has to be there, but there has to be post-event accountability.

Q175 Mr Ruffley: Just on that point of post-event accountability, is there anything you have seen in the legislation or any of the FSA documents that would suggest that the regulator, in exercising a veto, would be obliged to explain the reasons publicly for that exercise?
Peter Vicary-Smith: I haven't myself seen something that would imply that is there yet, no. That is something I would like to see, be it in legislation or in conduct rules.

Q176 Mr Love: I want to ask you some questions about product intervention but I cannot resist the temptation, since you are before us, to start with a couple of questions on the decision of the Payments Council in relation to cheques but they have not changed their mind, as we understand it, about cheque guarantee cards. Can cheques be viable in the longer term if you don't have a cheque guarantee card? Mr Vicary-Smith?
Peter Vicary-Smith: You can imagine that there are some isolated instances where you could use a cheque. If I am thinking of paying my builder or sending a cheque for Christmas to my nephews or something I could imagine it being used there, but I don't know many people, despite the fact that I have a very trustworthy face, who would take a cheque off me without a cheque guarantee card and certainly I don't see any retailers who take cheques. They all have a sign saying, "Because guarantee cards are going out, no cheques here, thank you very much." So it seems to be an imbalance, yes.
Christine Farnish: May I congratulate this Committee on highlighting this issue and investigating it, because I think it is a very real, serious issue for consumers? Some consumers still rely heavily on cheques. I am thinking of the elderly, people who subscribe to charities and a number of small businesses. It would be irresponsible for anybody to aim to get rid of cheques without making sure there were suitable alternatives in place that people understood and were confident about using. I think the cheque guarantee card in many ways goes with the cheque so the two should sit together. We are quite worried about this.

Q177 Mr Love: Should they reconsider their decision? What does the Citizens Advice Bureau think?

Gillian Guy: I think that decisions ought to be made on the basis of understanding their impact, and if they have an impact of excluding people in the financial market and the financial world, they should not be taken until that world is ready. It doesn't feel as if it is ready. Cheques without cheque guarantee cards don't seem to sit easily, apart from on private transactions and they are not in the main the transactions that the lower-income families and vulnerable people would be affected by. I think the same goes for things like ATMs and decisions that are taken without really thinking what the consequences are or the groups of people that are likely to be affected.

Q178 Mr Love: You tempt me on to the subject of ATMs, but I will resist that because we are here for a purpose. My questions relate to product intervention, which is, of course, being able to ban products and issue public warning notices. I am assuming all three of you are in favour. Certainly that is what your written evidence suggests, but perhaps you could just tell me. I will ask Mr Vicary-Smith first. You suggested that the FCA should be allowed to go further in terms of the powers that it uses. Perhaps you could outline where you think they need to look to make sure that they maximise their product intervention results.

Peter Vicary-Smith: The first thing I would say is that if we had a well-functioning market, we would not need to intervene against products in this way, because we don't recommend that kind of intervention in other marketplaces. It is because products are often poorly designed and then poorly marketed that we think these powers are necessary here. I think there are three types of powers, if you like.

One is the actual ability to intervene and say some types of terms are just not acceptable. That happens in other markets. If you look at estate agencies, for example, there are certain clauses in estate agents' contracts that have over the years been banned because it has been accepted that they were discriminatory in one way or another. So that is not a unique intervention by a regulator, and that is a self-regulator that, of course, did that. The second dimension is how things are marketed, and I think there is much more need for intervention on that. A lot of the problems we have over products are about the marketing twist, so they are about things like guaranteed capital products where the product is not actually covered by the Financial Services Compensation Scheme, so the capital is not guaranteed. Anything that has a word like "gold extra plus" we are inherently suspicious of. Our experience is that, when you dig into the returns, they are more fool's gold than gold.

I think intervention—that product regulation—is important because the industry has not shown itself willing to recall products that have performed badly. I am sorry to use another illustration with the retailing sector, but whenever we have a food scare the people who pull the products off the shelves are not the regulator, but the retailer. Waitrose, whatever, will take it off the shelves immediately. That is not what happens in this industry and therefore you need the regulator to have the power to ban such products.

Q179 Mr Love: In relation your submission, you suggested that public notices ought to be even stronger than has been suggested, but the industry itself is saying, "That makes us guilty before we have had a chance to explain." Can you justify going that far?

Christine Farnish: Clearly that would be a big step and a different stance and style of regulation were the FCA to do what we are asking. However, the way the regime currently works is that a firm can be under investigation for serious breach of the rules and serious risk of treating customers unfairly and selling inappropriate products. That investigation can take months. While it is going on nobody knows about it and consumers continue to buy those products, so detriment is likely to increase. That is our main concern and that is the reason why we suggested some mechanism for making sure that everybody is aware and there is a more transparent system, whether it is formal investigation of breaches of rules or marketing material that is felt to be misleading. We feel that more transparency in general has to be a good thing, both for the industry in terms of a deterrent and for consumers in helping them not buy stuff that is going to do them harm.

Gillian Guy: Let me just add that Citizens Advice would also welcome warning notices. I quite like the analogy of the food retailer, but it is not seen as, "Well, let's wait and see what happens." It is actually that there needs to be a warning out there to stop the product going further. The other thing that we would welcome as well as product intervention and the business plan that was mentioned, because that is often the important part of it for consumers, is positive indication of what there should be, as well as banning things—something saying, "It would be good to see this type of product or this moderation or modification to the product and to the business plan."

Q180 John Thurso: Christine Farnish, can I come to you? I used your evidence yesterday, citing the time it took to understand agreements—what was it, PhD level for PPI, degree level for an ordinary loan, 55 minutes or whatever it was? Is it not wholly unacceptable that financial products simply do not do what it says on the tin and that is that? Should not that be the benchmark for all producers of such products?

Christine Farnish: I think you touch on an extremely important issue. This gets us right to the fundamental ethos of regulation and what the regulator has been doing up until now. I think there has been a general belief by the FSA until very recently that the way in which you regulate retail financial markets is through the pure sort of rational consumer model whereby everyone is intelligent, everyone reads every single piece of paper that is put in front of them and understands it and then, providing the information is disclosed, people will make informed choices. All the evidence that we have had over 10 to 15 years, plus market research and behavioural economics, tell you that that is not the way things work in real life. So we

firmly believe that a different approach is needed. The old approach has not worked and, to our mind, the best approach that is likely to be successful going forward is for mass market products, not for the products for the higher rate taxpayers and the people who have means.

Q181 John Thurso: Let's make that distinction, because it was made by Martin Wheatley, that the law is all consumers, from the hedge fund to our respective grannies, and what you and I are talking about is the ordinary civilian purchaser in the high street.

Christine Farnish: Yes, and the ones who don't necessarily have the time, inclination or means to want or need sophisticated and expensive bespoke financial advice, like buying a Savile Row suit, if I can use that analogy. For mass market consumers we think it would be well worth exploring some sort of new arrangement. I am not sure whether it would be appropriate for the formal statutory regulator to do this or for some new body to be set up by the industry, possibly in partnership with consumer groups, but we would very much like to see an attempt to try and produce some standard terms and conditions—minimum standards—for a suite of mass market products that most ordinary families and consumers need during their working lives, that could then be identified through some sort of mark or trusted brand, and that people could buy cheaply, easily, safely. They would be good value and have clear terms—you would know what was said on the tin and what you were in for. You would know whether you would lose your money and what might happen to you. There would be no nasty surprises. If we could get to that point, we think that would benefit the industry as well as consumers, because many more products would be sold and the industry could regain public trust.

Q182 John Thurso: Really we are talking about pre-approval of products?

Christine Farnish: Some sort of minimum standards.

Q183 John Thurso: Any of you, is there anything wrong with just pre-approving basic products for retail consumers?

Peter Vicary-Smith: I think you probably would not want to get into pre-approving every product that is coming out, because I can imagine you would have an industry developing.

Q184 John Thurso: What about shifting the onus so, "Your product must do these five things," that everybody agrees? If it says I am insured against unemployment then I am insured and you cannot just change the terms when I am not looking or whatever it might be, whatever those simple things are. The moment you have not done that you are guilty, period, and you get fined, and you get fined about 10 times more than you get fined now.

Peter Vicary-Smith: There are two things in there. One is, yes, the idea of some sort of default mechanisms is a very strong one. The second one then turns into how you give consumers information and advice that is useful to them. I remember being before this Committee about five years ago on the subject of risk indicators on investment products—traffic light indicators—and this Committee was in favour of them, we were in favour of them, and, actually, the industry was in favour of them. The regulator didn't like it because they were scared that if they had said something was green and it went bust they would be held liable, but the consequence was nobody gave any guidance to people. So having something that is simple enough for people to be able to easily understand is important.

The third thing you touched on there is the sanctions for getting it wrong and I think there is an issue over fine levels but also over personal accountability. I believe it is true that the only individual who was caught over PPI mis-selling was actually the chief executive of Land of Leather. None of the bank chief executives, despite what has happened within those institutions, has been held liable. None of them, as far as we are aware, have had bonuses clawed back or anything, so where is the sanction for having breached those kind of conditions you talk of?

Gillian Guy: We also have to be aware that in a recession such as we are in more and more people are susceptible to the kind of offers and promises that are made around products so I think there needs to be scrutiny of those. Pre-approval of every product would probably lead us into another debate about the cost of regulation and hold up the market quite considerably. A clear framework in which providers have to operate would help protect the consumer, not only transparency about what products will do but clarity about where there is uncertainty about what they will do, because this is a market after all, but being quite clear where the risk is as well.

Q185 John Thurso: If you take a really big decision in life, such as a mortgage and buying a house, everybody will engage the services of a solicitor and the solicitor will cast an eye over and will point things out. If you look at, say, buying payment protection very often as part of something else, you may well not be taking legal advice and somebody says, "Jolly good idea—a few quid, you're protected," little knowing you have five years' insurance for which you are going to pay for 25 years. I think it is so loaded on the side of the industry that we have to do something to give that consumer at least a fighting chance of coming out with a product that works. You all seem to be less aggressive than I am about this.

Gillian Guy: I think we need a clear framework that is workable, otherwise if we end up with too much detail we may get something that is not workable, which would be even worse.

Christine Farnish: If I could just add a supplementary point. The Money Advice Service is now up and running and is starting to develop its financial health check that leads consumers who go there—you have to get people there in the first place, of course—to the point where they have a recommended generic product, life insurance say. If they could then go one step further to a suite of products that have been benchmarked, that you could compare because they have got the same terms—they have no toxic features—it is very clear what they do,

how much they cost, what the deal is, that would be a big step forward.

Chair: We have covered a lot of territory in a short time, none the less, I am sure there are things that you feel have not been dealt with adequately. Please come back to us on paper on those. We had a brief discussion in private session about cheques and you can be confident that we are going to persevere on that pretty vigorously. Let us bring this session to an end now and go straight on to the next session for which we acquire an extra witness, I think.

Tuesday 8 November 2011

Members present:

Mr Andrew Tyrie (Chair)

Mark Garnier
Stewart Hosie
Andrea Leadsom
Mr Andrew Love
John Mann
Mr George Mudie
Jesse Norman
Mr David Ruffley
John Thurso

Examination of Witnesses

Witnesses: **Mr Mark Hoban**, MP, Financial Secretary to the Treasury, and **Emil Levendoglu**, Deputy Director, Financial Regulation Strategy, HM Treasury, gave evidence.

Q186 Chair: Minister, thank you very much for coming to see us this morning. Can I begin by asking you whether you are deep in a trench on having the objective "protecting and enhancing confidence" as the top line for what the new bodies will do?
Mr Hoban: Chairman, as we set out in the White Paper in July, we are prepared to listen to comments about both the overall objective and the operational objectives.
Chair: So you are not in a trench on that?
Mr Hoban: No. We never seek to be in a trench.

Q187 Chair: Good. So it means that if we and others come forward with alternative suggestions—indeed, others already have—these are seriously in play?
Mr Hoban: Yes. We have been very clear throughout this process that we are listening. It has been a very collaborative process, and of course we have this Committee and the Pre-Legislative Scrutiny Committee, which Mr Ruffley sits on, and we have also had thoughts from the ICB too about the nature of the objectives of the FCA, and we will respond to those in due course. We have had all that feedback.
Chair: We will be coming back to that issue in a short while, later on this morning.

Q188 Andrea Leadsom: Minister, there is a lot of regulation coming out of Europe at a time when we are rewriting our own regulatory environment. Since the PRA and the FCA are going to deal with their European counterparts through a memorandum of understanding, could you talk us through how you see that working to ensure that we can maintain a strong relationship with those regulators?
Mr Hoban: What will happen is that the FCA will represent the UK on ESMA, and the PRA will represent the UK on the EBA and EIOPA, the banking and insurance arms, and that reflects the nature of their responsibilities, but it is not a new situation for there to be one lead voice on those bodies, with others contributing to the process. Under the previous regime when you had the various committees, you had people like the FRC, for example, working with the FSA in its dealings with CESA, the securities regulator; the pension regulator worked with the FSA on CEIOPS, the old insurance supervisor. The idea that there is one voice at the table is not new, nor is it new to say that they will work with others to ensure that consistent views are reached, that we identify areas where someone has specialist expertise, or where the expertise needs to be channelled through the FCA or the PRA.

Q189 Andrea Leadsom: But isn't it new that the European regulators will have far more statutory powers in future to be able to require British regulators to act in accordance with EU regulation, and under QMV? Does some of the talk concern you? The potential short-term bans on short selling, for example, and some of the proposals that we could, in spite of having 60% of Europe's financial services, only have an 8% vote on under QMV?
Mr Hoban: It does concern us, which is why we engage actively with the Commission. Of course, when it comes to the negotiation of level one insurance, like directors or regulations, it is not the FSA that is leading that process; it is the Treasury. We draw in views from the regulators and from industry in formulating our response, but we do need to robustly engage with those institutions. In the discussions around closer fiscal integration, the Prime Minister made it very clear that one of the national interests we need to safeguard is the way in which financial services are dealt with in any new institutional architecture.

Q190 Andrea Leadsom: Specifically on that point—the Prime Minister's determination to safeguard financial services—do you anticipate that we would go to the extent of enforcing what is called, I believe, the "Luxembourg compromise", where effectively we say that, under EU law, financial services is such a strategically important industry to the UK that we can override EU legislation on that matter? Do you think that we would go to that extent?
Mr Hoban: Clearly that is one of the options available to us. We would always hope that our ability to influence and persuade other member states meant that we would not need to use that.

Q191 Andrea Leadsom: What about the location of the European regulators? Obviously the EBA is going to be in London, but ESMA is going to be based in, I believe, Paris. Since the markets bit of financial services is clearly very dominated by the City of London, do you think that the location presents unique communications problems?
Mr Hoban: Not particularly, no.

Andrea Leadsom: Right, okay. Thank you, Chairman.

Q192 Mr Love: Regarding the memorandum of understanding, we have had it put to us at this Committee that it will be at best a muddle. With a chequered history of memoranda of understanding, has any thought been given to having something of a more executive nature, say, for example, the CBI's proposal that there should be some sort of executive co-ordinating committee? Is that something being considered?
Mr Hoban: The institutions we are referring to, who interact with ESMA and the EBA and EIOPS, are used to working together already, and the MOU just puts it on a slightly more formal basis. I do not think we need to overly formalise that process.

Q193 Mr Love: Let me ask you a second question relating to last week. We had the FSA representatives in front of us, and they reminded us that there is a strong political element to regulatory activity at a European level through the Parliament. Does that not mean there should be a stronger role for Government in this country to co-ordinate activity at European level, not just the interlink between the regulators, but also through the political processes as well?
Mr Hoban: We as Treasury engage not just with other member states and the Commission, but we also work very closely with MEPs—not just our own UK MEPs, regardless of party, but also MEPs from other member states—and I am going to Strasbourg later this month to continue that process of engagement at a political level. But you are right, Mr Love, to identify the dynamic in Europe in terms of regulation. It is very different to the dynamic we see here, where it is broadly a technical approach. In Europe, there is a political element, and that is not just for the Parliament. It is also in the Council of Ministers too, and we are alive to both the threats and opportunities that presents us with.

Q194 Chair: Can you think of any major area that the EU is engaged in at the moment on financial regulation, where you are confident that if their proposals are implemented, we will benefit?
Mr Hoban: We have seen areas where—
Chair: No, I am not talking about the future. I mean from their proposals.
Mr Hoban: Measures such as MiFID, which I think will help complete the single market across a whole range of securities and asset classes, will help London. What we are pushing for are measures that will make it easier to trade cross-border. That will break down some of the barriers, and there are good examples of where that is coming up on the horizon. I do not see this as a one-way traffic, Chairman.
Chair: I am only asking you for an example.
Mr Hoban: Yes, I think MiFID is a good example of that.
Chair: Of something that we are pushing for?
Mr Hoban: Yes, and we have been very vocal in MiFID, in making sure we get the rules right to enable London to—

Q195 Chair: I will just have one more go at the question. I am just asking for one clear market area where we are going to pick up business or do better than we would otherwise do as a consequence of a proposal on the table at the moment.
Mr Hoban: If you looked at the issue around scope in MiFID around the clearing obligation, where we want to extend the clearing obligation to exchange-rated products—currently it is restricted to OTC products—I think that will benefit London, where there is a good platform for trading derivatives.
Chair: Okay, thank you.

Q196 John Mann: I would like to clarify something as well, Minister. In what areas are we giving more powers to Brussels?
Mr Hoban: What we agreed last year as part of the supervision package is a range of areas; for example, the new ESAs we were referring to earlier—ESMA, EIOPA and EBA—that, for example, can ensure consistency between member states and the application of the rulebook. They can improve the quality of supervision across Europe. They are very important areas where the new European architecture can help. One of the concerns I hear often in London is a lack of a level playing field—that we are very good at enforcement here in London, but that those same standards are not applied elsewhere—and by giving the ESAs more powers than their predecessor bodies, it will enable that consistency of supervision, consistency of enforcement and consistency of the interpretation of the rulebook, which will become much more effective than it is now.

Q197 John Mann: The Germans and the French have their own priorities that they have been pushing, are pushing and will continue to push. Are any of their proposals already formalised, or that have been lined up, that you would regard as a good thing?
Mr Hoban: I think it is the case that all member states will champion their own interests. London is uniquely placed in this, because we have a wide range of financial service bodies.

Q198 John Mann: I am asking for your view as the Minister responsible. You have full oversight, more than we have, of some of the things that are perhaps not fully in the public domain, but obviously full oversight of things that are in the public domain. Are there any proposals from France and Germany that you think are a good thing?
Mr Hoban: I would not say it is strictly a Franco-German proposal, but I think their shift to make sure that exchange rate derivatives are cleared is a good thing. It is good for financial stability. It happens to implement a G20 commitment, and that is a positive.
John Mann: I think it would be helpful, Minister, if you would be so kind as to provide a note for the Committee on precisely which powers are being shifted to Brussels from here in these areas, so we can gain knowledge of them.
Mr Hoban: Yes, I would be very happy to do that.

Q199 John Mann: That would be helpful. How is it going to affect UK international competitiveness?

Mr Hoban: One of the challenges that we have as a Government when we negotiate these directives is, on the one hand, to take measures that strengthen financial stability and learn lessons from the crisis, and I think our constituents would want us to do that. It is also to ensure that those measures are proportionate, evidence-based and do not unduly impact upon our competitiveness.

Q200 John Mann: How will these changes to the Financial Conduct Authority impact on UK international competitiveness? There are some concerns that people have been raising about this.
Mr Hoban: A strong regulatory system is a competitive advantage, and many businesses come to London because they want to operate in strong, well-regulated markets. They want to know that the regulator is up to the job, that they have a rulebook that reflects the sophistication of markets in London, that the rulebook is implemented properly, that firms are properly supervised and that adequate capital is in place. Those things are the hallmarks of a good regulatory system and are a competitive advantage.

Q201 John Mann: Looking at the regulatory system that you want to see come in here, obviously you will know where the inherent weaknesses in British banks are and you will know better than us what the exposures are, not just to Greece, but to Italy and other potential scenarios, including in the immediate term. With this new system that you are proposing, is the British taxpayer going to have to bail out any other British banks in the foreseeable future, let us say in the next two years?
Mr Hoban: The first point I would make is that changes have happened over the course of the last two or three years that have led to banks increasing their capital. Increasing their holdings of high-quality liquid assets has, to an extent, insulated them against some of the problems we see elsewhere in the eurozone, and the EBA have said that there is no requirement for British banks to recapitalise as a consequence of the recent exercise they have been through. That is a good sign. What we are trying to achieve through our reforms of the banking system and regulation is to move away from a situation where the taxpayer has to stand behind the banks, and that is partly the thrust behind why we asked Sir John Vickers to do his work looking at the structure of banking.

Q202 John Mann: Obviously we are trying to, but in that answer you just used the phrase, "To some extent this will insulate British banks". What I am trying to ascertain is precisely to what extent this will insulate British banks and, therefore, the British taxpayer.
Mr Hoban: If we go back to the EBA exercise that was completed recently, they indicated that banks will have to increase their capital by €106 billion. In that exercise, there were two elements. One was to increase capital to 9% of core Tier 1. The other exercise was to make sure that the banking book and trading book exposure to sovereign debt were mark to market, and it was off the back of those two elements that the EBA said that no banks in the UK needed additional capital. What we have seen are high levels of capital to enable banks to absorb a write-down on a mark to market basis, but obviously the ability to which banks are able to fund themselves means they do not have to go out to markets to replace funding. It helps protect them from that crisis.

Q203 John Mann: But "helps" is a vagary. With this new regulatory regime, how much help? What is the risk to the British taxpayer? You appear to be reluctant to state that this is going to solve the problem. Will the British taxpayer be asked in the next few months to be contributing further, or is this regulatory regime sufficiently robust for you and others—the regulators—to be able to identify what the risks are and, therefore, what can be done about them?
Mr Hoban: The degree of engagement between regulators and banks is such that they can identify what the risks are, and there is a very open process of communication there, but what I would say, Mr Mann, is that there is a range of interventions we are making to improve the resilience of the financial system in the UK. High levels of capital and liquidity holdings are part of that, and improved supervision and regulation is another part, but some of the structural changes proposed by the ICB will help too. I don't think there is a single magic bullet that will solve this problem, but we are taking a range of steps that will lead to an increase in the strength of the banking system and away from the point—

Q204 John Mann: But the question is, will they work?
Mr Hoban: We believe they will work, which is why we are pushing these reforms ahead.

Q205 Mr Ruffley: The strategic objective of the FCA, "Protecting and enhancing financial stability in the UK financial system", has come under quite a bit of flak. The FSA says that that definition overlaps significantly with the responsibilities of the FPC and the PRA, and we also have the potential confusion for consumers. The FCA, the OFT and the FSA say it risks confusion in the authorities themselves, in regulated firms and among the public, because the super complaints go to the OFT under your regime, I think. They do not go to the FCA. Because of the kind of criticism you are getting, are you going to review significantly the strategic objective of the FCA?
Mr Hoban: As I indicated to the Chairman earlier, we will look at it.

Q206 Mr Ruffley: In which direction is your thinking turning?
Mr Hoban: What is important is that the strategic objective, as with the operational objectives, sends out a very clear signal as to what the FCA is there to achieve, and it is a conduct regulator.

Q207 Mr Ruffley: Forgive me, Minister, but the whole point is that the FCA speaks for all of us when it says, "The formulation does not adequately capture the distinctive nature of the FCA's responsibilities" and it is confused about competition, such as the

example I gave of who gets the reference of super complaints; it is the OFT, not the FCA. What do you say to that?

Mr Hoban: There are two aspects here. One is, what is the right remit for the FCA around competition? That is a topic that this Committee has opined on. It is an issue that has been raised by the Independent Commission on Banking, and we have signalled our willingness to listen to that. Once you recast, if you choose to do so, the operational objectives of the FCA around competition, we then need to ask, "Are the powers of the FCA proportionate to those operational objectives?"

Q208 Mr Ruffley: Let us just stick with the strategic objective. The argument is that protecting and enhancing the confidence of the UK financial system certainly overlaps with the PRA.

Mr Hoban: It is how consumers feel confident about the service they get when they buy products or access services from the providers of financial services. That is why it is important you do not just see the strategic objective in isolation from the operational objectives, and it is the operational objectives that give the meat to the bones and set out what the FCA will do.

Q209 Mr Ruffley: There is also an argument that having that over-arching strategic objective—forget the operational objectives—could enhance confidence in markets that may inadvertently lead to the risk that the regulator continues to support and build confidence in a market where confidence in the market is misplaced.

Mr Hoban: I do not think you can prise apart the strategic from the operational objectives. The strategic objective is an umbrella statement about the role of the FCA. It is amplified through the operational objectives, and that, I think, gives a clear remit for the FCA.

Emil Levendoglu: Mr Ruffley, I just want to expand on what the Minister said, because the way the objectives operate is that the action taken by the regulator must be consistent with the strategic objective and at the same time advance one of the operational objectives, so it would be difficult, if not impossible, for the regulator to act in a particular way in advance of the strategic objective, which was nevertheless contrary to its consumer protection mandate, for example.

Q210 Mr Ruffley: On that point, there is another thing you have missed out, but I will mention it, which is the requirement in the discharge of general functions to do it in a way that promotes competition. That is another limb, isn't it, after you have the three operational objectives and the over-arching strategic objective? Can you tell us about that?

Mr Hoban: Yes. That is the duty that the FCA has in trying to fulfil its strategic operational objectives. Can they be fulfilled in a way that increases competition, or can you use competition powers to deliver those operational objectives? That really is in response to the concerns that this Committee and others have raised about the role competition will play in the toolbox, as it were, of the FCA.

Q211 Mr Ruffley: On the discharge duty which you have referred to, that explicitly is to do it in a way that promotes competition.

Mr Hoban: Yes.

Q212 Mr Ruffley: When we go to the operational objective, it is a slightly different formulation. It does not use the word "competition". It says, "Efficiency in choice is the operational objective". I want to know why you do not take the advice from this Committee, and also from the FSA and others I could list, which is to have an explicit duty to promote effective competition? Why do we use woolly words like "efficiency in choice", which is three words, when one word, "competition", would be preferable?

Mr Hoban: There are two points I would make. The first is that the way in which the operational objective is articulated focuses on the outcome of competition. Competition should lead to better choice for consumers and better prices for consumers, and we are trialling this in heading up the FCA to focus on good consumer outcomes, and I think competition should lead to better choice and greater efficiency in pricing. The second thing I would say is that the duty you refer to is not just in relation to the efficiency and choice objective. That duty applies to all three operational objectives, so we do not see competition purely delivering on a single operational objective. We should see the way in which the FCA uses competition to deliver against all three of its operational objectives.

Q213 Mr Ruffley: Basically this duty to discharge its general functions in a way that promotes competition, you are arguing, covers everything—the word "competition" is there and, therefore, it all right—but I think this Committee takes the view that the word "competition" is not included in the strategic objective, nor is it included in any of the three operational objectives, and I rather wondered why.

Mr Hoban: But Mr Ruffley, I have been quite clear in my evidence this morning that we will listen to the comments that this Committee has made.

Q214 Mr Ruffley: So you will look at using the word "competition" in one of the strategic or operational objectives?

Mr Hoban: What I do not want to do, in the same way as you would not wish me to prejudge the outcome of your inquiry, is to prejudge the outcome of the PLS process or, indeed, pre-emptively respond to the ICB.

Mr Ruffley: I will make one final comment, just so that it is on the record. We have four objectives in the legislation, three of which are operational, one of which is strategic, and in not one of those objectives is the word "competition" mentioned, and I think this Committee, or certainly myself and others, would like to see it there.

Q215 Chair: We are all very grateful for the flexibility that we are hearing in the remarks that are coming back across the room.

Mr Hoban: It should be clear.

Chair: We are listening, and I expect the wider world is too.

Q216 Jesse Norman: Mr Levendoglu, you will excuse my appalling ignorance, but I have no idea who you are or why you are here. Could you just give me a little bit of background?
Mr Hoban: Emil is the official who is leading the work on financial services, but I am sorry I didn't have a chance to introduce him at the start of the session.

Q217 Jesse Norman: I am enormously grateful. Thank you very much. This is really a question for the Minister. It is about this idea of confidence in financial services and markets, because it is obviously part of the core purpose of the FCA to protect and enhance market confidence. Could you tell us a bit more about what that means to you, and the way in which the FCA would be protecting and enhancing market confidence?
Mr Hoban: You want to be in a position—I think this is right for both the consumer and for the industry as a whole—where people have the confidence to buy products, and that they know, if they go and seek advice, they will get good advice, and also that market participants, whether they are retail consumers or trading in derivatives at Canary Wharf, have confidence in their counterparts as well. It is trying to ensure that whether you are a retail customer or a wholesale customer, you have confidence in the people you are dealing with, and that is a different issue from the choice and efficiency objective, or indeed the market integrity objective.

Q218 Jesse Norman: I understand that. The kind of confidence you have in mind is, as it were, justified confidence. They should feel confident because they are buying good quality products from reputable counterparties. One could have irrational confidence; we could be pumping, as it were, laughing gas into the system as a way of achieving confidence.
Mr Hoban: That confidence comes from having a good regulatory system, but of course it does not absolve either senior management or consumers from their responsibility in this process.

Q219 Jesse Norman: No. I am just thinking about cases where the FCA uncovers behaviour which, if revealed, might unnerve the markets, as you often find with cases like Barlow Clowes or misbehaving firms, where lots of retail investors have money held. If you had a market confidence issue there, would it feel, as it were, a requirement to diminish confidence in the short term by going after these characters, or to maintain confidence in the short term while privately pursuing its own regulatory and supervisory responsibilities? How does that work in those cases?
Mr Hoban: You need consumers to be confident, and trying to hide from them and sweep them away under the carpet does not promote confidence in the longer term.
Jesse Norman: Emil, did you want to add something?
Emil Levendoglu: It would be very difficult for the FCA to take action that it thought was enhancing false confidence of the sort you described and that it knew was having a detrimental impact on consumers, because that would be contrary to its objective to protect consumers and potentially to promote market integrity as well. It would not be able to act in a way that was consistent with its strategic objective but was inconsistent with its operational objective.

Q220 Jesse Norman: That is very helpful. There is conflict then, potentially, between the desire to maintain confidence and the desire to preserve the integrity of the markets and, as it were, to prosecute wrongdoing. You are saying it would go on the integrity and prosecuting wrongdoing side, or going after wrongdoers side, rather than the confidence side.
Emil Levendoglu: It is debatable if there is an actual conflict, because confidence has to be justified, as you say, but the operational objectives would trump in those circumstances.

Q221 Jesse Norman: But you might get a run on the markets in some situations, if you were balled with a sufficiently large retail organisation.
Mr Hoban: I need to think about this quite carefully. I do not think the market is well served by hiding or sweeping away these things. One of the principles that will drive the FCA is transparency and openness about some of the regulatory actions it has taken. For example, we are going to give the FCA the power to publish details of misleading adverts or adverts the Financial Commission has required firms to withdraw, and we have given them the power to publish warning notices. The thrust of the FCA is to use transparency as a very powerful tool to improve people's confidence in the market and their understanding of how these markets function.

Q222 Jesse Norman: That is very helpful, thank you. One of the reasons why we have had all these problems recently has in part been because of excessive and foolish risk-taking, as well as ignorance about different kinds of financial products, and it has also been part of a certain kind of clubby-ness at the top of many of these institutions, where there has been insufficient challenge or threat to some of the dominant figures. Do you think promoting more women to senior positions in the financial sector would help that, and is that something you think is important within the regulatory system?
Mr Hoban: I don't think it is the role of—
Jesse Norman: There is clear evidence that it does challenge both of those issues.
Mr Hoban: I do not think it is the role of the FCA or the PRA to do that. It is important that we have more diversity on boards and that we have good people there who are prepared to challenge the perceived wisdom. One of the outcomes of the financial crisis is the need to have more challenging voices in the board room, not fewer.

Q223 Jesse Norman: No kidding. I agree. But you think that it would be valuable to have it in the supervisors for the same reason—to avoid clubby-ness and to improve challenge?
Mr Hoban: Yes. Supervisors need to be robust, and that is why we have been very clear about the remit of the PRA and the FCA; we want to move towards a much more judgement-based approach with much

more discretion, earlier intervention, and that requires greater challenge to the firms that they regulate.

Q224 Jesse Norman: More female judgement might be quite a good thing as well?
Mr Hoban: I think more judgement generally is a good thing, Mr Norman.
Jesse Norman: Thank you very much.
Chair: When we talk informally with quite a number of the people who have thought deeply about this, very few of them have much confidence in the confidence objective, and I am very grateful—we are all pleased—that it sounds as if you are giving some thought to whether we should stick with it or amend it in some way.

Q225 John Thurso: I want to talk about consumer protection, but before I do that, can I ask you about the overall cost of regulation and what analysis has been made of the costs and benefits of the proposals for the FCA and the PRA?
Mr Hoban: There is an impact assessment published in the White Paper.

Q226 John Thurso: What is the broad cost? We have had a variety of different answers, and it is interesting for us to know. Nobody seems to really know where the costs are going to land.
Mr Hoban: Right. We published an impact assessment that set out some of the transitional costs for the FCA and the PRA and also some of the costs to business, and it is set out in the back of the White Paper.
John Thurso: I will read it later.
Mr Hoban: For example, the best estimate of the total cost on a net present value basis is £770 million, with an average annual cost of £75 million, and a transitional cost—again, my best estimate—of £275 million over two years.

Q227 John Thurso: I have one last question on that bit. One of the points that was put to us is that, on the benefit side, if you have something like the mis-selling of PPI and you look at the cost of that, the benefit of preventing that is very high. Has that been taken into account in what you have looked at?
Emil Levendoglu: Most of the benefits that have been calculated have been in terms of the financial stability improvements, using some of the research that the Bank of International Settlements has carried out to understand the impact of financial crises. On that basis, in the impact assessment, the reforms clearly come out with a net benefit, but you are right to identify the avoidance of those sorts of mass detriment issues as an additional benefit on top. We will be working through and quantifying those benefits in addition.
Mr Hoban: As Emil said, there is a financial benefit, but there is a benefit to confidence in the market as well.

Q228 John Thurso: Coming on to the objective to protect the consumer, what protection do you expect the FCA to provide?
Mr Hoban: The FCA is given under this Bill a range of new powers to enable it to better protect consumers; one of the powers it has is the product-banning power, which is a new power. I referred earlier to the power to publish warning notices and the power to publish details of promotions that they have required firms to withdraw. What we are trying to do is beef up the powers of the FSA so it is in a position to give better protection to consumers, but of course this is not a zero failure regime. It is a regime where both consumers and management need to take some responsibility for their actions.

Q229 John Thurso: Consumer Focus said, "The Draft Bill does not strike the right balance between the responsibility of firms and consumers, and is too geared to an unrealistic concept of consumer responsibility". How do you respond to that?
Mr Hoban: The Bill sets out a series of factors that need to be taken into account in thinking about consumer responsibility. It is very difficult to quantify precisely the amount of responsibility a consumer should take, because it depends on the context and perhaps the product. A retail consumer going into their high street insurance broker and buying a motor insurance policy is in a different position from a retail consumer going into a bank and buying a pension, because asymmetry information is greater. There is a different level of responsibility, perhaps, in wholesale markets, where you are dealing with sophisticated investors on both sides of the transaction. You need to look at this in the context of individual decisions, rather than saying there is a simple principle you can apply across all transactions.

Q230 John Thurso: What I am trying to get at is, first of all, the definition of "consumers". Leaving aside the informed wholesale consumer, we are talking about the retail consumer who walks into a shop, is offered a product and is told, "It will do X", and on the basis of having been told it will do X, buys it, then discovers it doesn't do X, whatever X may be, which is exactly what happened with PPI. They were told that it would protect, and it doesn't. We had some interesting evidence from a range of City firms that suggested there should be a number of plain vanilla products, where what is written on the tin is exactly what they get, the sort of thing that people buy without going to get advice. Therefore, the suggestion is that what the product is meant to do should be wholly regulated, almost pre-approved, but the consumer's choice as to which one of them does it best should be a matter for the consumer. Is that a definition you would concur with?
Mr Hoban: I go with you part of the way on that journey. I certainly think there should be a range of products where it very clearly does what it says on the tin, and that is why last month we launched a working party chaired by Carol Sergeant to look at simple and simplified products, so people do know what it is they are buying. A very good example of where the market works well in this respect is motor insurance. We know what we are buying when we buy motor insurance, and you can have—

Q231 John Thurso: That is because the law tells them they have to provide it.
Mr Hoban: Absolutely, but it also means it is easy for the consumer to know what they are buying, and that is where I see simple and simplified products going; consumers will know exactly what a simple protection product does for them. In recognising the range of consumer needs, I do not think that simple products would be right for everybody. You will want some product innovation going beyond those. There is a view—certainly among the industry; I suspect it may be shared by consumer groups—that simple products are very good in their own right, but moving to a product approval process for all products would stifle innovation, adaptation and competition in retail financial services.

Q232 John Thurso: But, for example, again in evidence to us, "Consumer documentation from a major high street bank for a personal loan requires degree-level education to understand. A standard text describing a PPI product requires PhD-level education to comprehend. It takes 55 minutes to read a standard consumer credit agreement before you can start to try to understand it".
Mr Hoban: Absolutely right, and I think there is a challenge here about how we make sure we equip consumers to buy products and services, and that is why I am a very big supporter of the Money Advice Service, which helps there. I also think we need to make sure we give consumers the information they need to enable them to buy the right product, and sometimes we have gone for—it is a personal bugbear of mine—lots of information rather than the right information.

Q233 John Thurso: Would you concur with those who say, "A simple statement on half a page of A4 that guarantees what the products does is worth a million times more than 30 pages of dense text that leaves you confused"?
Mr Hoban: I think it is the right approach for relatively straightforward products, absolutely.
John Thurso: Thank you.

Q234 Andrea Leadsom: I wanted to come back, Minister, on this issue of women at the top of financial services, because it does seem to me that it is more than just an issue of getting better people with better judgement. There is a very real issue. Fifty per cent—in fact, more than 50%—of the population of this country are women, and it is not just that there aren't women at the top of the Bank of England, the FSA, the future PRA, the FPC or the FCA. I could go on. There just aren't any women, but it is not just that. It is also the same men who saw us through the financial crisis and arguably presided over the biggest crisis since the 1920s, and I would like to press you a bit further. Do you really think that it is simply a matter of getting people with more judgement? I certainly don't. I realise I am a woman and, therefore, I may have a biased view, but I certainly think personally that the different approach of women would bring something very valuable to the senior levels that we desperately need to get right, and at the moment, even on our own Draft Financial Services Bill Committee, there isn't a single woman, so there is no female perspective anywhere in this.
Mr Hoban: I think Baroness Wheatcroft would suggest she was a woman.
Andrea Leadsom: Oh, okay. I am sorry. I did not realise there was a lady peer. I beg her pardon.

Q235 Mr Mudie: Minister, I am sad to see that you are less sympathetic about the case of consumers in relation to how the Bill affects them. It is down to the challenges to equip consumers through the FCA, who promised to do a lot more for the consumers than the FSA. That hardly cheers us up, because the FSA were a bit deficient in the area.
If I can come to two things, when the consumer groups came before us, they were united in their concern about the definition of "consumers". They were united about their opposition to the principle that consumers should bear responsibility, as it is framed. It is interesting that providers and sellers were absolutely for this and welcomed it. You will have done your homework and you will have read the evidence from the consumers group. Do you not have any sympathy for the argument that the definition of "consumers", covering hedge funds to grannies, if you like, is a bit too all-embracing?
Mr Hoban: This is a conduct authority and the consumers of financial services are many and varied, and it has a remit across all aspects of financial services conduct, so inevitably "consumer" will be a broad term.

Q236 Mr Mudie: You say that, but need it be? You have the power to be a bit more sensitive and to break that broad definition of consumers in a way that protects the rights that consumers already have under common law and are in danger of losing, in their view, by this lumping together of consumers as anyone who purchases a—
Mr Hoban: I think that the FCA will take a much more nuanced view than that would imply. They are not going to assume that consumers of fairly straightforward retail financial products are as sophisticated as the people who trade in Canary Wharf, and I think there is a distinction. They talk in the objective about "appropriate protection", recognising that some consumers are different to others. It is emphasised in section 1C (2) as well, so I think that differentiation is there.
It is important that consumers do take some responsibility, in the same way as it is right that senior management should take responsibility for compliance with the rules. I suspect if you asked senior management privately, they would rather not have that responsibility imposed upon them in the Bill, but I do think it is right for both consumers and management to take their share of responsibility. This is not a zero failure regime, and the FCA cannot take on its shoulders the responsibility for every player in the market. What is important is to make sure the right protections are in place. The product intervention powers are very strong consumer protection, and are powers, frankly, the FSA should have had. I think that is a big step forward for consumers.

Q237 Mr Mudie: I feel the definition is too wide, but then it drops down to the matter you have raised, which is the question of consumers taking responsibility for their actions. Because of the wideness of the definition, that applies to all consumers, and you have just heard John Thurso. Do you think that Consumer Focus was exaggerating when they said you needed a degree to understand a major high street bank application form for a personal loan? It is fine to say, "Well, we treat all consumers the same", but you are now saying, when we drop down to it, "They have responsibility for their own actions".
Mr Hoban: No, Mr Mudie, I am not saying we treat all consumers the same. I am saying we must differentiate different types of consumers.

Q238 Mr Mudie: But how do you, under that? You are passing a law.
Mr Hoban: When you then look at the next sections of the Bill, in subsection 1C (2), it differentiates there. This is broadly the same sort of definition of consumer that was in FSMA, so I do not think there is anything particularly new. The only amplification is the way the markets side of FCA is dealt with. It is very clear that consumers have different levels of protection, given their degree of sophistication, and it is right to do so.

Q239 Mr Mudie: How? An ordinary lad with no university education goes into a bank—it says here you need a university education for a major bank giving you a loan, and you have to understand its terms—and this major bank requires a university education for you to understand that. The lad goes in, signs up for the personal loan, lands in trouble, goes before the courts, and the court looks at the law and says, "Well, you are responsible for signing up for this loan. You must take responsibility, and therefore I find against you". That is the detailed fact that the consumer organisations are raising with this Draft Bill. It cuts across present protections and weakens the position of consumers.
Mr Hoban: I made the point to Mr Thurso around information on supplying those products that I think we should go for greater transparency and less disclosure. I recognise the concerns that are raised by people like Consumer Focus about the complexities of some of these documents, and that is why things like simple products are quite helpful, because people will know what they are meant to do and know what their responsibilities are. I am equally as uncomfortable with the status quo as you are on this, Mr Mudie, but I do think we need to recognise that both management and consumers have responsibility.
Emil Levendoglu: Could I just add one point, Mr Mudie?

Q240 Mr Mudie: Just before you do, Emil, if you are uncomfortable, Minister, is there any chance you will give it further thought in view of the strength of feeling among the consumer groups?
Mr Hoban: Consumer groups need to be clear about what degree of responsibility they think consumers have. If we move to a situation where consumers take no responsibility, I think that will lead to a situation where you see—
Mr Mudie: No, they don't do that.
Mr Hoban: But this is where I think this is—

Q241 Mr Mudie: At the meeting, as you have read Minister, we asked them to provide us with a changed definition in the Bill, and if that is available and comes forward as they promised, will you undertake to have a good—
Mr Hoban: Mr Mudie, we have conducted a very open process on this, and if the consumer groups come forward with a measure that is workable and sensible and will not damage the integrity of Bill and how the systems function, clearly we will look at it. One of the things I would say is that throughout this process, which kicked off in July last year, we have been open, we have been collaborative and we have listened, and I think it is one of the reasons why we have had quite a lot of support from industry and consumer groups about the process. We have not closed down options prematurely or unnecessarily, and we continue to reflect on the representations made.
Emil Levendoglu: The consumer responsibility principle is a principle that the regulator has to have regard to, but that does not mean in any way that it is a principle that cuts across the statutory or common law rights that consumers would expect to enjoy in terms of their dealings with people in the financial services market, so it does not abridge their rights in any way.

Q242 Mr Mudie: I hear what you say, but in the view of the consumer organisations, it weakens their existing rights, cuts across them and weakens them in court, and that is something the Minister is agreeing he will give thought to, depending on the evidence presented, and that is acceptable.
Mr Hoban: But at the moment, we do not believe it does cut across those rights.

Q243 Mr Love: Can I move us on to the regulation of consumer credit? You carried out a consultation earlier this year about moving it from the Office of Fair Trading to the FCA. Have you concluded your view on whether that should now take place?
Mr Hoban: No, not yet.

Q244 Mr Love: You have had seven months to think about this. Can you give us some indication of your thinking in relation to the issue?
Mr Hoban: This is a complex area. It does involve 100,000 registered people who have consumer credit licences. It is a different regulatory regime to the one that the FCA will operate, so it is a complex issue that we are thinking about very carefully, both with the existing regulators, with ministerial colleagues in BIS and consumer credit organisations.

Q245 Mr Love: I take your point about the complexity of the issue. Could I sum up what you have said by saying that, in principle, you are minded to move in this direction, but you want to sort out the technicalities?

Mr Hoban: There are some big practical issues here, one of which is the cost, and one of the things that we are keen to do is keep the costs of regulation low. We do not want to impose unnecessary costs on business or indeed on consumers, who ultimately bear many of those costs, so we need to work this through properly.

Q246 Mr Love: The Draft Financial Services Bill is working its way through Parliament, as we have been hearing this morning. That would be the ideal place to append any changes that you want to introduce, but if there is further delay in the system—one understands why there is a delay—you might miss the boat. Are you giving consideration to that, and is there likely to be a decision in the fairly near future?
Mr Hoban: It is something that is under very active consideration and ongoing debate between ourselves, BIS and the regulators. I recognise that the Financial Services Bill is an opportunity to legislate for that, and we will need to think about that quite carefully.

Q247 Chair: Minister, the twin peaks system envisages that the PRA should be able to veto the FCA's product-banning power. How is that going to work?
Mr Hoban: What the veto is aimed at is trying to avoid the disorderly failure of a business that would damage consumer confidence and would damage the market. I think it is a very narrow power that we have given the PRA in this area, and clearly it is not one that either the PRA or the FCA would enter into lightly.

Q248 Chair: There is a big difference between banning something targeted at a business and a market. Can you give us any examples of a product that would be so bad that it ought to be banned, but so important it cannot be banned?
Mr Hoban: We need to have this power as a precaution. There are products that can be quite toxic if a firm depends wholly upon them for their revenue or for a large part of their revenue, and banning would cause a problem, but what I want to be made clear is that we would want the PRA and the FCA to work out how to implement that ban, while taking steps to manage financial stability. Of course, there is transparency over the use of that power of direction as well, which adds an extra safeguard.
Chair: I do not want to linger on this, but bearing in mind we have just been through a huge financial crisis, in which there must be plenty of examples around, or at least one to justify this, perhaps it would be helpful if you could write to us and give us an example.

Q249 Mark Garnier: Clause 46 of the Draft Bill provides for triggers in relation to the FCA mounting an internal investigation, but it also talks about when the Treasury can intervene as well, and order an internal investigation. In practical terms, when do you think that will happen?
Mr Hoban: One of the things that excites me about the current regime is that—I think a number of colleagues will be aware of this—there is a power in FSMA, section 14, where the Treasury can call for the regulator to launch an investigation in particular circumstances. That power has never been used.

Q250 Mark Garnier: This is a sort of nuclear option, isn't it?
Mr Hoban: It is, and that is probably one of the reasons why it has not been used. I am clear that as we adopt a much more transparent regime in terms of the relationship between the regulator and the firm, and pushing firms to do more by way of transparency—publishing warning notices and publishing details of financial promotions that have been withdrawn—the regulator needs to be more transparent in the way it exercises its functions. The existing section 14 power is a nuclear option. What I am seeking to do through section 46 is set in place some objective triggers so people will know as a matter of course that there will be an inquiry in a particular set of circumstances, so rather than the Treasury having to exercise discretion, people know that if there is a particular failure, "Yes, this will lead to an inquiry".

Q251 Mark Garnier: But in the case of clause 46, everybody knows where those triggers are going to be, because they are going to define them, but in reality, all of these things are never that clear. Do you see then that if the Chancellor were to intervene under clause 46 and say, "You need to have an internal inquiry", that will be a nuclear option as well?
Mr Hoban: No, I don't think it should be; we need to work on the objective triggers quite carefully and get them right. I want it to be as automatic as possible. If there was a situation where there were five inquiries in a year and the Chancellor asked for an additional inquiry, that would be less nuclear than one inquiry being launched in a 14-year period. My objective is to make these a matter not of routine, when there are so many that they lose their importance, but sufficiently often that one does not cause a huge stir.

Q252 Mark Garnier: It is quite a challenge for you to set those triggers at the right level so that you are not just having endless internal investigations, but also that it is high enough that it justifies having an internal investigation without devaluing the currency, if you like, but not too high that you have the Chancellor intervening.
Mr Hoban: Yes. That summarises the position fantastically.

Q253 Mark Garnier: Fantastic. Turning more to the accountability of the FCA to the Treasury Select Committee, you will be well aware of the absolute wails of complaint, particularly from the IFA community, when the FSA were almost indecently hasty in their response to our RDR report. A lot of people within the IFA community saw that as utter contempt by the FSA for the work of this Committee, and indeed Parliament as a whole. How would you respond to that?
Mr Hoban: You raised this with Hector. I think he has responded, and I am not answerable for the way that he and the FSA respond to these things.

Q254 Mark Garnier: He was very apologetic and made an unqualified apology, which I was very grateful for, but it does raise a very important point. The FSA is now seen to be completely—by a large amount of people—unaccountable to Parliament and unaccountable to the Treasury Select Committee. There is a challenge now with the new FCA in terms of trying to remedy the damage that has been done by the action the FSA took. What I am really seeking from you are your feelings on that, and what does the FCA have to do, and indeed, the FSA, to remedy the damage it has done?
Mr Hoban: My sense is that the FSA takes its accountability to Parliament and to this Committee very seriously. Certainly, from conversations I have had with both Hector Sants and his predecessor, John Tiner, and also with Callum McCarthy and so on, so it is not a question—

Q255 Chair: It is not that way over RDR, though.
Mr Hoban: No, but I think generally, Chairman, that they are very aware of their accountability and they take the accountability and the challenge from the TSC very seriously. That is absolutely right. I would counsel against arguing from the particular to the general, because I think there is a particular set of circumstances around RDR that makes it difficult to draw a general conclusion, but I have been struck in my dealings with them how important or how seriously they take this Committee, and I think that is absolutely right.

Q256 Mark Garnier: It is quite interesting, from the point of view of those of us who are new to this Committee and new to Parliament, certainly as I see it, that they are not as accountable as I assumed they would be before I got elected, which is a very interesting dynamic. One thing that Adair Turner said was that the FCA board should approach its relationship with Parliament and the Treasury Select Committee more in the way that the MPC does in terms of much more transparent minutes, more accountability of the minutes, and getting external members of the FCA board to come along and present to this Committee, in addition to just the usual culprits. Again, do you think that is a step in the right direction?
Mr Hoban: It is a very helpful suggestion. There are two things I would say about accountability of the FCA. We have introduced in the Bill the power for the NAO to audit the FCA, which is a good means of accountability and good value for money and so on, and will help to reassure people on the cost.
The other thing is that there is a difference between the MPC and the FCA. The FCA and the FSA do go through a quite thorough consultation process in the development of their ideas and policy, and I have seen this for myself with the Mortgage Market Review, which has gone through a series of stages in a very public way, where questions have been raised in Parliament, and where industry and consumer groups have had an input. There is a lot of transparency around its policy-making process, and they are making a series of policy decisions, but I think it is slightly different from the MPC, where it is one decision per month with transparency around the minutes and the speeches. I think we do need to make sure that the decision-making process for the FCA is transparent and that politicians are exposed to the public domain. They are, in the consultation process they go through, but I do not see that as a reason not to proceed down the route that Lord Turner suggested, where the non-executive directors could appear. But of course, don't forget that the non-executive directors of the FSA and the FCA will also be the people who make decisions on adopting policy. It is a slightly different relationship, I would suggest, than between the court and the MPC and the court and the FPC.
Mark Garnier: Yes, absolutely. Indeed. Thank you.

Q257 Stewart Hosie: Minister, I have a couple of questions on the regulatory architecture, but before I do that, can I pick up on the answer you gave John Thurso? You seemed to suggest that pre-approval of products might stifle innovation or competition. Why would that be the case?
Mr Hoban: Because you would end up in a situation where you have some huge organisation based in the FCA that would have to vet every single product that came on to the market. In the heyday of mortgage markets, I think there were something like 6,000 different products. Each one of those would have to be approved, and there would be a process of approving them, so that would potentially act to the detriment of consumers who want to shop around for a good fixed-rate mortgage or a tracker mortgage. I think the bureaucracy that would impose would be quite significant and there would be some consumer detriment to that.

Q258 Stewart Hosie: Presumably, if the right people had been involved, they would have picked up some of the more exotic collateralised instruments that helped crash the financial system. That is an example.
Mr Hoban: Yes, but that is why we need to be clear where the product-banning powers will be used, and it is predominantly focused on getting the right retail outcomes. The reason why we have given the FCA product-banning powers is to give it the power, when they identify a product that will lead to consumer detriment, to tackle it early, rather than simply waiting until it gets to the point of sale or distribution, which is their current approach. Product banning is an important way of delivering better outcomes for retail consumers.

Q259 Stewart Hosie: That is helpful. In terms of the structure, some of the people we have had before us have said that the FCA should be responsible to the Bank of England directly, some have suggested it should be responsible to the FPC, as the PRA is, and others have told us it should be a subsidiary of the PRA. Did you consider placing conduct regulation in the bank when you formed the proposals?
Mr Hoban: Yes, we did. It was an option. That would move the bank into very new territory, making it a conduct regulator. While there is synergy between the FPC and the PRA—because they are both looking at threats to financial stability, one at a macro level and one at a micro level, and there are good arguments

there—making the bank responsible for conduct regulation of everything from an IFA through to trading activities at Morgan Stanley would stretch that synergy beyond belief.

Q260 Stewart Hosie: I agree. I think that would just be a step too far. However, co-ordination is required between the FPC and the PRA, between the FCA and the other institutions, but only the chief executive of the FCA will sit on the FPC. Given the requirement to have this co-ordination, is there not a good argument to say there should be more structural linkage between the different bodies, even if it is only to avoid the underlap we saw in the last crisis between the tripartite?
Mr Hoban: You raise an interesting point. We need to think carefully about the relationship between the FPC and other bodies. We should not think of the PRA reporting to the FPC, as they have very different responsibilities, although there is a shared interest. In the same way, there may well be conduct issues that give rise to a greater systemic risk to the stability of financial services, so that is why it is important that you have the chief executive of the FCA on the FPC, to make sure that link is there. We are setting in place a more formal process to recognise how different bodies will operate with each other, so there will be a MOU between the FCA and the PRA, for example. For things at the moment where there is either no agreement in place or some of those tensions are internalised, the change in the structure brings those tensions out, and there needs to be a way of formalising that co-ordination.

Q261 Stewart Hosie: What is the time scale for the MOUs? When do you envisage them coming out?
Mr Hoban: Emil will be able to give a more definitive answer, but as we take the Bill through Parliament, it is important that the MOUs are exposed so that there is debate and discussion about them, in the same way as one would wish to ensure that most statutory instruments are published in draft during that process as well.

Q262 Stewart Hosie: I know I am taking advantage of the Committee and I probably shouldn't, but I think it would be really helpful to have those as quickly as we could, and in addition, a very clear understanding of how Government sees all these bits of the UK twin peaks architecture relating to and working with the bits of European and international architecture, which is not in one place. It is not quite clear yet, and certainly some of the practitioners are not quite sure where all of this is going to lie.
Mr Hoban: The mapping of the FCA and the PRA on to the European bodies is clear. The mapping of the FCA on to IOSCO, for example, is clear, but I will take those points on board.
Chair: I am sure you understand that certainly, speaking personally, I take a somewhat jaundiced view of MOUs, having had the experience of trying to get some debate on the tripartite when it came before Committee Room 10 late at night at a time when nobody thought it was worth discussing or showed the least interest in it. If we are going to use MOUs again, we need to give them a full and early airing, and I strongly agree with what Stewart said; it would be helpful to have them out sooner rather than later so they can begin full scrutiny.

Q263 John Thurso: I have a quick question, Minister, that is not on the subject at hand. In June, the Office of Fair Trading upheld a super complaint on card surcharges. When is the Government going to respond?
Mr Hoban: Shortly.

Q264 Chair: Can you do any better than that, Minister?
Mr Hoban: I thought it was an accurate answer. I take this issue very seriously. We are looking at the range of remedies proposed by the OFT and we will see what action can be taken, but one of the things I am very keen to ensure is that there is much more transparency around pricing. That is an important consumer protection. Transparency gives people confidence about how markets operate, and I take this very seriously.
Chair: Thank you very much for coming before us this morning. We have picked up quite a lot. I hope you have a sense of where we are coming from on some of these issues as well. We welcome the flexibility we have heard and we also welcome the support, among other things, that we have had on trying to do something about cheques and the reform of the Payments Council. We are very grateful for that.
Mr Hoban: Thanks.

Written evidence

Written evidence submitted by Citizens Advice

Introduction

Citizens Advice welcomes the opportunity to respond to the Joint Committee's call for evidence on the Financial Services Bill. The Citizens Advice service is a network of around 380 independent advice centres that provide free, impartial advice from more than 3,500 locations in England and Wales. It values diversity, promotes equality and challenges discrimination.

In 2010–11 the CAB service helped 2.1 million people deal with over 7 million problems. These included 2.2 million debt problems and 130,000 non-debt related problems with financial services.

In recent years the CAB service has dealt with a succession of widespread consumer problems with financial products and services including mis-selling of payment protection insurance (PPI), poor lending and arrears collection practices 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 severe detriment in each of these areas, including spiralling indebtedness.

We have limited our comments to the inquiry questions which are most relevant to our concerns and experience.

Are the objectives of the Financial Conduct Authority (FCA) clear and appropriate?

Whilst we strongly support the Government's intention to develop a new approach to financial conduct regulation that will do better at both preventing consumer detriment and ensuring markets for financial services work better for consumers in future, we are concerned that the FCA objectives in the draft Financial Services Bill are neither clear nor appropriate.

There is an explicit recognition in the draft Bill and supporting documents that persistent and widespread consumer problems in the financial services sector are rooted, at least in part, in regulatory failure. This is illustrated in the FSA's *Approach to regulation* document that starts by recognising the low level of confidence in the financial services sector and how "conduct issues since 1990 have been a major factor in this". The FSA also reflects that it has not always been quick enough or tough enough to prevent or control consumer detriment. For instance, the regulator concludes on PPI mis-selling that "stronger action sooner could have limited the growth of the problem".

The case for a new approach to conduct regulation seems clear, but this must be based on a correct understanding of the problems and limitations of the current conduct regime if the FCA is to avoid the same mistakes. Both HM Treasury and the FSA have emphasised the role of *regulatory culture* as a key driver of past regulatory failure. For instance, in launching the FSA's new approach to conduct, Hector Sants described the previous approach as "…essentially reactive. Too often, it focused on high-level systems and controls… merely reacting to crystallised risk and consumer detriment… There are significant limitations to this approach. Our new conduct model seeks to take a dramatically different approach".

There is no doubt that the regulatory culture of the FSA has changed significantly and for the better over the last few years. This is both welcome and important. But this has happened partly because a new FSA leadership has had to reflect on the failures of the old approach in the wake of a financial crisis and partly because the government has come to accept that firmer regulation of financial services is necessary. But this does not address the reasons why the regulatory culture of the FSA was too light-touch in the first place.

The FSA has never been an impotent regulator. The Financial Services and Markets Act 2000 (FSMA) established a conduct regulator with significant (albeit incomplete) powers to protect consumers and these powers have been further developed over time; for instance the updating of the Section 404 provisions by the Financial Services Bill 2010.

The problem with FSMA is that it did not give the FSA a clear mandate or a clear duty to use its powers in a timely manner to pre-empt detriment and ensure that financial services markets worked well for consumers. We believe this is a key reason for past regulatory failure. Regulators only use their tools to carry out their duties and functions. Where duties and functions are not clear, a regulator may not make best use of its consumer protection tools. This seems to be the case for the FSA.

The FCA's Strategic Objective

Citizens Advice believes that the FCA's strategic objective of promoting and enhancing confidence in the UK's financial system adds very little to our understanding of what the regulator will actually do. As a minimum, we believe that the strategic objective should be amended to "protecting and enhancing consumer confidence in the UK financial system", which would at least have the benefit of reflecting the FCA's remit to "specialise in protecting consumers". However we are more concerned that both the *consumer protection* objective and the *efficiency and choice* objective in the current text of the draft Bill fail to give explicit focus and definition as to the FCA's role.

The Consumer Protection Objective

The draft Bill repeats the FSA's existing vague and unfocused consumer protection objective. There is no definition of the phrase "appropriate degree of consumer protection" with reference to actual consumer outcomes. This is left to the board and senior management of the FSA to determine as a matter of regulatory culture.

We are concerned that the FSA's new approach to tackling consumer detriment is not locked-in by the current legislation and the draft Bill gives no more guarantee of an effective regulatory culture than FSMA gave for the FSA's failed old approach.

Here the draft Bill seems at odds with the Government's stated policy intention. HM Treasury's *Blueprint for reform* states that "at the heart of the Government's proposals will be a more pro-active approach to conduct regulation, with a clear focus on consumer outcomes". The previous consultation, *building a stronger system*, made a similar point, stating that "It is this sense—that of putting appropriate consumer outcomes at the centre of the regulatory process—that the FCA will be a 'consumer champion'". Citizens Advice supports this sentiment. An effective consumer protection objective needs to be framed in terms of broad but clear consumer outcomes that the FCA can be held to.

The FSA has already developed some good candidate consumer outcomes, setting three goals to underpin the new approach to conduct[1]. We have amended these to emphasise our particular concerns about *marginalised* consumers and they are set out below as follows (our changes in bold):

- Making the retail market work better for **all** consumers.
- Avoiding the crystallisation of conduct risks **into consumer detriment**.
- Delivering credible deterrence and prompt and effective redress for consumers.

These address past regulatory failure and give the new regulator ongoing strategic direction. But they have no legislative basis and so cannot hold the FCA to account. Citizens Advice therefore believes that the consumer protection objective should be amended to include consumer outcomes along these lines. This would help lock-in the pro-active and outcome focused regulatory culture that consumer confidence requires.

The Efficiency and Choice Objective

Citizens Advice believes that the meaning, scope and intent of the "efficiency and choice" objective is also unclear and under-defined in the draft Bill. In particular, we are concerned that the draft Bill gives no detail about the FCA's role in ensuring that choice extends to consumers (particularly lower income consumers) that are under served or poorly served with inappropriate products.

The HM Treasury consultation, *Building a stronger system*, picks this point up, agreeing that *financial inclusion* is an important issue that the *efficiency and choice* objective will give the FCA a mandate to address. But this is qualified with a statement that a more formal "have regard" on financial inclusion would be inappropriate as this is a matter for social rather than regulatory policy.

We are concerned that the draft Bill does not elaborate on the *efficiency and choice* objective as to what the FCA should actually do to ensure that the market for financial services will work better for **all** consumers. The explanatory notes to the Bill do not provide much more help, merely suggesting that the efficiency and choice objective *may* be used to promote choice in the market for basic financial products. The FSA approach document discusses this objective, but almost entirely in terms of promoting competition. But a key issue in *financial inclusion* debates is the recognition that competition does not always bring benefits to people with little consumer power and may even exacerbate the problems they face.

Here *financial inclusion* picks up issues for both regulatory and social policy. For instance, Citizens Advice believes that ensuring that essential transactional financial services (such as bank accounts, payment services and ATM's) are accessible and can meet the needs of **all** consumers should be a core function of the FCA. Issues like access to free ATM's for low income households and access to basic bank accounts without fear of high charges are directly relevant to public confidence in financial services.

We would also argue that the FCA should have a key role in ensuring that other specified financial needs of currently under served consumers are met. In the absence of such a role, financial inclusion initiatives, such as the HM Treasury work on simple and transparent products, have no route to practical implementation.

We also note that the new product intervention rules appear to focus on prohibiting products or product features from being marketed to consumers or specified groups of consumers that might be harmed as a result. Without a balancing objective to ensure products with positively beneficial features come to market, the FCA could become trapped in unnecessary trade offs between consumer protection and financial inclusion.

Therefore as a minimum we believe that the efficiency and choice objective should be supported by a duty on the FCA to "have regard" to the need to ensure all consumers have access to essential transactional financial services that they can afford and which meet their needs. Ideally we would like the Bill to go further, by requiring the FCA to "have regard" to the need for all consumers to have access to suitable and affordable

[1] See UK Financial Regulation: After the Crisis, speech by Hector Sants, Chief Executive FSA, 12 March 2010.

products meeting any financial need specified in an order by HM Treasury. This would keep social policy decisions with Government but empower the FCA to implement these decisions through its regulatory tools and functions. Without such amendments, we believe that the current wording of the efficiency and choice objective will deliver the FCA with a choice mandate that is simply too weak to make a difference in practice.

Should the FCA have a primary duty to promote competition as recommended by the Treasury Select Committee and Independent Commission on Banking? How should this work in practice?

Citizens Advice welcomes the measures in the draft Bill requiring the FCA to promote competition. We agree that competition is a highly effective means of protecting consumers' interests and see problems where unfair practices and uncompetitive markets go hand in hand. For instance, the PPI mis-selling scandal was accompanied by a mis-charging scandal, with the Competition Commission finding consumers being overcharged by as much as £1.4 billion a year. We believe that the lack of a clear role in respect of competition issues probably hindered the ability of the FSA to deal with PPI quickly and effectively.

However we would also reiterate the point made above that competition will not always, by itself, deliver benefits for all consumers. For instance, the Office of Fair Trading market study into personal current accounts showed how a market can simultaneously deliver good outcomes to some consumers and poor outcomes for others. The CAB service sees many people with little or no consumer power. They are financially vulnerable or lack the skills, resources and resilience to complain, switch or shop around. They find it difficult to challenge firms' bad behaviour or get a good deal (or indeed any deal). The benefits of competition do not reach them.

Therefore we would not support the recommendation of the Independent Commission on Banking that the *efficiency and choice* objective should be replaced with an objective to promote effective competition. Promoting competition and financial inclusion approaches are both needed if the FCA is to ensure that retail financial services work better for **all** consumers. Equally we believe that the FCA must use both competition and consumer protection approaches together in order to support the different needs of different groups of consumers, rather than treating all consumers in the same way.

From this perspective, standard concerns of competition policy, such as lowering barriers to market entry, need to be balanced by regulatory objectives that can focus on consumers at greatest risk of detriment. We believe that this balance will be particularly important if the FCA takes on responsibility for consumer credit, where low barriers to entry allow rogues to prey on financially vulnerable consumers, rather than create any competitive benefit.

We also support the new Section 345D power of the FCA to make a competition request to the Office of Fair Trading. Although given the FCA status as a broad sector market regulator (and as a matter of regulatory efficiency), we would question whether it might be appropriate to allow the FCA to expedite a reference to the Competition Commission (or a second tier investigation in the proposed new Competition and Markets Authority) where the OFT/CMA agrees with this.

Does the FCA's approach to regulation, as outlined in the Financial Service Authority (FSA's) June 2011 document, represent an improvement on that of the FSA?

The FCA's approach outlined in the June 2011 document builds on the FSA's *new approach* to conduct, which is a significant improvement on the previous FSA approach. The addition of the new tools and disclosure powers set out in the draft Bill should also help the FCA to be a more pro-active and consumer outcomes focused regulator than its predecessor.

However as we argued above, Citizens Advice remains concerned that the FCA objectives do not lock-in an improved regulatory approach for the future.

To whom should the FCA be accountable? Are the lines of accountability clear?

Citizens Advice believes that the most important accountability issue is the lack of a clear statutory duty on the FCA to act on evidence on emerging consumer problems. This has been a key weakness of the current FSMA regime. **As a result Citizens Advice strongly supports the proposal in the HM Treasury *Blueprint for reform* document to introduce a super-complaint like process for the FCA.**

Citizens Advice is a designated "super-complainant" under Section 11 of the Enterprise Act 2002. This Section allows designated consumer bodies to make a complaint to the OFT where "any feature, or combination of features, of a market in the United Kingdom for In each case we have found that the super-complaint process has been vital in getting the regulator to look at a serious issue that might not otherwise have been addressed. Here we would like to highlight three key parts of any such 'duty to respond' that we believe would provide a very direct form of accountability for the FCA. These have been adapted from the Enterprise Act 2002 duties on the OFT and Competition Commission respectively.

— *Establish a right for* designated *consumer bodies to make a complaint to the FCA.* The FCA should also be required to properly investigate evidence of consumer detriment that it uncovers.

— *The regulator must be placed under a duty to make an initial response to the complaint within a specified time frame.* This echoes the 90 day time period that Section 11 of the Enterprise Act gives the OFT.

— Where *the FCA finds that the interests of consumers are being harmed, it should be placed under a duty to resolve the problem as far as reasonably practicable within a second specified time limit.* This echoes the duty that Section 138 of the Enterprise Act places on the Competition Commission.

To conclude, we believe that a super-complaint like process would help lock-in a culture of proactive regulation at the FCA. It provides the means for a direct and practical accountability, ensuring that the regulator deals with emerging consumer problems quickly and effectively.

Are the powers of the FCA suitable? Will their exercise be subject to appropriate scrutiny? How should the FCA be interacting with industry as well as using its intervention powers?

Citizens Advice warmly welcomes the new regulatory tools that the draft Bill proposes for the FCA. This appears to be a well thought out package that is well directed at addressing weaknesses in the current regulatory regime. An overview of our views on specific powers is set out below:

Business model scrutiny: Citizens Advice welcomes clause 7(1) requiring an authorised person to satisfy the regulator that their business model or strategy for doing business is suitable having regard to the regulated activities they intend to carry on. We have seen examples of financial services (for instance some sub-prime mortgage lending on right-to-buy properties and some sale and rent back agreements) that appeared to be potentially harmful by design.

Enhanced powers to vary and impose requirements on permissions: The FCA should be sufficiently nimble to deal with problems caused by a specific firm, product or practice through a quick and decisive targeted intervention that is local to the problem causing detriment. Our reading of the Bill and explanatory text

Product intervention rules: Citizens Advice strongly supports the FCA having a power to address potentially detrimental features of a product or service before this becomes a problem for groups of consumers. The lack of such a power has prevented the FSA in tackling consumer detriment at root cause. For instance, an early intervention to address unfair and potentially misleading exclusion clauses in PPI products could have prevented some of the mis-selling problems seen by the CAB service.

Financial promotions: Citizens Advice welcomes the power for the FCA to publicise action it has taken against financial promotions that breach the financial promotion rules. The inability to inform consumers about action against misleading or otherwise unacceptable financial promotions seems a glaring omission in the current regulatory regime.

Publication of warning notices: Citizens Advice also welcomes the proposal to allow the FCA to disclose information about warning notices. If the regulator is sufficiently concerned about a product, service or practice to consider enforcement action, then consumers need to know about this. Enforcement action by the FSA can be a long drawn out process, leaving consumers exposed to potentially harmful practices that the regulator is aware of but they are not. This is not consistent with a pro-active approach to preventing consumer detriment and represents a consumer protection failure. We do not accept that disclosing information about warning notices is likely to have a seriously detrimental affect on firms—we have seen no evidence that publication of final notices about PPI mis-selling, poor practices by mortgage lenders or poor complaints handling by banks has put any of these firms out of business. Instead, earlier publication by the FSA might have encouraged firms to address problems sooner or helped consumers to make better choices.

The draft Bill provides little detail as to how some of these powers will be used in practice, the product intervention powers in particular, and so an early policy statement from the FCA to further clarify its approach would be useful.

The FCA's rule making powers are bounded by both the regulatory principles and the general provisions on cost-benefit analysis and consultation. Citizens Advice believes that this will generally provide a good level of scrutiny and engagement with both firms and consumer groups.

Nevertheless, we are concerned that the regulatory principle that a burden or restriction should be proportionate to the expected resulting benefits should not be interpreted in a way that could undermine action by the FCA to support the needs of particular consumers, such as people with protected characteristics under the Equality Act 2010. The costs of an intervention necessary to ensure good outcomes for such a group may appear to outweigh the benefits where that group is small in numbers, even though they may experience significant and severe detriment. Therefore we believe that there is a potential for tension between a focus on consumers at the margin of the market and the FCA's public sector equality duty on one hand and the cost-benefit regulatory principle on the other.

The Bill does contain provisions allowing the FCA to make rules without consulting on cost-benefit analysis if the FSA considers that the *delay* would be prejudicial to the interests of consumers. But we are not clear whether there is an equivalent waiver of cost-benefits in order to meet an equality objective or protect a group of consumers whose relationship with a firm or firms is particularly vulnerable to causing detriment. Therefore we would ask HM Treasury to consider amending the waiver in new Section 138M to take account of this.

How should the FCA be interacting with other domestic regulators? For example the FCA's relationship with the Bank of England and Financial Ombudsman Service

Our comments in response to this question are limited to the relationship between the FCA and the Financial Ombudsman Service (FOS).

By giving consumers an independent route to escalate complaints, FOS plays a vital role in making financial services markets work better for consumers. A recent report from the Office of Fair Trading found that "informed consumers asserting their rights can have a significant impact on business behaviour and appear to be a key driver of compliance".[2] A good complaints handling system is therefore a key part of maintaining confidence in the UK financial system.

The FSA and FOS have established procedures for co-operative working to spot emerging conduct risks including a co-ordinating committee of FSA, FOS and the OFT to scan for emerging risks. The draft Bill formalises this working relationship between the FCA and FOS in the legislation. We support this, as it simply formalises an existing and important relationship.

However we would argue that the key challenge for the FCA will be to act quickly and decisively on intelligence of emerging widespread consumer problems with regulatory implications, something that the FSA did not always do in the past. Again, Citizens Advice believes that the FCA should be placed under a duty to act in response to emerging evidence of problems causing significant harm to consumers.

Finally, Citizens Advice welcomes the new Section 230A requirement (inserted by Schedule 10 of the draft Bill) on FOS to publish reports of its determinations as a useful innovation of the Draft Bill. FOS currently publishes summaries of decisions that set out its approach to resolving particular types of dispute. These give useful guidance to consumers and firms on the merits of similar disputes. Expanding the publication scheme can only help to improve confidence in the financial services sector by helping consumers to make better complaints and firms to handle complaints better.

October 2011

Written evidence submitted by the Financial Services Authority

1. We welcome the opportunity to submit this memorandum to the Treasury Committee's inquiry into the Financial Conduct Authority (FCA). This Committee's scrutiny, along with the current work of the Joint Committee on the draft Financial Services Bill, presents an important opportunity to debate the major reforms proposed and to identify the key judgements and decisions which Parliament and Government will need to make during the passage of this legislation.

2. The FSA's thinking on some issues covered in this memorandum continues to develop. We would like to submit a further memorandum to the Committee, taking into account further discussions in the FSA Executive and Board, ahead of our oral evidence session.

3. In this memorandum we set out the FSA's views on a number of issues raised in the Committee's terms of reference. We have also highlighted areas that the Committee may wish to consider as part of their scrutiny, and have noted a number of other points on which we would find it particularly helpful to have the Committee's views. Our memorandum covers:

- the objectives of the FCA;
- the FCA's competition remit;
- the FCA's approach to regulation;
- accountability of the FCA;
- effective coordination, in the UK and internationally; and
- other important issues on which the Committee has invited views.

4. We believe that if the FCA is to succeed in delivering the required improvements in regulation, it will be very important that its objectives are clearly articulated and agreed at the outset and that it is given the necessary statutory powers. We would urge the Committee to focus on these aspects of the legislation and to resist industry pressure to cut back those powers or to constrain their use in a way which would be likely to make them ineffective in practice.

5. The FCA will need to take stronger action to limit the growth of emerging problems in consumer protection and market developments. To do this it will need to make difficult balancing judgements and important trade-offs. It is important that Government, Parliament and society recognise the balance that will have to be struck between: cost and effectiveness of regulation; consumer freedom and protection; early intervention and innovation; and structural intervention and market autonomy.[3] Where possible the desired balance should be reflected in the details of the legislation. And once the FCA is in operation, Parliament and

[2] Consumer law and business practice. Drivers of compliance and non-compliance. Office of Fair Trading 2010.

[3] In a recent speech, the FSA Chief Executive, Hector Sants, commented on these balancing judgements and trade-offs, in the context of the FCA. The Committee may find this useful further background to its deliberations. (Financial Conduct Authority Conference, June 2011) http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2011/0628_hs.shtml

society should continue to be engaged in the debates about how to strike the appropriate balance, within the limits of regulatory framework.

6. The FSA's historic approach to conduct focused on point of sale regulation—disclosure of information to consumers and a requirement on advisers to give suitable advice—and on dealing with observable consumer detriment after the event. The FSA has recognised the inadequacy of this essentially reactive approach in preventing past mis-selling, and last year it announced a revised approach to dealing with conduct risk. This involves earlier intervention in product development, to anticipate and head off consumer detriment at a much earlier stage, before risk crystallises. The establishment of the FCA represents an important opportunity to make further improvements, using the FCA's enhanced powers. We believe that achieving this will be crucial to fulfilling public expectations and making the FCA a credible regulator.

Are the objectives of the Financial Conduct Authority (FCA) clear and appropriate?

7. The draft Bill proposes that the FCA will have a single strategic objective of "protecting and enhancing confidence in the UK financial system". This strategic objective would be complemented by three operational objectives. These are:

- securing an appropriate degree of protection for consumers;
- protecting and enhancing the integrity of the UK financial system; and
- promoting efficiency and choice in the market for certain types of services.

These strategic and operational objectives are complemented by two duties. The first requires the FCA, where appropriate, to discharge its general functions in a way which promotes competition. Second, the FCA has a free-standing duty to minimise the extent to which it is possible for a regulated business to be used for a purpose connected with financial crime.

8. We welcome the Government's policy of setting out objectives in the draft Bill to give clarity on what the regulator is expected to achieve. However, we have some observations about the objectives as currently drafted.

THE STRATEGIC OBJECTIVE

9. The draft strategic objective is very broad. The FSA is concerned that this formulation does not adequately capture the distinctive nature of the FCA's responsibilities and that it overlaps significantly with the responsibilities of the PRA and FPC. The PRA's focus will be financial stability and the prudential soundness of individual firms—which is of course very relevant to "protecting and enhancing confidence in the UK financial system". The Government's intention is that the FCA will be responsible for conduct issues in relation to consumers and markets. We therefore think it would be more appropriate for the FCA's strategic objective to be: "promoting fair, efficient and transparent markets in financial services".

Should the FCA have a primary duty to promote competition as recommended by the Treasury Select Committee and Independent Commission on Banking? How should this work in practice?

10. In our submission to the Joint Committee on the draft Financial Services Bill, we expressed our concern that the interaction between, on the one hand, the proposed "consumer protection" and "efficiency and choice" operational objectives, and, on the other, the competition duty, leads to a lack of clarity about the FCA's remit.

11. As we pointed out in that memorandum, there are two further possibilities, either of which would set out with greater clarity what is expected of the FCA. These are:

- A full-blown competition mandate for the FCA, which we understand to be the preferred solution of this Committee and the Independent Commission on Banking. This would involve the FCA taking over some of the current responsibilities of the Office of Fair Trading, but would have the advantage of establishing clear demarcation lines between the future responsibilities of the two authorities. However, as we pointed out in our memorandum to the Joint Committee, it would make the FCA a very different—and potentially much larger—organisation than currently envisaged in the draft Bill. Early intervention to restrict the development and marketing of unsuitable products might be desirable under the "protection for consumers" objective but may amount to a restriction on competition.
- The second possibility is for the FCA not to have an explicit competition remit at all, but to rely on the operational objectives on consumer protection and efficiency and choice, to allow it to make interventions (for example, on price) which might also have a positive impact on competition. These interventions would be made expressly to protect consumers. This would give the FCA an altogether clearer focus.

12. We recognise that these are finely balanced arguments. We will submit a supplementary note to the Committee before our oral evidence session outlining our further thinking.

Does the FCA's approach to regulation, as outlined in the FSA's June 2011 document, represent an improvement on that of the FSA?

13. The creation of the FCA as a regulator with a primary focus on conduct, and with stronger powers, provides an opportunity to improve on what the FSA has done over the last ten years in this area. The June document sets out the FCA's initial thinking on how it plans to achieve those improvements. The FCA will be more outward-looking and engaged with consumers than the FSA has been (providing more consumer-oriented and more effective communications) and better informed about their concerns and behaviour where this is relevant to regulatory action. The FCA will also intervene earlier to tackle potential risks to consumers and market integrity before they crystallise. We believe that this new approach will offer a significant step forward in conduct regulation.

14. Between now and implementation of the new regime, the FCA will continue to develop its thinking and will consult further on its new approach in the course of 2012. The FCA would welcome further opportunities to discuss its evolving thinking with this Committee.

To whom should the FCA be accountable? Are the lines of accountability clear?

15. We share the Committee's concern to ensure that the legislation should put in place robust accountability arrangements for the FCA, and that these should be clearly understood by all stakeholders from the outset. Regulators should be accountable to Parliament, Government and the public, not to the firms they regulate. The backbone of an effective accountable system should be clearly defined and agreed objectives for each regulator, against which success or failure can be measured; otherwise, regulators may be criticised for failing to act on matters which they did not believe to be their responsibility.

16. In recent years there has been a general trend, for public policy reasons, for regulators to be set up at arms-length from Government and Parliament. Recent examples in the UK include Ofcom and Ofgem, as well as the FSA. This pattern is followed in the current draft of this legislation which proposes that the FCA should be established as an operationally independent authority. This is also in line with the Basel Core Principles.[4] The FSA Board strongly supports this approach.

17. Under the independent authority model, the FCA will have the authority to make rules and guidance which govern the conduct of financial firms, and to take individual supervisory and enforcement decisions based on its assessment of the right course of action. It is essential for operational effectiveness that it is able to take swift and decisive action. But it is also important that the FCA is subject to appropriate governance and accountability arrangements and to appropriate challenge and questioning.

18. It is for Government and Parliament to propose and establish the regulatory framework within which the FCA will operate—its scope, objectives, and powers. But, however clearly objectives are defined, there will remain important judgments and trade-offs to be made. The FCA Board will therefore be empowered to make decisions on rules and guidance which strike a balance between different interests and considerations (for instance, between the benefits of financial innovation and competition and the dangers of mis-selling to imperfectly informed customers). In addition the FCA Board will be responsible for the oversight of the FCA Executive. The composition of the FCA Board therefore deserves careful thought to ensure that it represents the full range of expertise and perspectives which the new authority will require.

19. The FCA Board is also responsible for giving a public account of the FCA's work, primarily through its Annual Report to the Chancellor, which is also laid before Parliament. The legislation will set out the matters to be covered in that Report, and the FCA will continue to be required to hold an annual public meeting, which offers a valuable opportunity for interested stakeholders to hold it to account for its actions in the previous year.

20. We also believe that your Committee will play a key role in the accountability system. The FCA will be required to explain its actions and plans to the Committee, which will be able to ask questions and, if necessary, challenge those actions and plans. We expect that this Committee will wish to continue to take oral evidence from the FCA on its Annual Report, and we welcome this as a further opportunity to ensure that the FCA accounts for its actions over the year. We would also welcome engagement in future with the Committee on the FCA's published Business Plan, setting out its priorities and budget for the coming year, which should offer a useful forum to discuss the FCA's future strategy.

21. In addition to having powers to make general rules and guidance and to take specific supervisory and enforcement actions, the FCA will also have wide-ranging powers to levy fees. This power must also therefore be subject to governance and accountability arrangements. The FCA Board will have the prime responsibility for challenging executive proposals for budget and fee levels and for approving the fees levied in each year. But Parliament and regulated firms also have a clear interest in the new authority's economy and efficiency. We would therefore expect that the total cost of the FCA and its balance of activity would be subjects on which this Committee will want to question and challenge the FCA in future. And while the FSA already makes use of the National Audit Office for its own audit, we welcome the Government's proposal to put this on a statutory footing for the future.

[4] The Core Principles for Effective Banking Supervision, developed by the Basel Committee, are an internationally-agreed standard for the sound prudential supervision of banks. They include a section on the objectives, independence and powers of banking supervisors.

Reporting on Regulatory Failure

22. In addition to the mechanisms outlined above, the draft legislation proposes new arrangements which would require the FCA to investigate and report on evidence of regulatory failure. We believe that clearly defining these arrangements is highly desirable. They should ensure that where—due to a regulatory failure—events have occurred that have had a significant adverse impact on the regulator's objectives, Parliament and others understand the actions the FCA took and its reasons for taking them. This is vital for two reasons. First, it ensures that the FCA remains publicly accountable where there has been a regulatory failure, and second it allows the regulator (and society at large) to learn the lessons from that failure. As a result, we welcome the inclusion of the formal reporting requirement in the draft Bill.

23. Since this note is provided for the Committee's inquiry into the FCA's accountability, we restrict ourselves to commenting on how we believe reporting on regulatory failure should operate for the FCA. If the Committee would find it helpful to have a separate note on PRA aspects of this issue, we would be happy to provide it.

24. We note that the draft legislation proposes a double trigger before such a report would be prepared. The first trigger would include events that:

- indicated a significant failure to secure an appropriate degree of protection for consumers
- had or could have had a significant adverse effect on the integrity of the UK financial system
- had or could have had a significant adverse effect on efficiency and choice in the market for financial services or
- caused, or could have caused, a significant restriction in competition in the provision of financial services.

The second trigger is that those events might not have occurred, or their impact would have been less, but for a serious failure in either the system of regulation itself, or the operation of that system by the regulator.

25. We would welcome debate in Parliament on this draft provision, which causes us a number of concerns:

- First, it seems inappropriate that the regulator itself should decide if the triggers are met; it would be preferable for that decision to be taken by others, for example, Treasury Ministers.
- Second, while we believe that the first two triggers above are appropriate and could prompt the need for a report, it is not clear to us how the third and fourth triggers would work in practice. Moreover, we see a risk that firms and others could use this provision to challenge actions we are taking using our early intervention (e.g. product banning) powers. (The drafting of this provision is also, of course, linked to the issue of the nature and extent of the FCA's competition remit).
- Third, it will be important to agree appropriate thresholds for such reports to be triggered; as we explain below, the FCA will not aim to eliminate all failure in financial markets nor will it seek to ensure that no consumer ever suffers loss.

26. In addition to these concerns relating to whether a report should be produced, there are also important issues relating to timing. These arise in particular because of potential conflicts between the benefits of early reports from a public accountability perspective and the need to avoid prejudicing enforcement action.

27. As well as the interest in public reports on past failures, there is an equally strong public and parliamentary interest in securing prompt and effective enforcement action by the FCA. Enforcement action identifies firms and individuals who have not met regulatory standards and whose conduct has caused consumer detriment or damaged market integrity. In such circumstances Parliament and the public rightly expect the FCA to take prompt action to investigate what happened, with a view to punishing those responsible (including removing them from the marketplace, where appropriate), issuing strong warnings to others who may be involved in such conduct and, securing redress for affected consumers. Such enforcement action may be prejudiced if reports containing judgements about the causes of failure or customer detriment are published before such enforcement action is concluded.

28. We would welcome a debate in Parliament on how the FCA should best balance the need to produce a prompt public report on past failures and the importance of effective enforcement. There are in principle three options; first, to pursue both objectives simultaneously; second, to give priority to preparing and publishing the report into failure; third, to give priority to enforcement action. In the light of our experience, including preparing our report on the failure of RBS, we believe that the first option would involve considerable difficulties from both a legal and operational standpoint. In the rest of this section we elaborate on this point and explain why we believe the third option offers the best prospect of achieving both objectives in a way which is legally safe and operationally manageable. A useful parallel may be drawn with the way in which cases involving allegations of both criminal behaviour and regulatory breach. In such cases it is normal practice for criminal investigations and prosecution to take precedence and for the public regulator to await the outcome of the criminal proceedings before pursuing regulatory or other civil action.

Legal Risks in Producing a Report before Enforcement Action is Complete

29. In our view there are a number of risks associated with publishing a report into regulatory failure while enforcement action is ongoing. These include:

- There is bound to be an overlap between the matters being investigated for the purposes of enforcement and the report, and the issues are likely to be fiercely contested by the individuals and firms involved. If the FCA is seeking, for example, to interview individuals for two distinct purposes at the same time, there is a significant risk that confusion will arise as to the purpose for which particular evidence is being collected and a greater likelihood of challenge by individuals and their legal representatives to one or both processes. Individuals will be less willing to cooperate in the production of a report if there is the threat of impending enforcement action against them.
- It is likely that a report may criticise the conduct of firms and individuals involved, which may be fiercely contested. The criticism may amount to a public censure. Both current legislation and the draft Bill set out a process that the regulators have to follow before they can censure a firm or individual, which includes opportunities for the subject to make representations and refer a case to the independent Upper Tribunal (part of the Courts Service). Even though the draft Bill does not require any particular process to be followed in preparing a report, the FCA would be required under its general duties in public law to give firms and individuals criticised in a report an opportunity to review those criticisms before publication. However, this is unlikely in highly contested cases to resolve real issues of dispute and a party who remains dissatisfied may challenge the publication of the report by seeking a judicial review. The greater the overlap between the two investigations, the greater the risk that the party may succeed in a judicial intervention.
- Our experience suggests that in some cases individuals will be less willing to cooperate in the production of a report if there is the threat of impending enforcement action against them.
- There is a risk that some of the findings in a report may be subsequently contradicted by a more focused enforcement investigation, leading to arguments from the subjects of enforcement action that the FCA is bound by its earlier reported conclusions.
- Finally, where the FSA takes action in the civil and criminal courts, for example in seeking injunctions or restraint orders in insider dealing and unauthorised business cases, we are concerned that an investigation into possible regulatory failure may interfere with ongoing judicial proceedings.

30. A further question arises about the powers available to the FCA to conduct reports into regulatory failure. Under the existing proposals, the FCA's powers to gather information for the purposes of a report are far more limited than the powers available in an enforcement investigation. For the purposes of the report, the FCA would require an extension of its proposed powers allowing it to call people in for interview and not be limited to using requested information from regulated firms. We would invite Parliament to consider further the powers which the FCA would need to prepare such reports successfully.

Operational Implications

31. We would also welcome debate in Parliament on the operational implications for the FCA of seeking to pursue both objectives simultaneously. In such circumstances, the FCA would have to deal with challenges from firms and individuals on two fronts. If the FCA uses two separate teams to investigate, there is the risk of inconsistency and/or duplication of effort between the teams. Using the same staff may disrupt the efficient prosecution of the enforcement investigation as well as having a consequential effect on the progress of other enforcement cases. In our judgement it would be more cost effective to resolve any contentious matters in the context of an enforcement action first.

32. The second option outlined above would be to postpone taking enforcement action until the publication of a report. This is likely to mean that enforcement action is substantially delayed. Reports of this nature, which are likely to be hotly contested by firms and individuals who know or suspect they are likely to be subject to enforcement action and perhaps collateral civil litigation, are unlikely be completed within a matter of months. By way of comparison, it typically takes 12 months to complete most enforcement investigations in less complex cases involving small firms, taking into account the procedural safeguards built into our enforcement process. More complex enforcement investigations often take longer to complete, particularly where there is a focus on individual senior managers. Reports into possible regulatory failure are likely to fall into this second category.

33. Prioritising the production of a report is therefore likely to lead to a significant delay in discipline of firm and individuals, with attendant delay to consumer redress and in achieving other benefits such as deterring others from committing similar breaches. In some cases, this may result in the FCA being unable to bring cases against individuals within the statutory three-year time period. The subjects of delayed enforcement investigations may in any event try to exploit a delay by arguing that it has caused them prejudice.

34. However, we recognise that there may be circumstances in which the public interest in having a quick public report on past failures outweighs the public interest in allowing enforcement action to take its course.

35. Parliament and the Government have told us that the FCA should be intrusive and effective, willing to take early, firm and decisive action to protect consumers. In our approach document, we began to set out how the FCA will fulfil that vision. We urge the Committee to consider carefully how the duty to produce reports affects that approach, with a view to ensuring that the FCA is able to take the robust action that Parliament expects where there has been misconduct, as well as producing a useful and effective report where there has also been a regulatory failure.

Are the powers of the FCA suitable?

36. As set out in: *A new approach to financial regulation: building a stronger system*, (February 2011), the Government expects the FCA to intervene more strongly in retail financial services markets. The proposed new powers, for product intervention and financial promotions, will enable the FCA to act, and be seen to act, more swiftly to prevent retail consumer detriment.

Powers to Deal Effectively with Misconduct and Mis-Selling

37. On the specific issue of misconduct and mis-selling, we consider that the Government's proposed legislation provides a basis for the FCA to deal effectively with such issues, for example, through the FCA:

- being more ready to intervene, making full use of its enhanced powers, to tackle potential and emerging risks to consumer protection and market integrity before they materialise, and in order to prevent large-scale detriment. This will include a new and intrusive approach to the way firms bring financial services products to the retail market;
- shifting the balance towards tackling the root causes of problems (for example, their commercial drivers), not just the symptoms (e.g. poor firm conduct at point of sale);
- having a more interventionist stance and lower tolerance for consumer detriment which is likely to require further enhancement of the FSA's recent strong activity in enforcement; and
- ensuring that firms provide prompt and effective redress where things do go wrong (given that the FCA will not be able, with finite resource, to prevent every incidence of poor consumer outcomes from crystallising).

38. It is important for Parliament and society to recognise how even these enhanced powers may operate in practice. Our experience is that members of the public and Parliamentarians have been of the view that the breach of the FSA's rules should in all cases entail the consumer receiving 100% redress. However, the FCA's ability to ensure that consumers receive 100% redress will be constrained by the general law, in particular by questions of causation. If the breach of rules did not in their entirety and without question cause the loss suffered by consumers, then the FCA will not be able to require firms to pay 100% redress.

39. If society expects as a matter of public policy that the regulator should be in a position to require higher levels of redress to be paid, then the FCA needs to be given a clear mandate and powers to do so in the legislation. It needs to be recognised, however, that an automatic right for consumers to receive 100% redress is likely to give rise to real questions of public policy as to what level of responsibility consumers should bear for the choices they make. This is a difficult issue that gives rise to real questions as to how far the regulator's powers should extend and we would very much welcome further debate on this by the Committee.

Warning Notices

40. In line with the Government's policy aim of encouraging greater transparency, we welcome the Government's intention to give the FCA power to publicise the fact that a Warning Notice has been issued. However, the Bill as drafted requires the FCA to consult the subject of the notice before any publicity. In our judgement this will seriously undermine the effectiveness of this power as we believe most, if not all, firms and individuals are likely to object to details of the Warning Notice being published. This in turn is likely to lead to satellite litigation, with firms and individuals seeking injunctions through the courts to restrain the authorities from making matters public. We do not believe this would be in the public interest, and would lead in large part to the power being undermined to a point that it is likely to be of little use, and almost certain not to achieve the policy intention of greater openness on the part of the regulators. Our strong preference, therefore, would be for the requirement to consult the subject of the notice to be removed from the draft Bill. The effect would be to bring this provision into line with standard civil and criminal legal powers and would counter the suggestion that the regulatory process is disproportionately biased in favour of non-disclosure in the interests of financial services and industry practitioners.

Powers for the Effective Regulation of Markets

41. Under the Government's proposals, the Bank of England will become responsible for supervising the providers of systemically important infrastructure (central counterparty clearing houses and settlement systems). However, the Bill does not give sufficient clarity as to the role of the FCA in this context. The implication by omission is that it has a role to oversee the conduct element but it is not clear what the nature of this role is. This will lead to confusion both in relation to the FCA's cooperation with the Bank of England but also lead

to confusion as to who is the lead authority on this issue in the European Securities and Markets Authority (ESMA). We would welcome greater clarity on this issue in the Bill.

Will exercise of FCA powers be subject to appropriate scrutiny?

42. We set out above the enhanced range of accountability mechanisms to which the FCA will be subject. In addition, other processes will assist in ensuring that the regulator has acted in line with its obligations under public law, that is, within its authority and acting in a reasonable manner. The FCA, like the FSA, will be subject to the general jurisdiction of the courts on judicial review. Moreover, those affected by major regulatory decisions will, as now, have access to an effective appeals mechanism. An important element in this process will be the scrutiny of FCA decisions by a Tribunal, operated as part of the Courts Services and completely independent of the FCA.

How should the FCA be interacting with industry as well as using its intervention powers?

43. In our approach document, we explain that the FCA will apply a differentiated approach to regulation. The FCA will tailor its approach and the use of its regulatory tools, to the particular risks in the sectors, firms and products which it regulates. This will focus on thematic work, targeting products, services and practices which have the potential to cause consumer or market detriment. We will also continue to emphasis on intensive, institution-specific supervision. These include major firms and market infrastructure providers.

How will the break up of the FSA work in practice?

44. The Government currently envisages that the legislation will gain Royal Assent by the end of 2012. In the meantime, we will continue our work on the detailed design of the FCA, taking full account of the legislative process as well as the views of stakeholders. We will publish further proposals on the FCA's operating model in 2012.

45. Subject to agreement by the FSA Board in November, the FSA will move to an "internal twin peaks" arrangement in April 2012. This will have three objectives:

- To enable FSA staff to begin operating as two separate specialist regulators, in relation to the 2,000+ firms which will be dual PRA/FCA-regulated—one responsible for prudential supervision, and the other for conduct regulation of dual-regulated firms and for all regulation of all other firms.
- To enable dual-regulated firms to begin working with two separate, specialised regulators.
- To use the changes which come into effect next April to learn lessons and plan further design work for the second phase, in preparation for full implementation in 2013.

46. Maintaining current performance while executing major structural change is challenging. The FSA management, with the full support of the FSA Board, is focused on handling both aspects of this work successfully. In particular, we recognise the need to retain key expertise during this extended transition period. We continue to be successful in attracting good people to work at the FSA.

Issues of coordination and information sharing between the FCA and the Prudential Regulation Authority (PRA)

47. Good co-ordination is designed to ensure that the institution or person taking a decision has the right information available; arrangements for co-ordination need to complement clarity of responsibility for decision-making. Experience tells us that where it is not clear which institution has the responsibility and power to take a decision, or where demarcation lines between authorities are not clear, the outcome is delay, inefficiency and poor regulatory outcomes. We would therefore urge Parliament at every stage in the legislation to ensure that responsibility for taking decisions on particular issues is clearly set out—accompanied, of course, in appropriate cases by a duty to consult others, take into account their views etc.

48. The draft Bill proposes to impose a legal duty on the FCA to coordinate the exercise of its functions with the PRA, so that regulatory processes will operate efficiently and effectively. This duty will be supported by a statutory requirement for the FCA and the PRA to agree and publish a Memorandum of Understanding (MoU) setting out how they will deliver that duty. Work on preparing this MoU has begun. The Government also proposes to legislate for cross-membership of boards; the Chief Executive of the FCA will sit on the board of the PRA, and vice-versa, to support coordination at a strategic level. Information gateways will be set up to allow the free flow of information between the two regulators where needed. Collaborative day-to-day working relationships at all levels between the two authorities will be essential.

Dual–Regulated Firms: Rulebook Coordination

49. The FSA is currently considering with the Bank of England how best to develop and set out those regulatory provisions which will apply to dual-regulated firms. An interim solution agreed between the FSA and the Bank of England is to carry over the FSA's existing rulebook past the regulatory cutover period and to badge each provision in the Handbook so that firms can readily identify which provisions will be the

responsibility of the PRA and which that of the FCA. Thereafter, the PRA and the FCA will jointly consider how best to present the provisions for which they are separately responsible.

Dual-Regulated Firms: Authorisations

50. The PRA and the FCA will seek to minimise the impact of dual regulation on the 2,000+ firms affected, but there is likely to be a degree of overlap and duplication. Co-operation will be enhanced through establishing domestic colleges to handle supervisory issues for dual-regulated firms.

51. The FSA welcomes the provisions in the draft Bill which provide for the FCA to consent to the authorisation by the PRA of a firm which will be dual-regulated. We also welcome the Government's decision that the authorisation process for dual-regulated firms should be run by one regulator so as to reduce the need for firms to submit two separate applications.

52. However, there are some concerns about the parallel provisions relating to approved persons. The draft Bill provides that the PRA alone is responsible for approving individuals performing significant influence functions in dual-regulated firms. In doing so, we would expect the PRA to consult the FCA under the general duty to consult.[5] By way of example, the PRA would be solely responsible for approving the Chief Executive Officer of a major bank or insurance company. In doing so, it will consider their fitness and propriety; however, it will do so through the lens of prudential regulation, for which it is responsible, taking account of the FCA's views, as appropriate. However, our experience has shown that the attitude of firms' senior management towards conduct issues can be a real driver of the way firms treat their customers—which points to the need for FCA consent to the appointment of such individuals.

53. Taking account of the IMF's view in its recent report,[6] the FCA would prefer that the Bill should—in line with the arrangements for the authorisation of firms—require the FCA's consent to the approval by the PRA of any persons holding significant influence in a dual-regulated firm.

How should the FCA be interacting with other domestic regulators? For example, the FCA's relationship with the Bank of England (BoE) and Financial Ombudsman Service (FOS)?

54. Coordination and information sharing between the FCA, the Bank of England, the Financial Ombudsman Service (the ombudsman service), the Financial Services Compensation Scheme (FSCS) and the Money Advice Service will be an important element in the success of the new regulatory arrangements.

The Financial Policy Committee (FPC) of the Bank of England

55. Whilst the FCA will not have explicit responsibility for financial stability, the FCA's supervision and other regulated activities will be important to the arrangements in the UK for preserving stability. The FCA's CEO will be a member of the FPC and the FCA will be subject to FPC recommendations and directions on the use of regulatory tools in the pursuit of macro-prudential policy. There will be a continuous exchange of views and information flow between these regulatory bodies.

Financial Ombudsman Service

56. The Government intends the ombudsman service to remain an operationally independent dispute resolution service and for the FCA to take on the FSA's existing functions in relation to the ombudsman service. A MoU will set out how both organisations will work together. The Government will require the ombudsman service to pass to the FCA any information which the ombudsman service considers could assist the FCA to advance its objectives and the FCA will be required to have regard to this information in fulfilling its objectives.

57. We believe that these mechanisms should enable the FCA to make full use of the information held by the ombudsman service on firms' treatment of their customers and handling of their complaints. If the FCA is successful in dealing with the major causes of consumer detriment before their effects become widespread, using its enhanced powers to act early and decisively, this should help to ensure that the ombudsman service is able to focus on its core function of dealing with individual disputes on a case-by-case basis.

Financial Services Compensation Scheme

58. The draft Bill proposes that the FCA and the PRA will have rule-making powers for the FSCS—the PRA for compensation and fees rules on deposits and insurance provision, and the FCA for all other types of financial activity covered by the FSCS. The two regulators will be jointly responsible for oversight and associated functions (for example, Board appointments) in relation to the FSCS. Proposals within the draft Bill require the FSCS to put in place a MoU with the FCA to strengthen transparency and accountability.

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[5] Draft Financial Services Bill—Section 3D (1) (a).

[6] The IMF in its recent Financial Services Action Plan review noted the importance of the approved persons regime to the UK's regulatory and supervisory structure. The IMF recognised the benefits of adopting a system of dual approval for certain key positions supported with coordinated information requests and assessment processes. http://www.imf.org/external/pubs/ft/scr/2011/cr11230.pdf

MONEY ADVICE SERVICE

59. The FCA will have the same responsibilities in relation to the Money Advice Service as the FSA currently has. We support measures included in the draft Bill that require the FCA to agree and publish a MoU with the Money Advice Service, replacing the current voluntary arrangement. We believe the Service will be a further useful source of intelligence and early warnings for the FCA on potential problems in retail markets.

How should the FCA be interacting with international regulators? Do EU regulation initiatives restrict or enhance the work of the FPC? Will the FCA be able to effectively engage with the EU supervisory authorities?

60. The FCA will continue to depend significantly on, and be constrained by, detailed requirements to be set out in European agreements that are still currently in negotiation. In addition, the new European Supervisory Authorities (ESAs) have the power to set binding technical standards. It will be important therefore for the UK authorities to seek to ensure that the EU policy framework leaves scope for regulators to make informed judgements about the risks to their objectives, the risks to their markets and consumers, and the actions they wish to take.

61. The FSA (together with the Government, the Bank of England, and other stakeholders) has played an active role in shaping the development of the common framework for regulation and supervision at a European level. We are confident this work will be continued by the FCA. We recognise that a key challenge of the twin peaks structure will be to ensure that the UK retains its influence in the European regulatory architecture. The FCA is committed to working effectively with the European Supervisory Authorities (ESAs), in close collaboration with other UK authorities. The draft Bill requires the authorities to include in their MoU provisions setting out how they will co-ordinate their relations with the ESAs. The FCA will represent the UK in the ESMA, where the FCA's priorities are likely to have much in common with the EU's consumer protection goals, including issues under the Markets in Financial Instruments Directive. The FCA will also be active in ESMA in seeking to achieve sensible outcomes in the regulation of wholesale markets. The FCA will also work in close coordination with the PRA, as the latter will be representing UK interests in the European Insurance and Occupational Pensions Authority (EIOPA) and the European Banking Authority (EBA).

OTHER POINTS ON WHICH WE WOULD WELCOME PARLIAMENTARY DEBATE

The cost of regulation

62. Reform and improvements of this kind will necessarily involve costs. The FSA takes very seriously its duty to be economic and efficient in the use of its resources. However, it is clear that the FCA is being asked to operate in a different way from the FSA, for example by intervening earlier to prevent consumer detriment. A system which requires 2,000+ firms, out of a total of 27,000, to be regulated by two authorities is inherently likely to cost more than a system of unitary regulation. We believe this is a price worth paying, but it should in our view be clearly recognised at the outset.

Implications of a zero-failure regime

63. It will be important to recognise that the FCA will tolerate some degree of prudential and conduct failure and we invite the Committee to consider whether this is an acceptable reality. On occasions in the past it has seemed that Parliament, in its response to individual cases, reveals a preference for zero failure—that is, no firms failing and no consumers losing money. This is neither realistic nor desirable in principle. The lower Parliament's appetite for prudential or conduct failure is, the more interventionist and expensive the regulatory regime will be. We would welcome further parliamentary debate on this issue, as this is one of the key choices to be made in the course of finalising this legislation.

October 2011

Written evidence submitted by Which?

EXECUTIVE SUMMARY

Which? does not believe that the strategic objective for the FCA is clear or appropriate. The objective is vital in conditioning the approach the regulator will take. The current drafting of "protecting and enhancing confidence in the UK financial system" sets the wrong tone for a regulator which is intended to take a proactive approach and place the consumer at the heart of the regulatory system.

Which? strongly supported the move to elevate the importance of competition in the FCA's objectives and believe the Treasury's decision to focus on the positive outcomes of competition in framing the objectives is sensible. After all, competition in retail banking should be seen as the means to achieve better outcomes for consumers, rather than an end in itself.

The FCA needs to take a far more proactive approach and be willing to tackle the root causes of consumer detriment such as poor quality products and inappropriate remuneration/incentive structures. The enforcement

and penalty regime must put in place a credible deterrent against poor practice and much stronger incentives to ensure fair treatment of consumers.

In the past it has been very difficult to hold the FSA to account for its decisions and the Treasury has been reluctant to question FSA decisions publically in order to preserve the appearance of regulatory independence. The only body that shows sustained willingness to publically question the FSA's policies has been the Treasury Committee who do an excellent job but are obviously limited in the resources they could commit. We think it would be worth exploring whether extra resources could be allocated to the committee to allow them to undertake more regular reviews. However while we support measures to improve the accountability of the FCA, we also support the need for the regulator to be independent from Parliament.

Proper accountability also requires greater transparency about the regulator's decisions and effectiveness. We are concerned that section 348 of FSMA prevents the regulator from disclosing information in the best interests of consumers.

We welcome the powers given to the FCA and believe that they will give the FCA more of the tools it needs to be an effective regulator. We particularly welcome the proposals regarding product intervention, S404 powers, consumer redress, financial promotions and the publication of warning notices. However, it also needs to undertake more robust enforcement action against firms and individuals and ensure higher financial penalties.

There will need to be formal information exchange between the regulators. Wherever possible we believe that any instructions, views and recommendations expressed between the regulators should be made public.

We are very concerned about the PRA's power to veto an FCA decision which would lead to a firm or group of firms failing. The concept of "too big to fail" risks becoming extended to "too big to be forced to treat your customers fairly". We are clear that the use of the veto should be seen as regulatory failure and believe the use of the veto should be one of the cases that triggers an independent inquiry.

Responses to Specific Questions

Question 1: *Are the objectives of the Financial Conduct Authority (FCA) clear and appropriate*?

1. Which? does not believe that the strategic objective for the FCA is clear or appropriate. The objective will be vital in conditioning the approach the regulator takes and thus it is essential that the legislation gets this right. The current drafting of "protecting and enhancing confidence in the UK financial system" sets the wrong tone for a regulator which is intended to take a proactive approach and place the consumer at the heart of the regulatory system.

2. This strategic objective sends the message that the regulator is more concerned about the perception of confidence than the reality of protection and will do nothing to convince consumers that their interests will be protected. For example, if the regulator is tasked with promoting confidence, it could be discouraged from publicising bad practice or drawing attention to areas where markets are not working properly for consumers. This would clearly hinder its willingness and ability to adopt proactive approach to consumer protection. As a result we strongly believe the Government should reconsider the objective it has set out. We would recommend the strategic objective for the FCA should be of "ensuring a fair and transparent market in financial services". If the Government believes that a reference to confidence is important then the strategic objective should be of "ensuring a fair and transparent market in financial services which justifies enhanced confidence".

3. We support the operational objectives set out for the FCA. However, we are concerned about the drafting of the "efficiency and choice" objective as these terms are not clearly defined. We would thus suggest section 1E of the bill should be amended to give clear definitions. Those relating to "choice" should include the ease with which consumers may obtain appropriate products at competitive prices, and the ease with which consumers may discriminate between products or services which represent good and poor value for money. Those relating to efficiency should include a remit to consider value for money and ensure consumers are provided with appropriate products and services to meet their needs at the lowest possible cost. Unless these terms are clearly defined in the bill the regulator will be able to make its own interpretations of them that may differ from the intentions of parliament.

4. In relation to the consumer protection objective we welcome the "have regard" which deals with consumers' need for information, but believe this could be better worded to achieve the desired outcome. In the past there has been an emphasis on disclosure of information rather than ensuring that consumers could understand and act on this information. Such an approach has resulted in large scale consumer detriment as evidenced during the PPI mis-selling scandal. The current draft only includes the term "accurate" information. We would note that information may be "accurate" without being of practical use to the majority of consumers if it is too complicated, technical or voluminous. We suggest an amendment to recognise consumers' need "for information which is timely, accurate, intelligible to them and appropriately presented".

Question 2: *Should the FCA have a primary duty to promote competition as recommended by the Treasury Select Committee and Independent Commission on Banking? How should this work in practice*?

5. We believe it is important to clarify precisely what "a primary duty to promote competition" actually means. We support the proposal for the regulator to discharge its duties in a way which promotes competition.

However, we do not think that competition should be elevated to a level above consumer protection. Competition in retail banking and other financial markets should be seen as the means to achieve better outcomes for consumers, not an end in itself. If the Government accepts the ICB's proposal to replace the "efficiency and choice" objective with "promoting effective competition" then it is still important that the objective is properly defined.

6. Which? are clear that competition is only effective if it acts to protect and benefit consumers. A market should not be considered competitive simply because there are thousands of different products available. Competition only works for consumers if they can easily identify products and providers which offer better service and value for money. We believe that truly competitive markets have the following characteristics. The FCA would report on the extent to which the markets it regulates met these characteristics as part of its thematic work and market testing:

- Competition on the merits—firms genuinely compete on the basis of the quality and price of their products or services rather than exploiting consumers' behavioural biases;
- Consumers are engaged and able to compare the quality or performance of different financial products and firms;
- The price, quality and characteristics of products are transparent and easily comparable;
- Products do not include hidden charges or unfair contract terms;
- There are low barriers to market entry and exit (while preserving essential services for consumers);
- There are low barriers to switching (both real and perceived);
- Consumers are able to pursue effective and speedy redress where necessary; and
- Conflicts of interests between firms and their customers are removed or managed appropriately.

7. The FCA should have greater latitude under its conduct of business powers to implement measures which improve effective competition. However, Which? agrees with the Government that more general competition powers may at times be suitable. Whilst we welcome the ability for the FCA to refer matters to the OFT and for the OFT to keep the provisions of the FSA under review, it is important that this process is exercised at the appropriate time. Under existing section 160(1) of the FSMA, the OFT has a duty to keep the regulating provisions and practices of the FSA under review. Where the OFT considers that regulations may have a significant adverse effect on competition, it may make a report possibly leading to further action by HM Treasury. We note that in over a decade the OFT has failed to exercise its power to make a report to HM Treasury. We believe that the FCA should explicitly report on the extent of effective competition in the markets it regulates and invite an independent person to review its performance at the end of each year in respect of how it has exercised its relevant powers to promote effective competition and make enhanced referrals to the OFT.

8. To help ensure that the FCA takes its new remit to promote effective competition seriously and makes appropriate referrals to the OFT, it is important that the FCA is designated as a recipient body for super-complaints and is required to report back within 90 days with regard to the action it is taking in response to the complaint. Super-complaints are made by designated consumer bodies (such as Which?) where we have identified a feature (or combination of features) in a market which is significantly harming the interests of consumers.[7] Responses to super-complaints can typically include measures to promote transparency, switching or to take targeted enforcement action—all of which will be within the remit of the FCA. Designating the FCA as a recipient body for super-complaints would help prompt it to exercise its powers in a more pro-active manner to protect consumers and promote competition.

9. We also believe it is essential for the FCA to be able to limit ancillary/default charges if it is to take an effective approach to competition. These "behind-the-scenes" prices can lead to a substantial risk of weakening of effective competition between firms, in particular reducing direct price competition as apparently low "headline" prices mask the true costs once ancillary / default charges are accounted for. Discovering the "true" price raises consumers' search costs, especially if price structures are frequently altered. This will distort consumer decisions leading to inefficient economic outcomes. A regulator with a clear competition mandate would ensure that consumers can be confident that once they have entered into a contract, they will not be subjected to any unexpected charges or, if they are, such charges are fair and proportionate.

10. The section on pricing in the FCA Approach Document sets out the regulator's view:

> "The government has said that the FCA will not be an economic regulator in the sense of prescribing returns for financial products or services. The FCA will, however, be interested in prices because prices and margins can be key indicators of whether a market is competitive. Where its powers allow, the FCA will take into consideration more positively the cost of products or services in making judgements about whether consumers are being fairly treated".
>
> "Where competition is impaired, price intervention by the FCA may be one of a number of tools necessary to protect consumers. This would involve the FCA making judgements about the value for money of products".

[7] In relation to financial services Which? has made super-complaints regarding Northern Ireland banking, Credit card interest calculation calculations and Card surcharges.

"The FCA will thus consider exercising its powers to take action where costs or charges are excessive".[8]

11. However as our barrister, John Odgers, notes:

"It is not clear whether, by not including in the Bill any specific provisions relating to price intervention, the Government intends the regulators to enjoy no such powers or whether it considers that price intervention is permissible under these rule-making powers.

"It seems to me to be desirable that a power of price intervention should be spelled out, if it is intended. Financial services regulators have not in this jurisdiction previously exercised that type of power, and might in future be loath to do so without a specific statutory authority, as the use of such a power would be particularly likely to attract a challenge".[9]

We would therefore welcome clarification from the Government on this matter.

Question 3: *Does the FCA's approach to regulation, as outlined in the Financial Services Authority (FSA)'s June 2011 document, represent an improvement on that of the FSA*?

12. As noted over the course of many years by Which? the FSA took an approach which was too reactive and failed to put in place the right incentives for firms, make competition work for consumers or to ensure that there was a credible deterrent against poor practice. There was an emphasis on disclosure of information and attempting to control the sales process. If the FSA found a problem it was slow to take the robust action needed by consumers. The previous approach led to a number of major problems surrounding issues like Payment Protection Insurance (PPI), precipice bonds and endowment mortgage complaint handling. These failures cost the industry and consumers billions of pounds and damaged consumer confidence.

13. We support the new proactive approach laid out in the June 2011 document. It is essential that the FCA takes quicker and more effective action to tackle the root causes of consumer detriment such as poor quality products or inappropriate remuneration/incentive structures. The FCA should work to ensure that market forces and competition can work more effectively so that companies which treat their customers fairly and offer good value for money products gain business at the expense of firms which do not. Similarly, it must be made clear to firms, their senior management and shareholders that a failure to treat customers fairly will have a significant detrimental effect on the firm's reputation and bottom line. There must be a credible deterrent against poor practice and much stronger incentives to ensure fair treatment of consumers.

14. However, we are concerned that the draft Bill does not go far enough to codify a new regulatory culture and a more proactive approach to regulation. We very much support the intention set out by the Government in its White Paper and by the FSA in the FCA approach document. However we believe the legislation, as currently drafted, gives the FCA too much leeway to determine its approach to regulation. Under FSMA the FSA was able to swerve from the light-touch approach of its early years to its current, more proactive, approach and we are concerned that under the new legislation the FCA will be able to do the opposite. As a result we would like to see changes made that would ensure the Government and Parliament's intentions are hard-wired into the way the FCA operates.

Question 4: *To whom should the FCA be accountable? Are the lines of accountability clear*?

15. We support the steps that have been taken to improve the accountability of the regulators, including through the requirement that the FCA will be subject to audit by the NAO. Proper accountability can only come alongside improved transparency about the regulator's functions and its performance. In order to further increase the accountability of the regulators we believe there needs to be greater transparency around the agendas, forward plan and minutes of board meetings to provide full information about when the Board is taking key decisions—though we acknowledge that financial stability considerations may occasionally limit the amount of information which can be disclosed in advance. This will improve the accountability of both the firms and the regulator and increase public confidence. In addition we believe it would be beneficial if the regulator made itself more available to scrutiny. This could take the form of a monthly question time where senior figures and board members were required to take questions from key stakeholders.

16. In the past it has been very difficult to hold the FSA to account for its decisions and the Treasury has been reluctant to question FSA decisions publically in order to preserve the appearance of regulatory independence. The Treasury Select Committee has been able to perform this role but it is limited in the resources it can commit. To continue this excellent work it may be worth exploring whether extra resources can be allocated to allow for more regular reviews. Alternatively, these inquiries could be undertaken by a new sub-committee if this were to be proved more efficient.

17. However while we support measures to improve the accountability of the FCA, we also support the need for the regulator to be independent from Parliament. We are concerned that some who argue for increased accountability actually want reduced independence. In contrast, while we believe the FCA must report to Parliament and explain its actions and policies, we would oppose moves which would allow politicians to control the FCA and require it to change its approach. At times the regulator may be required to take actions which are necessary to ensure consumer protection in the long-term, but will be politically unpopular in the

[8] The Financial Conduct Authority Approach to Regulation, June 2011, Pg 19.
[9] Written advice from John Odgers, Barrister, 3 Verulam Buildings, 12 August 2011.

short term. At other times the regulator may want to pursue a proactive approach to regulation while politicians support a light-touch approach. We believe the regulator should have to justify why it is taking the approach in question but, subject to this accountability, that it should be able to pursue the course of action it believes is necessary within the confines of the powers granted to it in law.

18. Proper accountability also requires greater transparency about the regulators decisions, how these are communicated to individual firms and the action the firms have taken in response. As noted below section 348 of FSMA excessively constrained the FSA regarding the information it can disclose and damages accountability. The FSA has refused to disclose the instructions which it had given to firms which had been fined for mis-selling PPI. More recently, it refused to disclose to us the names of any firms which had failed to meet a specific deadline set to deal with PPI complaints. These responses make it much more difficult to determine whether the regulator's actions are sufficiently robust. A culture of secrecy harms accountability and only benefits those firms breaking the rules.

Board Composition

19. We would also like to draw the committee's attention to the issue of governance. We believe measures should be put in place to ensure that a diverse range of expertise is included on the board of the regulators. In the past, we have seen a situation where 10 of the 12 members of the FSA board had been currently or previously employed by the industry. This raised the risk that only the prevailing mindset of the industry gained credence in Board deliberations. There was a clear preference to codify existing industry practice instead of asking searching questions about whether markets were working efficiently and in the interests of customers.

Question 5: *Are the powers of the FCA suitable? Will their exercise be subject to appropriate scrutiny? How should the FCA be interacting with industry as well as using its intervention powers*?

20. We particularly welcome the following proposals and believe that they will give the FCA more of the tools it needs to be an effective regulator.

21. *Product intervention powers*: We support the intention for the FCA to be able to make rules to place requirements on products or product features; mandate minimum product standards; or restrict the sale of a product to a certain class of consumers. These powers should enable the FCA to step in earlier and ensure products such as PPI are not able to be sold on a mass-scale to consumers. In some cases, this may require the regulator to take prompt action to prohibit the sale of a particular product or to control a particular product feature. It is very important that the regulator is able to act quickly so we strongly support the proposals for the FCA to be able to make temporary product intervention rules for a period of up to 12 months with immediate effect. It is important that the FCA sees its role in product intervention as being more than just "banning" toxic products but in also setting minimum standards, controlling variation terms and using the principles of "nudging" to set default standards for products in the best interests of consumers.

22. *s404 powers*: We welcomed the Government's decision to activate the s404 powers included in the Financial Services Act 2010. We believe the FCA must show greater willingness to utilise these powers to require firms to actively review past sales of a particular financial product where detriment has occurred. This would be a similar process to a "product recall" used in other industries.

23. *Consumer redress*: We are interested in the Government's proposal to allow nominated parties to refer to the FCA issues that may be causing mass detriment. We believe this could be a useful mechanism to allow groups who engage with consumers on an everyday basis to flag-up issues with the FCA. Careful attention must be given to how consumer complaints are dealt with while the FCA considers an issue. We would be wary of a situation where use of this referral power lead to a delay in compensation for consumers.

24. *Financial promotions*: We support the new powers to increase transparency around mis-leading financial promotions. These should increase awareness of mis-leading advertisements and enable consumers to respond accordingly if they had made a purchasing decision based on this advertisement.

25. *Publication of warning notices*: We support the new power to allow for the publication of the fact that a warning notice has been issued and for summary of the notice to be published. This should be part of a more open and transparent enforcement process. For example, if the debt advice agencies become aware through the publication of a warning notice that the FCA is considering taking action against a mortgage lender for treating customers in arrears unfairly they may be able to submit evidence to the FCA concerning the way the lender has been treating their clients.

In addition to its new powers the FCA should also ensure:

26. *Financial penalties are substantially higher*: It is clear that to provide a credible deterrent the level of financial penalties will need to be significantly higher than those levied by the FSA. The FSA's fines for mis-selling of PPI represented a tiny proportion of the revenue/profit gained from selling the product. They are also substantially below the level of penalties from other regulators.[10] We would recommend two adjustments to the powers to apply financial penalties. Currently any proceeds from financial penalties are applied for the

[10] British Airways was fined £121.5 million by the OFT for collusion over fuel surcharges. Argos was fined £15 million by the OFT for fixing the price of toys and games. Severn Water were fined £35.8 million by OFWAT for mis-reporting information.

benefit of authorised persons—so high fines result in lower levies. This perpetuates consumers' concerns that the regulator does not work in their interests so we would recommend that a portion of the fines received should be put into a fund to pay for financial education and inclusion projects. In addition, in order to ensure the level of penalties set by the FCA takes into account consumer detriment, we believe the "have regards" set out in section 210 should be extended to consider whether consumer interests had been endangered and whether the person or employer had benefitted financially from the contravention.

27. *Greater action against senior management who oversee mis-selling*: To improve the incentives of senior management to prevent mis-selling, they must be held accountable for regulatory failures. They should be subject to regulatory action and the FCA should make it clear that mis-selling is grounds for the clawback of bonuses. We note that the only senior executive to be held accountable for mis-selling at a large firm has been the chief executive of Land of Leather (a furniture retailer). No senior executives at major banks have been held accountable, nor suffered loss of bonuses because of the vast liabilities from mis-selling.

28. *There is more mystery shopping*: The FCA should undertake more work to test the "outcome" received by consumers. This should involve greater use of mystery shopping—a technique used effectively by Which? to test how real consumers are treated by firms. The FCA may also want to make greater use of thematic work and studies of individual product markets.

29. *The Conduct Risk division is retained*: The FCA should preserve the FSA's Conduct Risk division which is aimed at the identification of emerging risks before they crystallise and cause major consumer detriment.

30. *The FCA tackles the root cause of detriment from remuneration/incentive structures*: The FCA needs to move from a purely reactive approach to one which seeks to tackle the root causes of consumer detriment. This should include examination of remuneration systems linked to sales targets, which we believe create a conflict of interest between the consumer and the firm. They encourage banks to recommend courses of action which result in the sale of a product, rather than that which is most suitable for the customer and can therefore contribute to mis-selling. It should be noted that advisers at Alliance and Leicester received six times as much bonus for selling a loan with PPI as for selling a loan without PPI.

Question 6: *How will the break-up of the FSA work in practice? Issues of coordination and information sharing between the FCA and the Prudential Regulation Authority (PRA)*

PRA veto

31. We are very concerned about the PRA's power to veto an FCA decision which would lead to a firm or group of firms failing. To permit the PRA to overrule the FCA sends a dangerous message to the industry that only firms which are small enough to fail without causing damage to financial stability will be forced to bear the full consequences of mistreating consumers. The concept of "too big to fail" risks becoming extended to "too big to be forced to treat your customers fairly". If a firm has broken the regulations and/or common law and consumers have suffered financial detriment then it should not be possible for the PRA to extinguish the legal liability of the firm. This approach can only strengthen the moral hazard that led to the catastrophic failings in the banking industry which the regulatory reforms aim to prevent.

32. We do reluctantly accept the need for the PRA to be able to veto an FCA action in the interests of financial stability. However, we are clear that the use of the veto should be seen as regulatory failure. If, for example, the veto is used to prevent a firm becoming insolvent due to the payment of FCA-ordered redress to consumers, the regulatory regime will have fundamentally failed. The PRA will have failed in its role as a prudential regulator for allowing a firm to enter such a perilous prudential situation that it cannot meet its obligations to the conduct regulator.

33. Meanwhile, the FCA will have failed by not clamping down on misconduct at an earlier stage. We would therefore propose an amendment to part 4, section 46 of the draft Bill which would include the use of the veto as one of the cases where the Treasury should arrange independent inquiries.

34. There should also be further clarification from the Treasury about how consumers would be treated if the PRA exercised its veto to prevent a firm from failing and kept this fact confidential on financial stability grounds. Would the FCA still be able to prevent the firm from taking on new business? Would consumers who invested with the firm after the confidential PRA veto be entitled to more compensation if it subsequently failed? If so, who would pay this compensation?

With-profits funds

35. We are concerned about the Treasury's decision to place regulation of with-profits funds with the PRA. Consumers have around £330 billion invested in with-profits funds in around 25 million policies. The PRA's insurance objective is weaker in terms of consumer protection than that of the FCA. Furthermore, the PRA will not have the staff and culture in place to take a proactive approach to consumer protection. The PRA also lacks the remit of the FCA to exercise its functions in a way which promotes competition. The draft Bill also re-introduces the concept of "Policyholders Reasonable Expectations" which we believe is a retrograde step in terms of policyholder protection.

Question 7: *How should the FCA be interacting with other domestic regulators? For example, the FCA's relationship with the Bank of England and Financial Ombudsman Service*

36. There will need to be formal information exchange between the regulators. Wherever possible we believe that any instructions, views and recommendations expressed between the regulators should be made public. Splitting responsibility between three different regulators does not remove the conflicts which can exist between different functions, but merely externalises them.

37. We also think that it is important for the FCA to be consulted by the Financial Policy Committee when making policy decisions that will have a direct consumer impact. Taking advantage of the expertise, knowledge and experience available across the entire regulatory system will lead to better outcomes across the entire regulatory system.

38. We also strongly support the requirement for the FOS to pass to the FCA any information which could be important in helping to promote better consumer outcomes. The Ombudsman can provide the FCA with a valuable evidence base, both through identifying emerging issues and by flagging up companies which are persistently failing to resolve legitimate complaints. A free, independent and effective redress service is vital if we are to prevent further deterioration of trust in the financial services industry. The FOS strengthens incentives for firms to treat their customers fairly, promotes competition in the market and ensures consumers gain redress when they deserve it. Openness, transparency and the sharing of insight between the FOS and the FCA will be key in ensuring that lessons are learned.

Question 8: *How should the FCA be interacting with international regulators? Do EU regulation initiatives restrict or enhance the work of the FCA? Will the FCA be able effectively to engage with the EU supervisory authorities*?

39. At present, it is proposed that the FCA will represent the UK at the European Securities and Markets Authority (ESMA) while the PRA will lead at the European Banking Authority (EBA) and the European Insurance and Occupational Pensions Authority (EIOPA). Given that an increasing volume of consumer protection legislation will originate from the European Supervisory Authorities (ESAs), Which? is concerned that the UK consumer regulator will not have a sufficient voice in the negotiations. We believe the Government and the FSA need to set out a clear strategy for engagement and influence with the ESAs, and this strategy needs a dedicated section looking at the how to engage with the ESAs in their remit on consumer protection issues.

Regulatory transparency

40. Current EU directives regarding confidentiality may restrict the FCA from pursuing its regulatory principle regarding transparency. This is a result of the constraints imposed by s348 of FSMA which prevents the regulator from disclosing information it receives in the discharge of its regulatory duties, except in certain defined circumstances. Which? has submitted a number of FOI requests to the FSA asking for the names of mortgage lenders which had performed poorly in the FSA's thematic work. We believed that consumers had a right to know which lenders were treating customers unfairly and that this information should also be shared with the Court judges hearing repossession requests from these lenders. We have also submitted FOI requests asking for information about the instructions the FSA gave firms found guilty of PPI mis-selling and how they had been required to contact affected consumers. The FSA refused to disclose information in response to our FOI requests citing the constraints imposed by s348 of FSMA. While the Government is constrained in its ability to reform s348 as a result of secrecy provisions contained within various EU directives, we believe there are areas where the UK has gold-plated the EU directives. We therefore believe the Treasury needs to undertake a review into how it has interpreted the EU provisions and definitions.

41. The actual practice of the FCA would be influenced by a clear mandate to disclose information where it might help the FCA achieve its objective of ensuring good outcomes for consumers or where it might influence a consumer's decision to engage in a commercial relationship with a financial services firm. In addition to the legislative changes outlined above, Which? recommends further transparency in seven key areas:

- Thematic work.
- Conduct risk.
- Price data.
- Complaints data.
- Own-initiative variation of permission.
- Usage data.
- Redress schemes.

OTHER ISSUES

Consumer responsibility

42. Which? would note that under the common law, consumer responsibilities are already established and include the principles of reasonableness, good faith, participation, disclosure and action. As a result we would question whether it is necessary to include the principle of consumer responsibility in the legislation. However we understand many in the industry feel strongly about its inclusion and are comfortable with its inclusion as a "have regard" in the consumer protection objective. However we are concerned that there is a significant imbalance between the responsibilities of consumers and firms as set out Section 3B of the Bill.

43. As John Odgers, the barrister we commissioned, notes:

> "Regulatory principle (c) is thus the same as one of the principles to which, under proposed new section 1C(2), the FCA is to have regard when considering the degree of protection for consumers that is appropriate. But, whereas in the latter context, the principle's application and relevance is clear, when expressed as a general principle applicable to all the regulators' acts, the statement is perplexing: Why should only consumers accept responsibility for their own decisions? Why not regulated firms? Why not individuals who are approved to perform controlled functions? Indeed, why not the world in general? It is as if the Bill's draftsmen are at pains to ensure that consumers should have only themselves to blame. In my view sub-section (c) should simply be omitted".
>
> "Sub-paragraph (d) does highlight to some extent the compliance responsibility of senior management but it is not expressed in clear terms. Indeed, sub-paragraph (d) is hard to call a 'principle' at all, it seems to be no more than a reference to 'responsibilities' which are somehow defined elsewhere. It would be preferable if sub-paragraph (d) were reformulated to state outright that senior management should take responsibility in relation to their firm's compliance with requirements imposed on their firm by and under the Act. I would therefore suggest that proposed sub-section 3B(1)(d) be amended, so as to read 'the principle that the senior management of persons that are subject to requirements imposed by or under this Act are responsible for procuring compliance with those requirements'".[11]

44. In addition to addressing this imbalance, we are keen that attention is not paid to pressure that may emerge from sections of the industry who believe the regulator should designate specific actions that consumers should be responsible for undertaking. In particular we are aware of those in the industry who want to impose a responsibility on consumers to understand long and complex disclosure documents. We fully support the Treasury's analysis that "[retail] consumers…are often at a relative disadvantage when engaging with financial services, given information asymmetries, product complexity and long-term product payoffs".[12] As a result we believe it would be wholly inappropriate to extend consumer responsibility beyond the common law principles. An inappropriate extension of consumer responsibilities also poses a risk of damaging consumer confidence and ultimately leading to disengagement from consumers.

October 2011

Written evidence submitted by Killik & Co

1. BACKGROUND

1.1 Killik & Co was founded in 1989 to offer investment advice and trade execution services to the Private Client Stockbroking market. We currently operate from ten branch locations in the UK and one in Dubai, offering a range of financial services to our clients including traditional stockbroking advice, portfolio management, advice on CFDs and Spreadbets, Wills, and Trusts. We offer our own ISA and SIPP and have a separate Financial Planning arm called Killik Chartered Financial Planners, which holds prestigious Chartered Status and offers fully independent whole of market financial planning advice. We service approximately 24,000 clients and manage combined funds of £2.5 billion. We are members of the Association of Private Client Investment Managers and Stockbrokers (APCIMS).

2. EXECUTIVE SUMMARY

2.1 Thank you for the opportunity to offer our thoughts on the arrangements for the Financial Conduct Authority ("the FCA"). We believe that reform of the Financial Services Authority ("the FSA") is needed and we are hopeful that the new FCA will bring welcome improvements to the regulatory environment. Our comments are arranged under five headings:

2.1.2 Competition—we set out our concern that the focus has shifted from that originally envisaged by the Treasury and suggest that an independent committee is needed if there is to be proper scrutiny of the actual or potential effect of the FCA's regulatory decisions on the UK financial services sector's overall competitiveness in Europe and internationally.

2.1.3 FCA's approach to regulation and suggestions for improvements—we agree with the idea of differentiated and proportionate regulation and believe this could perhaps be achieved more easily by making

[11] Written advice from John Odgers, Barrister, 3 Verulam Buildings, 12 August 2011.
[12] A new approach to financial regulation: building a stronger system, HMT, February 2011, para 4.26, pg 64.

use of industry bodies, such as APCIMS in rule-making and guidance. Engagement with the industry bodies could help to direct policy in the areas it is most needed and place the industry bodies in a position where they can give more guidance to their members about FCA expectations and the actions firms need to take to ensure compliance with the FCA's rules. We explain why we think this would allow the best elements of self-regulation to exist within a regulated framework.

2.1.4 Accountability and appropriate scrutiny—we suggest that on an annual basis the FCA should face an independent committee to be challenged about its effectiveness and approach. The Committee could draw upon feedback from industry and consumer bodies in framing its questions and should have the power to direct changes in the regulator's approach and personnel where in its opinion there are shortcomings. Senior executives should be personally accountable for regulatory failings and, just as for banking executives, there should be no reward for failure.

2.1.5 Interaction with other domestic regulators—we propose that half-yearly meetings take place between FCA and FOS to review a selection of ombudsman cases where firms have behaved unfairly or contrary to expected industry standards or in breach of FCA rules. These discussions could then be used to help inform FCA Thematic Reviews as well as help the FOS to understand the FCA's expectations of firms and consumers , e.g. with regards to suitability or other key themes.

2.1.6 Interaction with international regulators—there is a clear need for the UK to be represented in Europe on regulatory policy-making matters. We suggest that the FCA has an important contribution to make here, but that there may be benefit in drawing from a wider variety of bodies to ensure that issues such as UK competitiveness are adequately considered.

3. Detailed Response

3.1 *Competition*

3.1.1 The approach of the FCA towards ensuring competition seems to have departed from the one envisaged by HM Treasury's February 2011 consultation document: *A new approach to regulation: building a stronger system* ("the Treasury Paper"). The proposed FCA approach seems to be about using competition as a tool for generating better outcomes for consumers. Whilst this is fine, there is no mention at all of having regard to the impact of regulatory action on innovation and overall competitiveness of the UK financial services industry. We believe this was intended in HM Treasury's proposed new approach to regulation and we believe it remains important and valid.

3.1.2 We believe that the FCA will always face a conflict if it is to have duties of both consumer protection and promoting competition in the way we believe was envisaged by the Treasury Paper. The FSA already has a requirement to "have regard to" competitiveness issues yet we do not see this forming a core part of their consideration when introducing new regulation.

3.1.3 We suggest that the impact of FCA actions on the UK's competitiveness should be reviewed by an independent committee. This could perhaps be within the Prudential Regulatory Authority ("the PRA") which also has obligations to promote competitiveness. Their reviews should look at the impact change by change and also the cumulative effect that the FCA's initiatives, the pace of change, and enforcement activity have on the ability of UK financial services firms to operate competitively within Europe and internationally. Having such a committee would force the FCA to consider the impact on competitiveness more deeply and require far stronger justification for change. Often we feel that in its consultations the FSA has paid lip service to the requirement to conduct a cost benefit analysis and that this has never been robustly challenged by any independent body. This would introduce challenge into the regulatory change process.

3.1.4 It is not just new rules that can have an impact on the UK's competitiveness: product intervention has the potential to stifle innovation and heavy-handed enforcement action can deter business from operating in the UK.

3.1.5 This committee would also then be well placed to consider the effect of initiatives like product intervention on innovation. In our response to the FSA June Paper we commented that:

> "The tone of tougher and bolder regulatory intervention could stifle the generation of new products that could ultimately be of benefit to groups of consumers. Again a balance needs to be struck, but we believe it should be explicit in the FCA's remit that it must give due consideration to all possible consequences of the regulatory decisions it makes and be accountable for them".

3.1.6 On reflection, we think that forcing the FCA to face a committee to justify their proposals is a surer way of making them fully consider the consequences of their regulatory decisions. We believe this approach is consistent with the statement in the Treasury Paper which said:

> "The Government wants to see a competitive, world-leading financial services industry in the UK. Financial stability, supported by a rigorous and effective regulatory framework, provides a strong platform for this industry's sustainable growth and success. It is also important that firms operate in an environment in which regulators can provide them with sufficient certainty about their expectations and likely actions, and where unnecessary regulatory burdens are minimised or eliminated". [Chapter 3.16]

3.2 *The FCA's approach to regulation and further suggestions for improvement*

3.2.1 We welcome the intention to apply a differentiated approach to regulation, as we believe this will be a significant improvement. If we have understood correctly, this would allow the FCA to tailor the way it deals with individual firms and have regard to the financial sophistication of the retail consumers belonging to those firms. We have said in response to various FSA consultation papers over the past year that the current "one size fits all" approach is clumsy, difficult and costly for firms to implement and often fails to achieve the intended benefits for consumers. Too often we have felt that regulation has been introduced to address problems in one specific area, but is applied to all firms even where their business models make it irrelevant (in the sense that the problems it seeks to address could not have arisen anyway). We are hopeful that the suggested differentiated approach will result in the FCA having a better understanding of the individual firms it regulates and see more targeted and effective regulation where it is most needed.

3.2.2 If the FCA is to apply a differentiated approach on its own initiative, it will need to have a detailed understanding of the firms it supervises. This will require an army of experienced and knowledgeable staff in each industry sector if it is to be done effectively. However, by engaging more closely with industry bodies, such as our own Association of Private Client Investment Managers and Stockbrokers ("APCIMS"), a proportionate and differentiated approach may be more easily achieved. Engagement with the industry bodies could help to direct policy in the areas it is most needed and place the industry bodies in a position where they can give more guidance to their members about FCA expectations and the actions firms need to take to ensure compliance with the FCA's rules. In a sense it would permit the best elements of self-regulation to exist within a regulated framework: (1) industry bodies would be allowed to engage with and influence policy-making in a way that is directly relevant to members; (2) targeted and proportionate regulation is more easily and comprehensively implemented by firms than "one size fits all" regulation; and (3) as a result the positive consumer protection outcomes that regulation is intended to address are more likely to be realised.

3.2.3 In the FSA June Paper, we noticed at 5.12 that there was a proposal for the number of "relationship managed firms" to be "significantly reduced." We would like to see the FCA developing a deeper understanding of the firms it regulates and were curious as to how this would be achieved within a programme to reduce direct contact. Perhaps an element of self-regulation could be considered here to bridge the knowledge gap. If a way could be found to bring about greater involvement of recently retired professionals, for example, these would be people with the knowledge and experience to comment meaningfully on new proposals and products. If such a panel of advisers to the FCA could be created, it may mean that FCA can obtain an increased understanding of the firms it regulates without as much direct contact.

3.2.1 If firms are also encouraged to raise issues via their industry bodies, these could be channelled to the FCA and further ease the demands on the regulator in terms of the amount of direct contact it needs to have with firms, e.g. common issues could be channelled to the FCA via industry bodies, rather than individual firms all asking the same question via the FCA Contact Centre. Direct contact between FCA and the firms it regulates should be encouraged, but if the FCA is determined to reduce the number of relationship managed firms, these suggestions could help to ensure that such a move is not detrimental to the level of understanding between the parties.

3.3 *Accountability and appropriate scrutiny*

3.3.1 There has so far been very little detail about "how" the FCA will be accountable. The FSA June Paper states that the FCA will be accountable to government and parliament, that they must produce an annual report to government and hold an annual public meeting. What has not yet been made clear is who will follow up on what is in the annual report and conduct ongoing scrutiny of whether or not the FCA is meeting its objectives or operating in the reasonable and proportionate way that is intended. If consumers or firms are concerned that the FCA is not meeting its objectives or operating in a reasonable and proportionate manner, to whom can they raise their concerns?

3.3.2 Without wishing to introduce further cost and complexity into an already expensive regulatory framework, it would seem that an independent committee or body is needed. If the FCA is required only to account for itself in an annual report it is unlikely that it is going to be critical of its approach or its effectiveness. Perhaps within a certain period from publication of the annual report, the FCA should face an independent committee to be challenged about assertions within it. The Committee could draw upon feedback from industry and consumer bodies in framing its questions. That Committee should have power to direct changes in the regulator's approach and personnel where in its opinion there are shortcomings.

3.3.3 Senior executives of the FCA should be appointed by and fully accountable to the Treasury. In the same way that the Remuneration Code seeks to ensure there is no reward for failure, senior executives at the FCA should not receive large bonuses or remain in their jobs where significant regulatory failings occur. There needs to be a personal consequence if senior executives are to be truly accountable for their actions and decisions.

3.4 *FCA interaction with other domestic regulators*

3.4.1 Information sharing will clearly be important if the new regime is to be successful. It is difficult to comment on how this can be best achieved, but we have a suggestion with regards to interaction between FCA

and FOS. A half-yearly meeting could take place between FCA and FOS to review a selection of ombudsman cases where firms have behaved unfairly or contrary to expected industry standards or in breach of FCA rules. These discussions could then be used to help inform FCA Thematic Reviews ensuring that they are targeted at evidenced areas of concern. These meetings would also provide an opportunity for FOS to understand FCA's expectations of both firms and consumers, e.g. with regards to suitability or other key themes.

3.5 *FCA interaction with international regulators*

3.5.1 It is essential that the UK is involved in decision-making at EU level. The FCA's knowledge of actual and intended UK regulatory policy makes it well placed to negotiate on the UK's behalf. However, in doing so it must still take account of any competition concerns by the independent committee that we have suggested above. Otherwise, potentially the FCA could try to use its influence in Europe to get through proposals that had already been rejected by the independent competition committee.

3.5.2 Whoever is representing the UK in Europe must have the interests of both UK consumers and UK financial services firms in mind. It maybe, therefore that it needs to be formed from representatives of various bodies (FCA, BOE, Treasury, competition committee etc).

4. Concluding Remarks

4.1 We hope you find our comments helpful. If you would like to discuss anything in more detail, please feel free to contact me.

October 2011

Written evidence submitted by Consumer Focus

About Consumer Focus

Consumer Focus is the statutory consumer champion for England, Wales, Scotland and (for postal consumers) Northern Ireland.

We operate across the whole of the economy, persuading businesses, public services and policy makers to put consumers at the heart of what they do.

Consumer Focus tackles the issues that matter to consumers, and aims to give people a stronger voice. We don't just draw attention to problems—we work with consumers and with a range of organisations to champion creative solutions that make a difference to consumers' lives.

Question 1: *Objectives of the Financial Conduct Authority*

We do not believe the objectives of the Financial Conduct Authority (FCA) as currently constituted are either clear or appropriate.

Strategic objective

We are convinced that an overarching strategic objective to protect and enhance market confidence is likely to reinforce a risk-averse regulatory culture that veers away from upstream preventative action for fear of possible impacts on market confidence.

We have reviewed our thinking on the objectives since our response to the Treasury and the Joint Committee and now recommend a formulation for the strategic objective as follows:

> 1B(2) "The FCA's strategic objective is: promoting fair, efficient and sustainable markets that work well for consumers and users of financial services".

Such a formulation would enable a supporting suite of operational objectives on integrity, consumer protection and competition to sit coherently beneath it. Without this amendment there is a significant risk that the new regulator will promote policies that promote short term confidence even where this is not properly grounded. Customers of Equitable Life and Northern Rock no doubt had plenty of confidence in the system until it was too late.

FCA's operational objectives

We support the *integrity objective*, which includes the soundness, safely and resilience of the UK's financial system. Having this objective will help ensure that the FCA does not act in a way that detracts from or reduces financial stability.

Consumer protection objective: The draft Bill falls into the same trap as the Financial Services and Markets Authority (FSMA) in defining "consumer" too widely. The definition includes not only ordinary consumers but also commercial entities whose professional role includes the purchase of, or dealing in, financial products. Because the definition is so wide and includes professionals there has been a need for clauses such as the

general principle that "consumers should take responsibility for their own decisions" 3B (1)(c), to which we have strong objections given that individual and SME consumers lack the knowledge, experience and expertise to fully do so in many financial services markets.

We believe the definition of consumer in 1(c)(3) of Clause 5 is far too broad. We recommend that the consumer protection objective (1C) be amended such that:

> The term "consumer" in 1C(3) is defined as "any natural person who [in purchasing financial products and services] is acting for purposes which are outside his trade, business, craft or profession".

This would focus the regulator where protection is most needed and align more closely with relevant EU Directives and other sector specific UK legislation on regulatory frameworks.

Such an approach would help the new FCA focus its consumer protection responsibilities on the right consumers and the right markets. It would also allow it to have clearer focus on its other main jobs, namely to ensure that wholesale financial markets function with integrity and to act as an effective micro-prudential regulator for the 26,000 or so firms for whom it will have prudential responsibility. It would also enable the removal of 3B (1) (c) (see below).

Consumer responsibility

The draft Bill does not strike the right balance between the responsibility of firms and consumers, and is too geared to an unrealistic concept of consumer responsibility. Few would dispute the notion that consumers have a duty to act as responsible citizens—acting within the law and giving truthful answers to questions, for example. But it is another thing entirely to suggest that there should be any kind of legal requirement on consumers as a whole to avoid making unwise financial decisions—the implication being that where any consumer has acted "irresponsibly" regulatory protection should in some way be reduced.

PhD required?

Consumers in the UK are among those most likely to describe themselves as "*knowledgeable*" in theoretical market research polls but research show that they are among those least likely to know their rights across a range of markets.[13] Meanwhile empirically levels of financial capability, functional literacy and numeracy remain extremely poor. Some key facts:

- It is estimated that over 5.2 million UK adults lack the basic day to day competencies of functional literacy.
- 6.8 million lack functional numeracy.
- More than 20% of adults, asked to choose between receiving £30 or 10% of £350, opt for the lower figure.
- A recent FSA survey asked the question: "if the inflation rate is 5% and the interest rate you get on your savings is 3%, will your savings be worth as much in a year's time?"—one in five gave the wrong answer.[14]

Compounding this lack of basic understanding is the complex nature of many financial product contracts despite years of effort by regulators to improve disclosure. Three examples:

- the consumer documentation from a major high street bank for a personal loan requires degree level education to understand;
- the standard text describing a PPI product requires PhD level education to comprehend; and
- it takes 55 minutes to read a standard consumer credit agreement, let alone understand it.[15]

It would therefore be unreasonable to argue that where a consumer has failed to fully read through and fully understand a complete set of terms and conditions they should automatically receive a lower level of protection. Problems of this kind were for example behind the recent Payment Protection Insurance scandal.

Remove the have regard for consumer responsibility

We can and should invest in financial education and we very much welcome the aims and work of the Money Advice Service (MAS). But we must be realistic about not only the timeframe for improving personal capability but also about how far education can realistically go in making us experts in markets and products that seem to continually get more complex as the recent HM Treasury paper on "Simple products" noted.

We believe the weight of responsibility to ensure the design, distribution and management of appropriate products, and information about them, lies with the firm. Products and services should be designed to prevent toxicity or detriment occurring based on empirical research of the likely consequences of product designs. Firms should ensure the products or services offered are appropriate for the consumer in terms of meeting their needs, accessibility and reasonable value for money.

[13] http://bit.ly/oq0eOZ
[14] http://bit.ly/r3Ydnc
[15] *Warning: Too Much Information Can Harm*, Better Regulation Executive/NCC http://bit.ly/oUP3lj

We fear as drafted, the Bill could legitimise and even exacerbate the current approach of some firms, of providing reams of documents for each product as a means of discharging disclosure requirements, in the hope that thereafter responsibility is transferred to consumers, as they "*should have read*" these documents.

As well as the removal of 3B(1)(c) in our opinion the evidence above supports a proposition to delete from the Bill:

> "The general principle that consumers take responsibility for their own affairs" in 1C(2)(f) (and is also deleted from the list of regulatory principles in Chapter 3 of the draft Bill).

In its place, we would like to see a general principle instead that the firm ensures, so far as is reasonable, the "*appropriateness of each product to the needs of the consumer*", embedding what is already in the FSA's Treating Customers Fairly principles (principle 6) which states: "*a firm must pay due regard to the interests of its customers and treat them fairly*".

Protecting the interests of all consumers

Consumers are not homogenous in their needs for products and services or in how they are able to access, use and understand financial services and products. People can face barriers in the market place for a variety of reasons both temporary and permanent. The regulator must have regards for these differences.

This should involve looking not only at individuals' characteristics and other risk factors which might put consumers at a disadvantage but also the nature of markets and situations in which consumers find themselves, and the extent to which some services are more essential than others. We also need to consider the effects of multiple disadvantages.

We recommend that a new clause be added to the list of have regards in 1C(2) in keeping with the other acts such as the Utilities Act:

> *The FCA shall have regard to individuals who are disabled or chronically sick; individuals of pensionable age; individuals with low incomes; and individuals residing in rural areas; but that is not to be taken as implying that regard may not be had to the interests of other descriptions of consumer.*

Longer term interests of consumers

With the Bill as drafted, it would be possible for the FCA to proceed on the basis of advancing one of the two operational objectives not expressly concerned with consumer protection—promoting efficiency and choice in the market for financial services; and protecting and enhancing the integrity of the UK financial system. But with either of these, there needs to be a clear guide to ensure these are accomplished with the consumer interest in mind. Most notably, reasonable access to financial services, fairness in the way markets operate and value for money must be ensured.

Thus, we think there is a need to add a "have regards to" that requires the FCA to take on board in any of its activities "*the longer term interest of consumers*". This could be included in 1(b)(5) proposed within Clause 5 of the Bill.

Question 2: *Should the FCA have a primary duty to promote competition as recommended by the Treasury Select Committee and Independent Commission on Banking? How should this work in practice*

We agree with the Independent Banking Commission that clause 1(B)(4) should be amended to become a proper competition objective under which the FCA can exercise its general functions including rule making, as follows: "To promote effective competition in the financial services market".

The term "effective competition" is generally preferred over "competition" in other statutory frameworks because it is a broader concept, recognising the fact that for competition to work properly for consumers both demand and supply sides of the market need to work well. In financial services complexity, intangibility of products, information asymmetries, behavioural biases and lengthy terms of many products present significant challenges to a properly functioning demand side. Where these problems persist then regulatory interventions beyond enhancing competition to protect consumers will remain necessary.

The efficiency and choice objective would then become superfluous and could be deleted.

Questions 3 and 5: *FCA's approach to regulation and the FCA's powers*

Clearly, judgements require a differing skill set than a compliance led "conduct of business" style approach to regulation. This will need more staff with wider skills including a better comprehension of consumer behaviour.

We commend the recent steps taken by the FSA to enhance the calibre and competence of regulatory staff and would like to see this developed further. It is important that further experience is not lost in the transfer to the new regime but equally there is scope and significant potential benefit to be gained from injections of new talent, including more people with consumer policy and research expertise and more practitioner expertise.

It is worth noting that any regulatory structure can be made to work given the right powers, tools, wider stakeholder engagement, and culture. What is crucial however is getting the statutory framework right, particularly in terms of statutory objectives, as this drives regulatory behaviour and approach.

Getting governance structures right, with an appropriate mix of independent directors with the confidence, style and ability to get on top of complex issues and constructively challenge in an effective way, will be crucial. Consumer interests should be effectively represented at Board level, as well as in the other branches of the regulatory regime.

As the FCA Approach document makes clear there is an ambitious remit for the new body. In terms of consumer protection powers available, we support the enhanced powers the FCA will have to meet its operational objective of ensuring an appropriate degree of consumer protection. In particular, we strongly support extended powers to ban or place conditions on products, ban misleading advertisements, and publish warning notices. We also support the revised FCA approach which will look at margins, pricing and ancillary charges with the possibility of capping (as it has already done for mortgages on default charges) where it judges charges excessive.

But we think the proposed powers could, and should, be enhanced further still.

The list below summarises the areas where we believe stronger or clearer FCA powers could further reduce the chance of consumer detriment eg through misselling and poorly designed products:

- The ability to apply a lighter touch regime for specified products which meet agreed minimum standards (which could be pre-approved and/or kitemarked).
- Stronger powers on disclosure of enforcement action.
- A wider duty on authorised firms to ensure the appropriateness of products.
- The removal of the regulatory principle of consumer responsibility which attempts to transfer responsibility from firms to consumers.
- A refined definition of "*consumer*" to focus much more on domestic consumers.
- An additional "have regard to" for consumers who are vulnerable and/or at a disadvantage.
- Greater clarity on the face of the Bill about the boundary between the regulatory scope of the FCA and that of the Office of Fair Trading (OFT) or new Competition and Markets Authority (CMA).
- A statutory duty to investigate and respond to super-complaints from designated consumer bodies about practices causing consumer detriment in financial services markets.
- The powers to undertake market studies where it does not believe markets are functioning in the consumer interest or where effective competition could be improved. If, following its evaluations, the issue requires a full Market Investigation then the FCA should make a formal competition reference to the OFT/new CMA.

Transparency

The regulatory principles applied to Prudential Regulation Authority (PRA) and FCA on transparency are:

- the desirability in appropriate cases of each regulator making information relating to authorised persons or recognised investment exchanges available to the public, or requiring authorised persons to publish information, as a means of contributing to the advancement by each regulator of its strategic and operational objectives; and
- the principle that the regulators should exercise their functions as transparently as possible.

We believe more needs to be done to ensure these regulatory principles are achieved. Under the Draft Bill the disclosure powers of the future FCA are still limited and it is unusual for principles to be qualified by "as appropriate" and "as possible". Section 348 limits the regulator's ability to publish firm specific information in their regulatory duties without the consent of the firm affected. The current Section 349 under FSMA still provides for disclosure of confidential information for the purpose of facilitating the carrying out of a public function. The new regulatory principles might bolster the case for regulations under this provision. However, while Section 348 remains it is unlikely that the interpretation will change.

We believe that the FSA should be given the power to name firms at the commencement of the disciplinary process where it has been established that the firm has a case to answer, the power to publish a warning notice immediately without referral to the firm, and earlier publication of decision notices *once* the decision has been made rather than after all appeals have been exhausted.

We call for amendments to Section 348 and the definition of "*confidential information*" to allow the new regulatory principles to empower the regulator to use transparency as a regulatory tool. Such an approach would allow the regulator to better deliver its operational objective "appropriate consumer protection" and comply with the draft regulatory principles 5 "*openness and disclosure*" and 6 on "*transparency*".

Why we need greater transparency

There are strong justifications for a more transparent approach which would deliver stronger incentives for firms to behave responsibly, send helpful signals to other market participants about what is and is not acceptable, provide useful information to consumers and consumer advocates and advisers, and enhance public trust in the regulatory process. We believe amendment to FSMA should allow the FCA, like regulators Ofgem and Ofcom, and the Advertising Standards Authority (ASA), to publish the initiation of enforcement proceedings.

In energy markets, Ofgem announces on its website when it is investigating firms for breaches to the licence.[16] It also openly reports after nine months what has happened to the investigation. Equally, the ASA publishes on its website when a complaint has been made that they are investigating. Ofcom also announces which firms it is investigating. We see no reason why financial services firms should be granted greater dispensation from public disclosure as will still be the case in the draft Bill.

Firms may argue that financial firms are sensitive to market fluctuations if they are unfairly accused, but the reality is the regulatory resources are so stretched it is extremely unlikely the FCA will pursue speculative cases. Indeed, the danger remains that enforcement action remains so difficult to prove and so resource intensive that firms will still escape enforcement action. If we are to move to a "*judgement based regulatory* approach" then the future regulator must have sufficient, easy to use tools, including publicity, to ensure that it keeps markets clean and fair.

Transparency can help fuel competition

Finally, under transparency and public disclosure, the regulator also needs to be able to ask for, and publicly disclose, market share in order for complaints data be shown against market share, allowing consumers to better judge firms' commitment to fair treatment and preventing future complaints from occurring. The FOS and FSA have tried before to gain this information but under the current regulations useable data has proved elusive. This would also deliver the comparison tool proposed in the ICB report on non-price characteristics.

Question 4: *To whom should the FCA be accountable? Are the lines of accountability clear?*

We are pleased to note that, judging by the FSA's *Approach to Regulation* document, the FCA intends to carry over a proactive engagement approach. While in recent years the FSA has enhanced its external engagement there are further improvements needed in this area.

The FCA, as an independent statutory regulator, needs to be accountable to Parliament—with the Treasury Select committee (TSC) having the ability to inquire fully into its operations—and to the wider public. As part of its accountability framework there is the need for the FCA to:

- consult fully with consumers and their representatives and with industry about how it will discharge its powers, proposed rules and guidance;
- publish in advance its forward work programme, priorities and risk analyses with consultations to ensure the widest feedback possible into it work;
- take and respond to advice from the Panels;
- investigate super-complaints from authorised consumer bodies; AND
- lay its annual report before Parliament.

We are unconvinced with arguments for the FCA to be held accountable to the PRA, FPC OR Bank and argue (below) that a PRA veto power is neither necessary nor wise.

We are very disappointed to note a number of the above process disciplines are absent for the PRA. The PRA will have significant prudential powers and these will impact consumers and the economy more widely. It should not be allowed unfettered exercise of discretion without a proper set of public accountability checks and balances. We see no reason why the PRA should not, for example, be required to consult the Financial Services Consumer Panel on matters affecting consumers (for example, appropriate protection of insurance policy holders). We also believe the PRA should be required to consult publicly, as the FSA does (and the FCA will), on its general policy approach to the discharge of its functions.

Question 6: *How will the break-up of the FSA work in practice? Issues of co-ordination and information sharing between the FCA and the Prudential Regulation Authority*

We are keen to ensure a proper "balance of power" between the constituent parts of the new regime, and note the experience of Dutch regulators in this regard. Their advice is to ensure that the two parts of any "twin peaks" system have equal weight.

We strongly believe that the PRA veto provision in 3H should be deleted in its entirety. The numerous other checks and balances in the Bill, including the FCA's integrity objective, the duty of the FCA to consult the PRA before taking action, the duty of the FCA to co-operate with the Bank in the pursuit of its stability

[16] Ofgem, *Enforcement Guidelines on Complaints and Investigations*, 232/07

objective, the duty on both the FCA and the PRA to co-ordinate their work, and the presence of the PRA CEO on the FCA's Board, make this additional safeguard unnecessary.

Furthermore, its existence risks unbalancing the system and could provide cover for more cautious behaviour and a reluctance to act appropriately in the discharge of its statutory remit by the FCA. We believe the FCA should have equivalent stature and status to parts of the new system and not be perceived to be subordinate in any way.

Question 7: *How should the FCA be interacting with other domestic regulators? For example, the FCA's relationship with the Bank of England and Financial Ombudsman Service*

Financial Ombudsman Service (FOS)

The extra "referral powers" for MAS and FOS are welcome if they find the regulator slow to act, but one would hope the new co-ordination committee as set out in March under FS11/2 should ensure FOS complaints data and MAS intelligence is fed back to the regulator.

Office of Fair Trading (OFT)/Competition and Markets Authority (CMA)

There will need to be good mechanisms for formal and informal dialogue between the FCA and the OFT, or its successor, around the usage of the FCA's new competition and market powers.

Oversight of payment systems

The BofE was recently given statutory oversight of payment systems under the Banking Act 2009 including inter-bank payment schemes. The Bank's oversight is largely in the context of financial stability and integrity of payment systems. There are important consumer and competition issues with respect to the UK's payment systems however; as the recent controversy around the phasing out of cheques has shown. We therefore suggest that the FCA be charged with a statutory responsibility for the consumer protection and competition elements of payment systems, and that both the FCA and the Bank be given duties to co-operate with each other on Payment system regulation.

The Draft Bill already proposes joint regulation by the BofE and FCA in recognised clearing houses (para 2.33). We call for similar coordination mechanisms to be put in place to ensure the effective regulation of payments infrastructure.

Regulating across financial services

We would like the FCA to be an effective regulator for the whole of the consumer financial services market. We therefore favour the transfer of responsibility for the regulation of unsecured credit from the OFT to the FCA, and would like this to be completed in time for the start of the new regime so the FCA can build it into its work programme and approach from the outset. It is important that any enabling legislation needed for this transfer is built into this Bill to ensure that the process can be expedited.

We also consider that this is therefore an opportunity to look again at whether the current split of regulatory responsibilities for defined contribution pensions between the FSA and the Pensions Regulator is helpful for consumers. We suspect that the split will prove increasingly dysfunctional, in which case the current opportunity to rationalise the regime should be taken.

October 2011

Written evidence submitted by Aviva

Are the objectives of the Financial Conduct Authority (FCA) clear and appropriate?

Consumer access

We welcome the FCA's operational objective to facilitate efficiency and choice in the market for financial services. We believe that facilitating choice should include broadening consumer access to suitable products. We note that the FCA objectives do not refer to innovation, which is one way to promote choice in the market. We therefore recommend the retention of one of the FSA's principles of good regulation: "the desirability of facilitating innovation in connection with regulated activities".

We consider that there needs to be some appreciation within the FCA that financial services products that are designed, marketed and sold appropriately can be (and often are) of value to consumers. We fully appreciate the FCA's lower tolerance of consumer detriment and its willingness to intervene earlier and more intensively to prevent such risks from crystallising. However, we believe that this needs to be balanced with an appreciation that consumers also face risks by not accessing financial services: for instance, by not saving enough for retirement or by families not protecting themselves from the risk of the loss of an income. This would be in line with Government objectives to promote a resilient society, financial inclusion and increased saving for retirement.

We therefore believe that the consumer protection objective should be amended to the effect that the FCA should have regard to the potential benefits of consumers accessing financial products that meet their needs. Alternatively, a reference to access should be added to the efficiency/choice objective. Without this balance there is a risk that the FCA may take ever stronger and rigorous consumer protection action which has unintended consequences, such as the dampening of innovation, fewer market entrants, or restricted consumer access.

We support the inclusion in the PRA's and FCA's regulatory principles of the general principle that consumers should take responsibility for their own decisions.

Should the FCA have a primary duty to promote competition as recommended by the Treasury Select Committee and Independent Commission on Banking? How should this work in practice?

We expect that the FCA's enhanced powers, coupled with a duty to discharge its functions in a way that promotes competition, amounts to a sufficiently robust remit on competition. We welcome the FCA's intention to strengthen competition by reducing barriers to entry or exit, helping consumers make better decisions, and improving transparency.

Does the FCA's approach to regulation, as outlined in the Financial Services Authority (FSA)'s June 2011 document, represent an improvement on that of the FSA?

We understand the spirit underpinning the FCA's more forward-looking and intensive supervisory approach and the shift towards product intervention—ie the desire for early intervention to tackle badly designed products which are targeted inappropriately and likely to cause widespread detriment and lack of confidence. Similarly, we appreciate that the FCA should intervene where there is evidence that the distribution of a product does not meet required standards. We are concerned, however, about some of the potential negative consequences of this approach:

Risk to innovation and consumer choice—Firms should be free to produce innovative products which serve a target audience provided that there are sufficient controls in place to reduce the risk of consumer detriment. The FCA should not intervene simply because it believes a product has a high inherent risk, provided that it is marketed and sold appropriately. The FCA should not dictate risk appetite for firms or consumers.

Transpareny—The criteria upon which the FCA will judge when intervention is appropriate should be transparent and consistently applied. The FCA should ensure that it consults on its intended product intervention approach, and it should set out its approach to intervention in a clear way. A clearly documented approach would also ensure consistency of approach by FCA supervisors.

Cross border activity—We are concerned that different standards will apply to firms in other countries that sell in the UK, potentially giving them a competitive advantage.

Regulatory costs—Product intervention could result in higher regulatory costs to the industry, which will in turn be passed to consumers. A full cost benefit analysis should be conducted in each case where the FCA intends to intervene.

Competition—Product intervention powers should not conflict with the FCA's duty to discharge its duties in a way that promotes competition. For example, the FCA should not intervene on products (or price) in such a way that firms are restricted in their ability to differentiate from other firms.

To whom should the FCA be accountable? Are the lines of accountability clear?

The FCA should be accountable to its Board. It is important that standard corporate governance principles are applied to the FCA. The selection process for appointing members to the FCA Board should be transparent. This process should aim to ensure that the FCA Board's expertise covers all financial sectors supervised by the FCA, including insurance and asset management.

Are the powers of the FCA suitable? Will their exercise be subject to appropriate scrutiny? How should the FCA be interacting with industry as well as using its intervention powers?

POWERS

The FCA's more intrusive approach to supervision in general, and the shift to product intervention in particular, could lead to unwelcome consequences. In addition, we are concerned about proposals on the following powers.

Financial Promotions—The draft Financial Services Bill currently states the FCA will be able to take action if there is a breach of the financial promotion rules, or there is likely to be a breach. It is the latter that we are concerned with. This will be difficult for the FCA to judge and apply consistently. The FCA should be transparent on the criteria upon which it will intervene and this should be subject to consultation.

Warning notices—We disagree with the proposal to enable the FCA to publish warning notices and are concerned that the regular publication of warning notices could damage consumer confidence in the industry and the firm's reputation.

Price—We note that the FCA intends to intervene on providers' pricing where it believes consumers are not being treated fairly or competitive forces are not working to consumers' benefit. We do not agree that the FCA should have the power to intervene on price. This could distort the market and is contrary to the FCA's duty to promote competition.

Scrutiny

The FCA should be subject to scrutiny by Parliament; with both the Chair and CEO attending sessions at the Treasury Select Committee who could review performance of the organisation against its strategic and operational objectives. The discipline of attending regular sessions would sharpen focus amongst the Board and Executive Management Team in terms of their roles, delivery and the challenges that exist.

We welcome the proposal that the FCA should be scrutinised by a Practitioner, Small Business Practitioner, Consumer, and Markets Panels.

Interaction with the Industry – Reducing Uncertainty

We believe that it is the effectiveness of supervision, rather than the structure, that is key to achieving good outcomes. A very important way in which a regulator can be effective is by acting consistently and valuing stability. This consistency enables firms to comply with relevant rules in an efficient manner. We understand that the FCA will need to change rules to tackle emerging risks, but these changes must be done in an orderly way, with advanced notice, as uncertainty can lead to unnecessary costs. For example, the FSA's Retail Distribution Review, which we broadly support, has been running since 2006 but final decisions have still not been made on important elements of it. The resulting uncertainty has made it difficult to develop new propositions and means that firms, even now, cannot be sure of the likely cost. This can have significant implications for cash flow management and capital allocation.

So, we would urge the FCA to learn lessons from the FSA's experiences and seek to deliver stability and certainty. As part of this, any new policy that the regulators take forward must have an appropriate time table for completion and implementation.

Interaction with Industry—Good Relationships

Different regulators take different approaches to using information disclosure as a supervisory tool. In our experience, the supervisory relationship works well when the regulator and the firm can have open, frank and confidential discussions. Relationships typified by high levels of trust can be very constructive and lead to issues being aired and resolved speedily.

We are concerned that a number of proposed changes, such as the publication of warning notices, constitute a strategic move towards "naming and shaming" firms. This may lead to a more adversarial relationship between the firm and the supervisor, particularly when a firm's reputation is at risk. Critically, this type of relationship many not actually deliver the practical outcomes that the supervisor is looking for.

Interaction with Industry—Due Process

A shift to judgement-based supervision should be balanced with a strengthening, not an undermining, of challenge mechanisms for firms. The draft Financial Services Bill will limit the course of action available to the Tribunal in the event it chooses not to uphold the FCA's decision. We strongly disagree with this view and believe that the course of action available to the Tribunal should remain unchanged.

We understand the FCA will use judgement-led decision-making. As these decisions may have a material impact on firms, it is all the more important that its decisions can be challenged and independently reviewed in an appropriate way. The ability to challenge decisions does not undermine judgement-led decision making, but provides an appropriate check and balance so that corrective action can be taken in the event that decisions are not fully thought-through by the regulator. The knowledge that decisions may be challenged and reversed may also lead to higher quality supervisory decisions.

Interaction with Industry—Consultation

We welcome the stated commitment of the FCA to build on the FSA consultation process and urge the FCA to consult on broader regulatory strategies and polices in addition to their rule making. For example, the FCA should consult on the criteria upon which they will use their product intervention powers. All consultation should be aligned to the FCA's objectives and principles.

We consider that the FCA should publish a cost-benefit analysis when it makes temporary product intervention rules. If no cost-benefit analysis is published, then the temporary product intervention rules should

only be valid for six months. Unless this power is used conservatively, there is a risk that its use results in a narrow and homogenised product suite which does not benefit consumers.

How will the break-up of the FSA work in practice? Issues of coordination and information sharing between the FCA and the Prudential Regulation Authority (PRA)

MEMORANDUM OF UNDERSTANDING

Aviva will be one of several Groups which will have some firms that are conduct and prudentially regulated by the FCA, and other firms regulated for conduct by the FCA and prudentially regulated by the PRA. In order to minimise complexity, reduce duplication and avoid coordination issues there will need to be considerable coordination between the FCA and PRA. We welcome the intended Memorandum of Understanding (MoU) which will set out how the two regulators will work together. We recommend that the MoU is made available for public discussion during the pre-legislative scrutiny phase of the draft Financial Services Bill. It is important that there is absolute transparency on the actions the regulators will take to ensure this is achieved. The regulators should specify in the MoU which areas they will share services and coordinate activities, and how this will be done in order to minimise duplication and additional burdens on firms. Finally, the MoU should be periodically reviewed and this review should also be subject to public consultation.

CO-ORDINATION

It is also essential that the two regulators have a joined up approach to supervision. Where firms are accountable to both regulators, it is vital that the regulator taking the lead on supervision coordinates with the other, both in the assessment itself and in any actions or decisions it takes. There should be one point of contact, and firms should be confident that where they have provided information to one regulator, that information will be shared (where appropriate) with the other regulator.

Firms should be confident that they can rely on one regulator's judgement and decision making, and the actions firms take as a result will not be contradicted or questioned by the other regulator.

"DOUBLE REGULATION"

We expect the two regulators to develop their own culture and regulatory approaches with firms. Nevertheless, it is very important that the draft Bill require them to identify areas where they can share services and co-ordinate activities in order to minimise duplication and burdens on firms. Uncoordinated "double regulation" with the attendant additional costs and contradictions must be avoided. Duplication will simply lead to unjustifiable extra regulatory costs for firms (which may be passed to consumers) and an unnecessarily complex regulatory environment (which may hinder compliance).

Shared services and co-ordination would be in the interests of efficiency but would not impose extra costs on the regulators or impinge on their ability to meet their objectives. The Government's proposed remedy, of references to the need for each regulator to use its resources efficiently and to only impose restrictions or benefits which are proportionate to the benefits, does not go far enough. This is because both regulators could set the same requirement (eg on interviewing people in significant influence functions) which would be proportionate to their benefits and an efficient use of each regulators' resources. However, there could still be duplication which would waste a firm's resources.

We therefore urge the government to include a specific requirement on the regulators to identify areas of activity that can be undertaken centrally to reduce costs and enable more efficient interaction with firms. Firms should have a single process for standard interactions, like approval of candidates for significant influence functions.

How should the FCA be interacting with other domestic regulators? For example, the FCA's relationship with the Bank of England and Financial Ombudsman Service

We note the Treasury's intended approach is for operational matters such as inter-agency coordination to be governed through a series of Memorandums of Understanding (MoUs) and not through primary legislation.

FOS

We support the role of FOS in providing independent dispute resolution. However, we believe there is a need to make the respective roles of the regulator and the ombudsman service clear and distinct. There should be clear and transparent coordination between the two bodies. We believe that FOS should be required to exercise its functions in a manner consistent with the FCA's objectives and regulatory principles, and it should report on its success in doing so in its annual report.

How should the FCA be interacting with international regulators? Do EU regulation initiatives restrict or enhance the work of the FCA? Will the FCA be able effectively to engage with the EU supervisory authorities?

FCA Interaction with International Regulators

Policy making is shifting from the UK to EU and global bodies such as the International Association of Insurance Supervisors, International Organisation of Securities Commissions and the Financial Stability Board. These global bodies are increasingly the locus for discussion and decision making on financial regulation which is then implemented at a regional and national level. It is therefore critical that the UK regulatory authorities (including the FCA) are able to effectively influence them in a timely, consistent fashion and with maximum impact.

To influence these bodies effectively, the FCA should lead on evidence based policy making and engage in policy debates early. It needs to have credible and expert staff who can negotiate well and understand the context of policy debates. It also needs to have a good understanding of how the national, regional and global bodies influence each other, and seek the best points of leverage.

The IMF's Financial System Stability Assessment of the UK, published on 1 August, recommended that the UK *"establish a forum for ensuring good governance and coordination among organizations in the new regulatory structure."* We believe that there may be merit in setting up a forum or secretariat in relation to EU and international engagement. A forum or secretariat could help co-ordinate strategy and support activity by the regulatory actors (but should not be a barrier to action).

European Supervisory Authorities (ESAs)

The new EU supervisory architecture, and its interactions with the UK regulatory framework, is very important for businesses like Aviva with operations across Europe. The new ESAs are preparing for greater harmonisation across Europe in terms of regulatory rules and methodologies. It is paramount that the UK authorities maintain close and active participation in ESAs as they develop their rule-making powers. For these reasons, it is critical that the new authorities are well equipped to engage with EU and international bodies

Effective international coordination is a priority for the financial services industry, and we believe that the need for strong international regulatory influence is such that it requires a legislative underpinning. We welcome the proposals to ensure co-ordination in the EU and internationally and would urge the Government to consult with the industry on the proposed MoU on overall international co-ordination.

Again, we believe that there may be merit in setting up a forum or secretariat to co-ordinate EU and international engagement.

October 2011

Written evidence submitted by Fidelity Worldwide Investment

Fidelity Worldwide Investment is a global asset management business. We operate in 15 countries in Europe and a further nine in India and the Far East. Our UK business is a substantial component of our overall business, we manage £24 billion in the UK for private investors, pension funds and insurance companies. The FCA will be the UK regulator for the vast majority of our UK business.

Summary

- The objectives are unclear and signally fail to include international competitiveness.
- Competition should be left to competent competition authorities.
- The early discussions about the likely FCA supervisory approach have been encouraging.
- The proposed accountability is weak and should be considerably strengthened.
- There are concerns over the relationship and practices of the FOS being left unchanged and doubts about early publication of disciplinary actions except where there is a clear public interest.
- Co-ordination between the new regulators needs to be strengthened in a number of areas.
- There are concerns about FCA representation in Europe especially on the retail conduct side.

Are the objectives of the Financial Conduct Authority (FCA) clear and appropriate?

Nowhere in any of the objectives for the new regulatory bodies is there any mention of having regard to the international competitiveness of the UK's financial services industry. We consider this a signal omission.

The Treasury clearly has a belief that international competitiveness is a euphemism for light touch regulation. We do not believe that is so. FIL operates with regulators globally and a number can produce appropriate regulations and supervision which protects investors but also does minimal damage to their country's

competitive position. There must also be a strong possibility that failure to consider the international context would be more likely to lead to poorer, inward-looking regulation.

Businesses like ours can fold their tents and move abroad with no-one noticing until, too late, people look back and realise hundreds of jobs and too much expertise has been lost.

It seems to us that it would be helpful to add to the current draft Bill a further operational objective for the FCA which might sit as an addition to Part 1A, Chapter 1, Clause 1B(3):

(d) *the international competitiveness objective*

This should be followed by a new 1F (subsequent clauses to be renumbered)

1F The international competitiveness objective

The international competitiveness objective is: maintaining the competitive nature of the United Kingdom in respect of financial services and markets having regard to best practice in international regulation and supervision.

More generally we are perplexed by the objectives in the Bill.

The Bank has an amended financial stability objective "to protect and enhance the stability of the financial system of the United Kingdom".

FCP: "The FCP is to exercise its functions with a view to contributing to the achievement by the Bank of its Financial Stability Objective".

PRA: the general objective is "promoting the safety and soundness of PRA-authorised persons".

FCA has a strategic objective of "protecting and enhancing confidence in the UK financial system".

It seems to us that the FCA objective is coterminous with that of the Bank and FCP and is likely to lead to misunderstandings and confusion.

Similarly the "integrity objective" seems to overlap with the FCP's objective.

Should the FCA have a primary duty to promote competition as recommended by the Treasury Select Committee and Independent Commission on Banking? How should this work in practice?

We believe that the promotion of competition is best carried out by the current competition authorities and will deflect from, and could conflict with, the FCA's prime task of consumer protection.

Does the FCA's approach to regulation, as outlined in the Financial Services Authority (FSA)'s June 2011 document, represent an improvement on that of the FSA?

From the document noted above and from initial discussions with the Conduct Business Unit of the FSA we believe that the FCA is aware that their approach to regulation will be able to be more suitable for agency firms such as asset managers since prudential issues will no longer be pre-eminent.

To whom should the FCA be accountable? Are the lines of accountability clear?

The accountability arrangements for the FCA follow those of the FSA. These are largely ineffective. We would recommend a number of statutory changes. We believe the chairs of the practitioner and consumer panels should be ex officio members of the FCA board. We believe the board meetings should be open to the public when discussion is on policy, as happens with the SEC. Our understanding is that the current board rarely, if ever, considers matters relating to authorised firms or individuals. We believe it would be helpful if the FCA had a statutory duty to report annually to the Treasury Select Committee.

Are the powers of the FCA suitable? Will their exercise be subject to appropriate scrutiny? How should the FCA be interacting with industry as well as using its intervention powers?

We welcome the addition of powers for early product intervention. But to be effective the FCA needs to understand the industry it is regulating better than the FSA does. In particular it needs to develop much stronger intelligence gathering. That would have helped with the Keydata fiasco. Some IFAs had looked at the product and rejected it; the FSA should have picked up on that but currently it simply does not talk to the industry outside the firm supervision context.

We have a particular concern that the FOS powers have not been altered. Because authorised firms operate under FSA/FCA rules and guidance but the FOS applies a "fair and reasonable" test, it can, and has, happened that actions by a firm which met the FSA rules has nonetheless led the FOS to impose redress ex post. These cases may be of benefit to the individuals concerned but because of the uncertainty this behaviour introduces for firms the effect has been to prevent firms from introducing services which would otherwise be of benefit to a wide range of the population, such as simplified advice. By operating on a set of alternative standards to those guiding FSA/FCA supervision, the FOS also loses its utility as an early warning system *for* the FSA/FCA.

We believe the FOS should accept that compliance with FSA/FCA rules and guidance at the relevant point in time should provide a safe harbour for providers. If the FOS believed that insufficient protection had been provided by those rules they should take the matter up with their board and the FCA and publically state their reasons for so doing.

We believe the alteration to the terms of reference of the statutory tribunal with respect to an inability to substitute their judgement for that of the FCA is unwelcome. It can be foreseen that cases could arise where if the tribunal can merely refer a decision back to the FCA, the FCA could make minor alterations to its case and start the process again, which can be hugely costly for those involved. We are not aware of any cases where the tribunal has replaced its own judgements with those of the FSA which can be held to be a miscarriage of justice.

On the question of early publication of disciplinary action we are somewhat ambivalent. We could accept it in egregious cases but that is rather difficult to enshrine in statute. In particular we feel the current drafting leaves too much discretion to the FCA on this matter. We would not want early publication to become the norm as it would be likely to unnecessarily damage the reputation of firms and individuals concerned, and potentially, the whole industry—including the regulator. We believe that a decision to publish a warning notice should be reviewed by the RDC and it would have to be shown that the public interest out-weighed the potential damage to the firm or individual.

How will the break-up of the FSA work in practice? Issues of coordination and information sharing between the FCA and the Prudential Regulation Authority (PRA)

We suspect that, as the recent IMF Mission noted, there needs to be detailed work on co-ordination. We would propose two joint standing committees, one on prudential matters and one on European issues.

How should the FCA be interacting with other domestic regulators? For example, the FCA's relationship with the Bank of England and Financial Ombudsman Service

We have commented above on the relationship with the FOS.

We are also concerned that given the primacy of the PRA in prudential matters there could develop an adversarial culture between these organisations, as has sometimes been the case between the Bank and the FSA and between US regulatory agencies. In this context we are particularly concerned about how this prudential primacy will work out in practice. UK banks in their recent results have reserved billions of pounds for redress related to mis-selling of PPI. Given that this is a conduct issue which was revealed at a time of great stress on bank capital, would the PRA have allowed the FCA to force through this issue?

This split might also bring bias into the financial system. If a similar conduct issue were to occur equally in a PRA regulated firm and an FCA regulated firm, the PRA might protect the capital of the PRA firm but not the FCA firm.

How should the FCA be interacting with international regulators? Do EU regulation initiatives restrict or enhance the work of the FCA? Will the FCA be able effectively to engage with the EU supervisory authorities?

The FCA should be interacting strongly with international and, in particular European institutions. We have a particular concern that the FCA's seat at ESMA will be taken by the markets division yet ESMA will play a crucial role in many conduct issues. We have also been disappointed at the Treasury's reluctance to allow the FSA to deal directly with the European institutions.

October 2011

Further written evidence submitted by the Financial Services Authority

1. As we promised in our memorandum of 10 October, this memorandum sets out in more detail our position on the Financial Conduct Authority's proposed regulatory role for competition in financial services markets. It covers:

- the approach to competition issues in financial services markets under the legislation currently in place;
- the proposals in the draft Financial Services Bill;
- our preferred approach; and
- the implications of that approach.

2. We also provide some further thoughts on the triggers in the draft Bill for reports on regulatory failures.

Current Approach to Competition Issues in Financial Services Markets

3. The Office of Fair Trading (OFT) currently has lead responsibility on competition issues in all markets, including financial services markets. The Enterprise Act confers powers on it to review markets for failings that harm consumers, while the Competition Act prohibits anti-competitive behaviour and gives the OFT certain enforcement powers. The FSA has not historically tackled issues of underlying market power per se, although it does undertake market failure analysis when considering proposals for new rules.

4. The following three examples illustrate how the current approach to competition issues in financial markets has worked in practice.

Payment Protection Insurance (PPI)

The FSA was aware of possible competition weaknesses in the PPI market. In line with its regulatory approach at that time, and its understanding of the OFT and Competition Commission's respective areas of focus and responsibilities, the FSA focused on firms' point-of-sale conduct and internal controls, while supporting the work of the competition authorities who were leading on this issue. The OFT began a market study in response to a super-complaint from Citizens Advice. The OFT concluded that there were features of the market that restricted competition to the detriment of consumers and referred the matter to the Competition Commission for a market investigation. Earlier this year, the Competition Commission prohibited (i) the sale of PPI with a loan, and (ii) single premium PPI. At the same time, the FSA was taking forward supervisory action that ultimately led to the introduction of measures in December 2010 for the redress of consumers who had been mis-sold PPI. The current situation, where both the OFT and the FSA have partially overlapping responsibility, has some disadvantages in that the two organisations were largely working on the same problem, pursuing different approaches, in parallel, over a number of years.

Personal Current Accounts (PCAs)

The OFT conducted a market study into PCAs which identified a number of market failings. The OFT agreed voluntary undertakings with the largest banks on a range of actions to improve competition in the market, and is now monitoring their effectiveness[17].

Cash ISAs

Last year Consumer Focus made a super complaint to the OFT about the time taken to transfer cash ISAs between banks. The OFT obtained voluntary undertakings from the industry to reduce the time from 25 to 15 working days.

Proposals in the Draft Financial Services Bill

5. The draft Bill proposes that the FCA will have a single strategic objective of "protecting and enhancing confidence in the UK financial system". It also gives the FCA an operational objective of "promoting efficiency and choice in the market for financial services", along with two other operational objectives and a duty (when discharging its general functions) to promote competition where compatible with the strategic and operational objectives.

6. As we said in our previous memoranda to the Joint Committee on the draft Financial Services Bill and to this Committee, in our view these provisions do not establish the nature and extent of the FCA's responsibilities with sufficient clarity. The proposed respective responsibilities of the FCA and the OFT are also unclear, risking confusion in the authorities themselves, in regulated firms and among the general public.

7. We note the recommendations from the Independent Commission on Banking (ICB) and the Treasury Committee that the competition remit of the FCA should be strengthened.

The FSA's Preferred Approach

8. The FSA recognises the benefits that efficient markets can have for consumers and, conversely, that ineffective competition can lead to poor outcomes across all sectors. As the conduct regulator of firms operating in the financial services markets, and with prudential regulation responsibilities for many firms, the FCA will have extensive knowledge of the key players, products and market dynamics. It will be well placed to take on a bigger role in promoting competitive and efficient markets (when discretion is not constrained by EU Directives).

9. The FSA therefore proposes the following alternative approach:

[17] **Unauthorised Overdraft Charges:** Alongside the PCA market study, the OFT pursued a separate investigation into banks' unauthorised overdraft charges. The OFT had concerns about the level and frequency of such charges. In relation to activities which are subject to FSA regulation, the FSA's rule making powers are sufficiently wide to implement remedies of the sort that could address consumer detriment arising from certain charges and fees. However, this situation is complicated by the division of responsibilities between the OFT and the FSA. Overdrafts are consumer credit and are therefore regulated by the OFT, which led on this issue.

— The operational objective of "efficiency and choice" is replaced with an operational objective to promote effective competition (across financial services markets, not solely retail banking) for the benefit of consumers.

— The competition "duty" is removed.

— The FCA has an explicit function to keep financial services markets under review.

— The FCA has a function/power which enables it to refer directly to the Competition Commission, for investigation, markets where it suspects market features are preventing, restricting or distorting competition (including allowing the FCA to agree certain undertakings—e.g. involving divestment—with firms in lieu of a reference).

— Consumer organisations are able to make super-complaints to the FCA (instead of the OFT) on aspects of the operation of financial services markets which are harming consumers.

10. This would position the FCA as having the lead regulatory role where there is ineffective competition due to market practices in financial services markets.

11. We do not believe it would be appropriate for the FCA to have responsibility for (largely) firm-specific Competition Act 1998 enforcement. The OFT has the relevant technical legal and economic expertise and experience. Nor would it be appropriate for the FCA to have a role in relation to mergers in the financial services sector, for the same reasons.

12. Although not creating a primary competition objective, we believe this approach would meet the ICB and the Treasury Committee recommendations for strengthening the FCA's competition mandate. It would extend to all financial services markets in scope, not just retail banking. We believe it would provide the FCA with the power and responsibility to tackle weaknesses in competition across these markets, and the flexibility to tailor its approach given the width of its remit—matters of market integrity, for example, cannot be solved solely through greater competition. A sole, primary objective to promote competition may restrict this flexibility.

13. We also believe that, if the FCA is given a clear operational objective of promoting effective competition for the benefit of consumers—conferring a clear accountability on the FCA to focus on competition—it will be unnecessary to retain the competition duty in the draft legislation.

Implications of this Approach

14. We believe our preferred approach would have had benefits when dealing with the examples highlighted in paragraph . In the case of PPI, there would have been one organisation with a clear remit to tackle all the issues (the competition issues arising from the bundling of PPI with a loan, the "toxic" single premium pricing structure, as well as providing for appropriate redress for consumers). The response would have been earlier and more determined for PCAs as there would have been one lead regulator able to carry out the market study and use its rule-making powers to implement appropriate remedies (subject to any constraints imposed by EU Directives). Similarly, in response to the super-complaint, the FSA could have investigated the operation of the market and made rules or guidance for the transfer of cash ISAs rather than rely on negotiating voluntary undertakings.

15. We recognise that having an objective to promote competition in financial services markets would require the FCA to undertake new functions. This would have cost and resource implications. There is clearly a degree of uncertainty about precisely what these costs might be, in advance of detailed consideration of how such an objective would be implemented. However, our initial estimate of the potential incremental impact on the FCA's annual budget of moving to the approach we advocate above is in the range of £10m to £15m.

Summary of our Proposed Changes to the FCA's Strategic and Operational Objectives and General Duty

16. Therefore, if we combine our recommendation on competition with what we have previously said to the Committee about the FCA's strategic objective, the resulting possible alternative to the current draft legislation is set out below:

Current Draft Bill	*Possible alternative*
The FCA's strategic objective is: protecting and enhancing confidence in the UK financial system. *The FCA's operational objectives are:* *(a) Securing an appropriate degree of protection for consumers.* *(b) Protecting and enhancing the integrity of the UK financial system.* *(c) Promoting efficiency and choice in the market for [financial services].* *The FCA must, so far as is compatible with its strategic and operational objectives, discharge its general functions in a way which promotes competition.* *The FCA must have regard to the importance of taking action intended to minimise the extent to which it is possible for a [regulated business] to be used for a purpose connected with financial crime.*	*The FCA's strategic objective is: promoting, fair, efficient and transparent markets in financial services.* *The FCA's operational objectives are:* *(a) Securing an appropriate degree of protection for consumers.* *(b) Protecting and enhancing the integrity of the UK financial system.* *(c) Promoting effective competition in the markets for financial services for the benefit of consumers.* *The FCA must have regard to the importance of taking action intended to minimise the extent to which it is possible for a [regulated business] to be used for a purpose connected with financial crime.*

TRIGGERS FOR REPORTS ON REGULATORY FAILURES

17. In our memorandum of 10 October to the Committee, we explained our concerns about the accountability mechanism currently proposed in the draft Bill for reporting on regulatory failures.

18. We understand the public policy arguments in favour of having a widely drawn and flexible set of tests for determining whether or not a report is required. However, we also recognise the importance, both for society and the regulator itself, of certainty as to when a report is required. A set of tests which is uncertain and subjective risks leading to protracted and unproductive debate, and possibly litigation, on the subject of whether or not a report should be produced, in particular whether the second limb of the test (that there had been a "regulatory failure") had been met.

19. One way to resolve this difficulty would be to make triggers for determining whether a report was required grounded on objective fact, rather than on the judgment of the regulator or the Treasury. A helpful parallel may be the obligation on the Governor of the Bank of England to write to the Chancellor if a specific inflation target is not met, explaining the reasons. We recognise that the objective tests would need to be carefully calibrated to ensure that they properly reflected society's expectations of the regulator, and we would welcome a debate as to at what level they should be set.

20. By way of example, a set of triggers might be:

- a particular level of consumer redress being paid as a result of mis-selling; and
- the need for a particular scale of Financial Services Compensation Scheme levy made on the industry.

21. We would expect such reports to focus on the circumstances leading up to the events that triggered the duty to report, and the lessons that could be learned from that, including for the regulator, rather than being the opportunity to reopen cases against firms and individuals. We believe it would not be appropriate to use the report-writing process to "name and shame" firms or individuals without following the disciplinary due process established by the Financial Services and Markets Act.

22. We look forward to discussing these issues with the Committee.

October 2011

Supplementary written evidence submitted by Fidelity Worldwide Investments

At the hearing of your Committee into the FCA last Tuesday you expressed the view that the Committee might be interested in working with the independent directors of the FSA/FCA to enhance the accountability of the FCA. You asked for any further thoughts on this.

May I offer three ideas, all of which are based around current practice with the MPC and FPC.

First it would seem helpful if appointments to the FCA Board were reviewed as a matter of course by your Committee. I noted that the day after my own evidence your Committee had an illuminating exchange of views with Robert Jenkins, a new appointee to the FPC. It seems that these exchanges are mutually beneficial.

Second, Fidelity had suggested that the FCA should formally report to your Committee or to Parliament on an annual basis and that your Committee should use that report to conduct an inquiry into the Authority's progress set against the statutory objectives. Within that I would suggest you have sessions with non-executive directors separate from those with the senior executives.

Finally I believe the FCA Board should be required to publish fuller minutes than the summary minutes produced by the FSA. Frankly these give no idea of the influence of the Board as against the executive. These should be based on the format used by the MPC and the FPC which, whilst not naming names, give good and intelligible summaries of the main lines of the arguments and explain the reasons why the Committee concluded as it did. We have also suggested that Board meetings should be held in public as the SEC does from time to time.

You also mentioned your interest in the costs of regulation. We assisted the IMA in their study for your Committee which has now been published.

If there are other questions or clarifications I can assist with, do let me know.

Philip Warland
Head of Public Policy

Supplementary written evidence submitted by HM Treasury

During my appearance before the committee to give oral evidence on the Financial Conduct Authority (FCA) last week, I was asked for further information on which powers in the area of financial regulation are moving to Brussels; further explanation of the relationship between the UK and EU institutional architecture; and an explanation of the application of the PRA veto to the FCA product intervention power. In addition, in a follow up question after the session, you asked whether the FCA would be a price regulator.

EU Regulation of Financial Services

On the 24 November 2010, the EU adopted legislation establishing three new European Supervisory Authorities (ESAs): the European Banking Authority (EBA), the European Insurance and Occupational Pension Association (EIOPA), and the European Securities and Markets Association (ESMA). These bodies are designed to facilitate better cross-border cooperation between regulators and ensure a more consistent implementation of EU rules by Member States.

The legislation enshrines the principle that supervision of financial institutions is a national competence (with one exception, which is that ESMA directly regulates Credit Ratings Agencies. This is a function which did not exist in the UK regulatory framework prior to the creation of the ESAs). The role for the ESAs is therefore largely limited to providing advice, enhancing coordination between national regulators, and ensuring compliance with EU law. However, Article 9 (5) of the ESA regulations provides the ESAs with certain limited powers to temporarily ban financial activities. These powers are tightly constrained by both the regulations and established EU case law, which prevents the ESAs from taking any discretionary decisions which may make possible the execution of actual economic policy. Therefore, we believe that these powers are limited to empowering the ESAs to require national competent authorities to comply with EU law and enforce product bans set out in sectoral EU legislation.

UK and EU Institutional Architecture

The Committee also asked for further explanation of how the UK twin peaks architecture will relate to and work with the European and international architecture. A detailed discussion of the Government's proposals for EU and international representation and co-ordination, including the proposed statutory international Memorandum of Understanding can be found at Chapter 7 of the February 2011 consultation document A *new approach to financial regulation: building* a *stronger system.*

Product Intervention Power and the PRA Veto

The Committee asked whether there could be a product so dangerous that it should be banned for consumer protection reasons, but so important that it ought not to be banned for financial stability reasons. I have therefore set out below how the product intervention power and the PRA veto work, and how they might interact.

New section 137C, inserted by clause 19 of the draft Financial Services Bill, provides the FCA with new powers to make rules which ban or impose restrictions on financial products to advance its "consumer protection" or its "efficiency and choice" objectives.

New section 138M provides the FCA with the ability to make temporary product intervention rules, without prior cost-benefit analysis or consultation, for up to one year. The Government believes that this power is necessary to enable the FCA to take timely and decisive action where it judges that a product or product feature is likely to be harmful, rather than waiting to intervene until there is clear evidence of widespread consumer detriment.

New section 3H, inserted by clause 5 of the draft Bill, provides the PRA with a power to require the FCA to refrain from taking a specified action, where the PRA is of the view that the FCA action would result in a firm failing in a disorderly way that would adversely affect the financial system, or would threaten financial stability. The PRA can exercise the veto where the FCA proposes to exercise any of its regulatory powers in relation to PRA-authorised persons generally, a class of PRA authorised persons, or a particular PRA-authorised

person. The scope of the veto therefore includes, but is not limited to, FCA rules, and this includes temporary product intervention rules.

The veto serves as a backstop and the Government does not expect its use to be a routine matter. In the event that FCA action is likely to affect the stability of a PRA-authorised firm or of the wider financial system, the Government would generally expect the PRA and FCA to agree a course of action that will enable both regulators to act consistently with their objectives. This could include adjustments to the speed or the manner in which the FCA action is implemented.

However, there is a risk that in exceptional circumstance the PRA and FCA may not be able to come to an agreement. In particular, they may not agree as to the level of risk that the FCA action will result in the disorderly collapse of a firm. In this case, the PRA must have a backstop veto power, as it will be the prudential expert on the firms it authorises and have the ultimate mandate to help protect financial stability.

The veto cannot be used to prevent the FCA from doing something that it is legally required to do, for example by EU or international law.

Where the veto is used, the PRA will be required to give a copy of the direction to the Treasury, and the Treasury will be required to lay the direction before Parliament. The PRA must also report on its use of the veto in its annual report.

As noted above, the PRA veto applies to all circumstances where the FCA has discretion as to how to act with respect to PRA-authorised persons. This includes, but is not limited to, use of the product intervention power.

In principle, therefore, the Government believes that it is appropriate for FCA actions in relation to financial products to fall within the scope of the PRA veto, as it is possible that such an action may lead to the disorderly failure of a firm or wider financial instability. This is turn would hurt financial stability and harm consumers.

In practice it is far more feasible that the PRA's veto power would come into play because a product that the FCA wished to ban was so fundamental to the stability of a systemically important firm, rather than because the product itself was so important to wider financial stability.

Such a scenario is, however, remote, as it is highly unlikely that a PRA authorised firm would be allowed to rely so heavily on the income from a single (type of) product, especially a product about which the FCA had consumer protection concerns.

Price Regulation

The Government has been clear that the FCA will not prescribe prices in the manner of some utilities regulators. In the financial services industry, in the absence of natural or granted monopolies, such an approach would not be proportionate or consistent with the FCA's competition remit.

However, the FCA should be looking at comparative prices and other possible indicators of where competition is flawed. We expect the FCA will take a keener and more informed interest in questions of value for money than the FSA has done in the past. One example of the type of intervention the FCA might consider would be to intervene to prevent misleading price structures, where a low headline price (to attract new customers) is offset by high ancillary charges, for example by charging very high prices for changes to personal details or to cancel aspects of a certain product. The FSA has already begun to take a similar approach to addressing consumer detriment, for example in its Consultation Paper on Responsible Lending where it proposed to limit the number of times that firms could charge a fee for missed payments, and clarified rules around how arrears charges relate to costs.

I was grateful for the opportunity of appearing before the committee to answer your questions and look forward to your report.

Mark Hoban MP
Financial Secretary to the Treasury

17 November 2011

Supplementary written evidence submitted by the Financial Services Authority

1. In the oral evidence session on 1 November, you asked us to provide further information on the FSA's proposed approach in a number of areas. This memorandum covers:

- our preferred approach to competition and how it would work in practice;
- our proposed approach to price intervention;
- how the new regulatory authorities in the UK will seek to coordinate their EU engagement;
- the process we adopt in implementing the recommendations made by the interim Financial Policy Committee (FPC); and
- firms' responsibility.

If we can be of further assistance to the Committee as they prepare their report, we would of course be happy to help.

A. *The FSA's preferred approach to competition and how it would work in practice*

2. Here we set out in more detail how a competition objective for the FCA, together with the functions and powers set out as our "preferred approach" in our note to the Committee of 26 October, would work in practice.

3. We envisage that the FCA will wish to intervene where its analysis of any particular market establishes that ineffective competition is leading to material harm to consumers. It will also have to be satisfied that its planned intervention will remedy or reduce the competition failings it has identified, and that it will do so in a proportionate manner. There will be cases where genuine concerns are raised, but the FCA may decide that it would not be proportionate to take action.

SUMMARY OF THE FSA'S PREFERRED APPROACH

4. Our preferred approach would enable the FCA to take the lead in ensuring that the process of competition in financial services is effective. To achieve this, as we said in our earlier memorandum of 26 October, we would like to see the following changes to the draft Bill (see summary in paragraph 6 below):

- The operational objective of "efficiency and choice" should be replaced with an operational objective to promote effective competition (in all financial services markets, not just retail banking) for the benefit of consumers.
- The competition "duty" should be removed.
- The FCA should have an explicit function to keep financial services markets under review.
- The FCA should have a function/power (instead of the OFT, as currently) to refer directly to the Competition Commission, for investigation, financial services markets where it suspects market features are preventing, restricting or distorting competition. This is known as a "Market Investigation Reference power". This should also allow the FCA to agree certain undertakings—eg including divestment—with firms in lieu of a reference.
- Consumer organisations should be able to make super-complaints to the FCA (instead of, as currently, to the OFT) on aspects of the operation of financial services markets which are harming consumers.

5. Under our preferred approach, enforcement of particular prohibited practices under the Competition Act—that is, collusion and abuse of a dominant position and control of mergers in the financial sector, would remain with the OFT. The OFT already possess both legal and economic expertise in this area and is, therefore, best placed to carry out this function. We do not think the OFT will need to have jurisdiction, as it currently does, to review the FCA's rules for anti-competitive effects, both because, under our preferred approach, the FCA will itself have a duty to promote competition and because of the other accountability and governance mechanisms that the FCA will be subject to (for example, the Treasury Select Committee and the National Audit Office).

6. Therefore, if we combine our recommendation on the FCA's strategic objective and competition, the resulting possible alternative to the current draft legislation is set out below:

Current Draft Bill	*Possible alternative*
The FCA's strategic objective is: protecting and enhancing confidence in the UK financial system.	*The FCA's strategic objective is: promoting, fair, efficient and transparent markets in financial services.*
The FCA's operational objectives are:	*The FCA's operational objectives are:*
(a) Securing an appropriate degree of protection for consumers.	*(a) Securing an appropriate degree of protection for consumers.*
(b) Protecting and enhancing the integrity of the UK financial system.	*(b) Protecting and enhancing the integrity of the UK financial system.*
(c) Promoting efficiency and choice in the market for [financial services].	*(c) Promoting effective competition in the markets for financial services for the benefit of consumers.*
The FCA must, so far as is compatible with its strategic and operational objectives, discharge its general functions in a way which promotes competition.	*[Delete]*
The FCA must have regard to the importance of taking action intended to minimise the extent to which it is possible for a [regulated business] to be used for a purpose connected with financial crime.	*The FCA must have regard to the importance of taking action intended to minimise the extent to which it is possible for a [regulated business] to be used for a purpose connected with financial crime.*

EXAMPLES OF COMPETITION PROBLEMS

7. To illustrate the role of the FCA and the boundary between the FCA and the OFT under our preferred approach, we set out three examples below.

EXAMPLE 1—CONCENTRATED MARKET

8. In this example we consider a mortgage market where the largest firm has a market share of around 40%. This could lead to detriment for consumers through weak competition, leading to higher prices and profits and poor quality products. However, a concentrated market does not necessarily have these effects. A market may work reasonably well, with a range of different sized competitors competing vigorously.

9. In order to decide whether a market, appropriately defined, was working effectively for consumers, the FCA could use its powers to gather information and would be likely to assess a range of indicators including:

- overall level of concentration in the relevant market (i.e. the size and number of other firms in the market) and the stability of their market shares;
- the extent to which products on offer in the market change and are responsive to consumer needs;
- the extent to which product features rely on negative indicators (e.g. inertia, tie-ins);
- the patterns of price movements;
- profit levels;
- the ability of new suppliers to enter the market, and existing competitors' response to new entrants;
- the frequency of switching and the level of any switching costs; and
- transparency of terms and conditions and prices (and how easily customers can compare).

10. If the FCA concludes that competition in this market is weak, it could consider making rules to improve the effectiveness of competition. For example, it could make rules for firms designed to:

- Enhance consumers' ability to exercise a greater degree of buyer power, including measures aimed at:
  - increasing pricing transparency, to assist consumers' comparison of products; and/or
  - making switching easier (eg limiting exit charges).
- Reduce barriers to entry or expansion, enabling existing firms and new entrants to compete more effectively.

11. An alternative approach, in the circumstances outlined in paragraph 8, would be to consider whether a divestment of a portion of the business of that firm would be warranted, for example by the divestment of client accounts or a specific subsidiary within the group (to create a viable new competitor). For this, the FCA could use its Market Investigation Reference powers to refer the matter to the Competition Commission to review (as the OFT currently does), or seek an undertaking from the firm to divest a part of its business, in lieu of a reference.

12. Concentration levels in a market could be the result, at least in part, of merger activity. Merger regulation focuses on preventing a "significant lessening of competition" in a UK market as a result of a transaction between companies. We believe this is best dealt with by specialists in merger control with expertise across a wider range of sectors than just the financial services sector. It would, therefore, be more economic to keep this specialist resource in the OFT where it would be used more frequently than at the FCA. The FCA would provide the OFT with any assistance it required in analysing merger activity involving FCA-authorised firms.

EXAMPLE 2—COLLUSION

13. This example involves two well-established firms, both with significant and stable market shares, which have discussed and coordinated price increases. Collusion is a prohibited practice under UK and EU competition law and there are penalties for both individuals and companies.

14. If the FCA obtained market intelligence suggesting such behaviour, it would pass this to the OFT (subject to the relevant legislation permitting disclosure) and would support any OFT investigation. Any consequential breaches of FCA rules as a result of collusive behaviour would remain the responsibility of the FCA.

EXAMPLE 3—LOCAL MARKET POWER

15. Products, such as Payment Protection Insurance, sold as ancillary to another transaction, often offer poor value, taking advantage of local market power and "point of sale advantage". The FCA could be aware of this issue either because of its own review of financial services markets or from a consumer organisation making a super-complaint. Consumers' attention is unlikely to be focused on value or suitability of the ancillary product offered, and they may make an uninformed purchasing decision—e.g. without shopping around, considering alternatives or considering whether such a product meets their needs or preferences. The ancillary product may not be widely advertised and general consumer awareness may be low.

16. This can result in consumers paying high prices and/or buying unsuitable products. Using its powers to obtain information on the market, the FCA may take into account:

- lack of consumer awareness and knowledge, and the advantage this offers firms selling ancillary products at point of sale, compared to firms seeking to sell the same ancillary product on a stand-alone basis;

— market shares of firms with a point-of-sale advantage and those that do not (to assess the viability of firms offering a similar product on a stand-alone basis); and

— loss ratios for the insurance product (low levels, such as with PPI, may indicate high premiums or poor value).

17. The FCA would be able to address through rule-making any problems that local market power is causing and that warrant intervention. For example, the FCA could ban the sale of ancillary products at the point at which the "main" product is sold.

Identifying where Competition Problems may be Harming Consumers

18. Giving the FCA the power to deal with super-complaints from designated bodies would provide another route by which issues of consumer detriment, including those caused by ineffective competition, could be brought to the FCA's attention. Designated bodies should primarily be consumer groups. We do not believe that it would be appropriate for regulated firms or industry trade associations to bring such super-complaints. Furthermore, we do not believe that the Financial Ombudsman Service should be a designated body for these purposes. There will be other arrangements in place specifying how the FOS will be able to bring problems to the FCA's attention and how the FCA should respond.

B. *Our proposed approach to price intervention*

19. In line with the government's stated objective for the FCA, we do not want the FCA to be a pure economic regulator in the sense of setting levels of return for particular products (as regulators do in some utility markets). However, the FCA will be prepared to make judgements about prices as part of its assessment of whether firms are treating consumers fairly.

Transparency and Disclosure

20. In order for financial markets to work efficiently, consumers must have sufficient information on product charges to enable them to make an informed decision on value for money, so allowing them to exert competitive pressure on providers and intermediaries. Promoting such transparency will, therefore, remain a key element of the FCA's approach to regulation. However, past experience suggests that competitive markets and product disclosures alone do not prevent poor consumer outcomes. We have found that even when information is provided to consumers in standardised form, they sometimes choose not to use it. It can be difficult for consumers to understand and compare products and their charges. In some cases, conversations (for example, with advisers or family and friends) are more influential than standardised information.

21. An FSA review of quality of advice on pension switching found that about 80% of unsuitable advice was due to customers incurring unnecessary additional costs when moving pension scheme.[18] In spite of detailed cost disclosures from advisers and product providers, and information requirements designed to ensure that charges are transparent, consumers still made poor decisions which resulted in detriment, or were unable to recognise where advice was of poor quality.

22. Furthermore, providers can make products appear more attractive by reducing headline prices at the expense of increasing more opaque ancillary charges—such as exit fees or overdraft charges—which are typically ignored by consumers when making purchasing decisions.

23. An example of a product where provider firms were able to exploit negative behavioural traits is single-premium Payment Protection Insurance (PPI). Firms created products with a single upfront premium payment (which was typically added to a credit product) and unfavourable refund terms. In this case, firms were able to capitalise on consumers' unwillingness or inability to search the market, which in turn was exacerbated by PPI typically being a secondary sale to a credit product and by high pressure sales techniques. The unwillingness or inability of consumers to use the information provided to them resulted in them ceding market power to providers and allowed providers to make considerable excess profits.

24. Even though the FSA introduced a number of measures to improve transparency in the provision of single-premium PPI products, detriment continued to grow in magnitude. In order to address this detriment, in March 2009 we agreed with firms that they would stop selling single-premium PPI alongside unsecured loans.

25. The Product Intervention measures in our Discussion Paper[19] and Feedback Statement[20] provide an outline of the new tools the FSA plans to use to address consumer detriment.

The FCA's Proposed Approach to Price Intervention

26. In order to meet our objective of achieving an appropriate degree of protection for consumers, we are likely on occasion to be required to make judgements about the value for money offered by individual products. To achieve this, we may be required to intervene in firms' decisions on the price of particular products and

[18] "Quality of advice on pension switching A report on the findings of a thematic review" at http://www.fsa.gov.uk/pubs/other/pensions_switch.pdf

[19] "DP11/1: Product intervention" at http://www.fsa.gov.uk/pubs/discussion/dp11_01.pdf

[20] "FS11/3: Product Intervention" at http://www.fsa.gov.uk/pubs/discussion/fs11_03.pdf

their overall charging structures. In our Feedback Statement[21], we set out a number of possible ways in which we may decide to intervene in pricing issues. We recognise that price intervention may have unintended consequences and that the FCA should proceed with caution before implementing such measures. However, we remain of the view that proportionate intervention on value for money is justified where competition is flawed and where there is clear evidence of risk to the consumer.

27. In our Consultation Paper on Responsible Lending[22], we give an example of our new approach to assessing the overall suitability of a provider's charging strategy. We have proposed limiting the number of times that firms could charge a fee for missed payments and have clarified our rules on how arrears charges are attributed to costs. Furthermore, we have already limited mortgage arrears charges to a reasonable estimate of the additional administration costs. These proposals and existing rules reflect one model of price intervention that we are likely to pursue in future.

28. However, as we made clear in our FCA approach document, price intervention is just one of a number of tools relating to product design and governance which we will consider in future in order to ensure an appropriate level of consumer protection. Such interventions may be used to provide temporary solutions to address consumer detriment, on the basis that they will be lifted when the source of consumer detriment (such as flawed competition) ceases to be a risk, or when a long-term regulatory solution can be implemented.

Structured Products – Future and Current Approach

29. The Committee also asked to provide more information on "what type of structured product it is exactly that we need to have in mind when reading Box 2 [of the FCA approach document, on the FCA's approach to competition and pricing]". Box 2 of our Approach Document states:[23]

> Where competition is impaired, price intervention by the FCA may be one of a number of tools necessary to protect consumers. This would involve the FCA making judgements about the value for money of products.
>
> The FCA will thus consider exercising its powers to take action where costs or charges are excessive. There are currently rules on excessive charges for mortgage arrears; and the FCA could, for example, re-introduce rules on excessive charges for a wider range of investments. For charges that are unfair or clearly out of line, there is an immediate value to intervention which would not require the FCA to be an economic regulator. The FCA could also consider requiring product providers to show that charges are not at a level that undermines the possibility of consumers achieving a return.

30. Structured products differ from other investments, in that customers are told the possible range of returns they might expect under different economic conditions, rather than the charges they will face. Owing to the complexity of these products, the charges applied by the provider may vary due to the large number of transactions which may be made during the operation of the product. For this reason it may not be possible to disclose the charges associated with the product in a way which is helpful to the retail consumer. An example might be a structured product which employs a protected cell company (typically offshore), through which investors' funds are channelled to spread counterparty risk, adding an extra degree of complexity to the product and fee structure. In such an instance, to disclose all charges to consumers would not add to their understanding of risk and the likely outcomes for them (and therefore to the effective working of competition); indeed, it may distract the consumer from more important information.

31. The FSA is already taking steps to raise value for money within product design as an issue that firms should consider carefully. To meet regulatory requirements, we expect firms to carefully consider whether their product presents value for money. Our recent proposed guidance on structured products development and governance suggests that where firms use a value for money test involving a comparison with cash, the potential additional return over cash should reflect a fair risk premium for the non-cash product.

C. *How the new regulatory authorities in the UK will seek to coordinate their EU engagement*

32. In preparing for the transition to the PRA and FCA, the FSA remains very aware of the importance of our international engagement. This is particularly true of the FSA's engagement with EU authorities as the EU has a heavy legislative agenda and the new European Supervisory Authorities (ESAs) are beginning to take on increased responsibilities. The FSA also recognises the importance of strong international relationships with foreign counterparts to facilitate enhanced cross-order cooperation in the supervision of firms.

33. The Treasury leads discussions on EU Directives and Regulations and the FSA provides technical expertise where required. We expect that the PRA and the FCA will provide this support to the Treasury in future.

Coordination of UK Engagement with the European Supervisory Authorities

34. The FSA currently devotes significant resources to the ESAs in recognition of the important role that they play. We expect engagement with them will continue to be a key priority for both organisations.

[21] "DP11/1: Product intervention" at http://www.fsa.gov.uk/pubs/discussion/dp11_01.pdf
[22] "Mortgage Market Review: Responsible Lending" at http://www.fsa.gov.uk/pubs/cp/cp10_16.pdf, ch.4.
[23] The Financial Conduct Authority: Approach to Regulation' at http://www.fsa.gov.uk/pubs/events/fca_approach.pdf, p18.

35. The ESA structure is based on sectoral lines—banking, securities and markets, insurance and occupational pensions. As an integrated regulator, the FSA is the UK member of the European Securities and Markets Authority (ESMA), the European Insurance and Occupational Pensions Authority (EIOPA), and the European Banking Authority (EBA). The Bank of England is also represented at EBA meetings, as is The Pensions Regulator at those of EIOPA. However, neither of these organisations has voting rights.

36. Under the new regulatory structure, it is not expected that the UK would have additional seats at the ESAs. It is expected that the FCA will be the UK member on ESMA and the PRA on EBA and EIOPA. However, there will be instances where the PRA or the FCA may have an interest in an issue appearing before an ESA of which it is not a member. The ESA Regulations state that when an item to be discussed by the Board of Supervisors does not fall within the national competence of the member, that member may bring a representative from the relevant national authority (non-voting). However, it is anticipated that in most cases the FCA and PRA will coordinate closely in advance to ensure that the interests of the UK are adequately reflected, without the need for both authorities to attend.

37. In order to address the need for close coordination among the UK authorities, the preparations for the move to the new structure include:

— An agreed process between the PRA and the FCA setting out in detail how the two organisations will cooperation and coordinate on Global Committees and the ESAs. This will include consulting on policy positions, sharing papers and agendas and meeting regularly to discuss strategic direction.

— A PRA and FCA engagement plan for our international stakeholders to ensure that they are kept informed and which continues to builds on good relationships established by the FSA.

38. In addition, as required by the draft legislation, we will agree a Memorandum of Understanding between the Treasury, the Bank of England, the FCA and the PRA on international coordination, which is likely to be published next year.

39. Given that high-level regulatory decisions are not made in the ESAs but through the political process, the FSA would support the creation of a more formal coordination committee led by HMT, which would ensure structural engagement with the whole of the European process by all relevant UK regulators and government.

Coordination Outside the Framework of the ESAs

40. In addition to the formal framework of the ESAs, the FSA engages with international stakeholders on a regular basis through a range of channels including bilateral meetings, supervisory colleges, crisis management groups and enforcement cooperation. We know that we need to embed these arrangements in the new regulatory structure. For example, we must ensure that our information sharing gateways are carried over into the new organisations so they can continue to cooperation with their international counterparts.

D. *The process we adopt in implementing the recommendations given by the interim Financial Policy Committee (FPC)*

41. The interim FPC was created on 17 February 2011, in anticipation of the establishment of the statutory FPC. It will undertake, as far as possible, the statutory FPC's macro-prudential role. The interim FPC has also begun to make recommendations to the FSA[24] which we will of course consider in accordance with our current duties and powers under the Financial Services and Markets Act 2000 (FSMA).

42. We are currently reviewing and revising our approach on how best to implement interim FPC recommendations in light of our experience to date. We expect the approach, set out in this memorandum, to be applied to current and future recommendations by the interim FPC.

Process for Receiving Recommendations from the Interim FPC

43. The interim FPC is a committee of the Bank of England and the Bank therefore provides the Secretariat. The Secretariat prepares briefings in advance of the meetings. Where appropriate, the FSA is given an opportunity to contribute to these, including preparing or contributing to a paper to the interim FPC containing options for action by the authorities.

44. The current membership of the interim FPC includes Hector Sants (in his capacity as future Deputy Governor for Prudential Regulation and Chief Executive of the Prudential Regulation Authority) and Adair Turner (as FSA Chairman). Martin Wheatley (future Chief Executive of the Financial Conduct Authority) attends the meetings as an observer. Such representation ensures that the discussion in the interim FPC benefits from the current experience and knowledge of the FSA's operations, powers and objectives. This will ensure that when recommendations are made to the FSA they are done so with prior knowledge of the feasibility of implementation.

[24] Records of recommendations are published and available at http://www.bankofengland.co.uk/financialstability/fpc/meetings/index.htm

Receiving Recommendations from the Interim FPC

45. Following the receipt of interim FPC recommendations, the FSA procedure is that they are considered initially at working level, involving the relevant experts. Proposals for action required to meet the recommendations are then referred to the FSA's Executive Committee for decision. In considering the options for implementation the Executive Committee takes into account the feasibility of such actions in the context of the existing legal framework (including any relevant constraints arising from European Union law). Interim FPC recommendations can sometimes be implemented by a number of ways and legal routes (for example, by making new rules or by firm-specific actions).

46. The Executive Committee, when considering the implementation of interim FPC recommendations, needs to act in accordance with the FSA's powers and objectives under FSMA and its obligations under public law, including proportionality.

47. If there were a legal impediment to the implementation of a interim FPC recommendation (for example, a risk that the proposed action would be at variance with the FSA's statutory objectives or incompatible with EU legislation), we would raise this with the Chairman of the interim FPC and could, in appropriate cases, ask him to convene a special meeting of the interim FPC.

48. The FSA Executive Committee has as a matter of principle committed to implementing interim FPC recommendations unless incompatible with the current legal framework and statutory duties. It has been agreed that if the Executive Committee feel they cannot implement recommendations this will be escalated to the FSA Board. Thus, any decision by the FSA not to comply with a recommendation of the interim FPC would go before the Board. The FSA Chairman would be responsible for communicating that conclusion to the interim FPC. To date this has not happened, and, given the high level of coordination between the FSA, interim FPC and the Bank of England, we do not envisage this happening in practice.

49. In response to the Committee's request to see relevant Minutes of FSA discussions on implementing FPC recommendations, we attach at Annex A, an extract from the FSA Executive Committee Minutes, dated 21 June 2011. There was also a presentation to the FSA Board (as part of a much wider-ranging awayday discussion) in March 2011, which explained the approach the FSA Executive would take to compliance with FPC recommendations. We attach at Annex B, a copy of the slide presented to the FSA Board on this subject.

50. The interim FPC publishes its recommendations. The interim FPC may delay publication of some recommendations if it believes that it would be in the public interest to do so.

51. We have agreed with the Bank a set of procedures for monitoring and reporting on the FSA's progress on implementing the recommendations. The FSA's Executive Committee signs off on progress reports that are sent to the interim FPC. The Secretariat of the interim FPC will keep a collated form of this information and will provide it to the interim FPC for review. Furthermore, the interim FPC intends to publish in the Financial Stability Report a progress report on its recommendations. It will thus be transparent whether the FPC's recommendations have been adopted and what methods were used to fulfil them.

Power of the FPC to give Direction

52. The FSA does not believe that the FPC should have the power to direct the FCA and PRA as to means and timing in all cases. If the FPC had such a power it would run the risk of significant overlap of responsibility with the PRA. There would be a risk that the FPC would become a shadow micro-prudential regulator, which would be a very inefficient structure and would risk confusing regulated firms. We do accept that for certain specified macro-prudential tools it may be appropriate for the FPC to specify both means and timing of the implementation of FPC Directions. However, as the Committee is aware, the FPC is still in the process of finalising these tools and therefore it is too early to say which tools in particular such a power may attach to.

53. The FSA agrees with the Bank of England that the FPC should have information gathering powers for those firms that are outside the regulatory perimeter. However, we do not think that this would be necessary for those firms within the perimeter for which information can be obtained through the FCA or the PRA.

E. Firms' Responsibility

54. We support the broad principle of firms' responsibility being defined in the Financial Services Bill. Therefore we would welcome a general principle that a regulated firm should act "honestly, fairly and professionally" in accordance with the best interests of its consumer when carrying on regulated activities with or for that consumer.

55. This drafting reflects the language used in European law to apply a "customer's best interests" principle to investment firms. As we are required to follow this principle for investment firms' conduct of business, it seems appropriate to use this as the basis for a more general approach.

56. There are two specific places within the Bill where such a provision might sit. First, such a provision could sit under section 1B at (4) or (5). Section, 1B defines the FCA's general duties and as this would seem to be a purely conduct business matter it may seem more logical for this provision to apply specifically to the

FCA. Second, such a provision could sit under section 3B in the Bill where the regulatory principles to be followed by both regulators are set out.

23 November 2011

Annex A

AN EXTRACT FROM THE FSA EXECUTIVE COMMITTEE MINUTES (21 JUNE 2011).

EXCO WEEKLY MINUTES

21 June 2011

Present: Margaret Cole (MC—Chair)
Andrew Whittaker (AW)
Hector Sants (HS)(dial-in)
Kathleen Reeves (KR)
Lesley Titcomb (LT)
Thomas Huertas (TH)
Tracey McDermott (TMcD)
Nicola Christofides (NC—Secretariat)

1. Procedure for FSA Implementation of FPC Decisions

Lyndon Nelson (LN) was in attendance.

ExCo discussed the topic of the interim FPC's recommendations and the FSA's reaction and obligations to their recommendations. ExCo identified three types of recommendations the interim FPC can make, noting that regardless of type that they carry the same weight as far as our obligation to implement them is concerned. The types of FPC recommendations were identified as follows:

— a recommendation that can be implemented without a change in our rules;

— a recommendation to change a rule following the standard consultation procedure; and

— a recommendation to change a rule with immediate effect without consultation.

Decision: ExCo agreed that the FSA would use the five day period between the FPC meeting and the resulting press conference to consider whether we intend on implementing or challenging any FPC recommendations.

Decision: ExCo agreed that an assessment of compatibility with EU directives should be factored into the decision on whether to take forward any FPC recommendations.

Decision: ExCo decided that the decision on whether to follow the FPC recommendations should be communicated at the press conference five days after the FPC.

Annex B

A COPY OF THE SLIDE PRESENTED TO THE FSA BOARD SETTING OUT COMPLIANCE ON FPC RECOMMENDATIONS (23 MARCH 2011).

Financial Policy Committee

— The third regulator in the new structure.

— It impacts on our transformation programme given that it is expected that it will be given the power to direct an recommend action to the two other regulators and also will require information (usually aggregated) to be sent to it.

— The main challenges for us are in the information demands and how we will supply them. We cannot make a start on this until FPC has outlined its needs. The interim FPC (Which has Adair and Hector as members and will have Martin as an observer once he takes on his role) has had one preliminary meeting in March.

— We are planning for the two states of the world—an interim FPC and the final FPC. The interim FPC will be interacting with FSA (pre and post twin peaks). Our current assumption is that the interim FPC will not direct the FSA, but will seek to influence it. We intend to take any such recommendations through our existing governance for financial stability issues (ie Executive Supervision Committee and Executive Risk Committee) where our working practice has been to accept such advice given the priority we have attached to financial stability issues. We would notify the Board if we were intending to reject the advice.

— We are comfortable that we have either existing processes or long experience in being able to deal with directions or recommendations for action in our risk-management processes, so are confident that we can meet the business needs here. However, directing policy outcomes is new.

— The next two slides outline the key operational questions we are answering and our assumptions on the solutions for both states of the world (ie interim FPC and final FPC) and in the context of risk identification, monitoring and mitigation.

Supplementary written evidence submitted by Which?

When I appeared as a witness before the Treasury Select Committee on 2 November you asked me to submit further evidence on how consumers are suffering from a lack of competition in the banking sector. I have also included a note on competition to clarify the remarks I made during the evidence session.

PROMOTING EFFECTIVE COMPETITION

Effective competition must be seen as a means to protect and benefit consumers rather than an end in itself. The legislation should include clear definitions to guide the actions of the regulator.

In common with the Treasury Select Committee, Independent Commission on Banking and Office of Fair Trading, we believe the Financial Conduct Authority (FCA) should promote effective competition. We strongly support elevating the importance of competition in the FCA's objectives and believe the Treasury's decision to focus on the positive outcomes of competition in framing the duty is sensible. However, as drafted, the Bill is unlikely to achieve the desired consumer outcomes. The drafting of the 'efficiency and choice' objective does not give any clue as to the intended definitions of these terms or include any 'have regards' that would direct the FCA.

The definition of 'choice' should refer to the ease with which consumers may obtain appropriate products at competitive prices, and the ease with which consumers may discriminate between products or services which represent good and poor value for money.

The definition of 'efficiency' should include a remit to consider value for money and ensure consumers are provided with appropriate and cost-efficient products and services.

Which? defines effective competition as:

— Firms genuinely compete on the quality and price of their products or services rather than exploiting consumers' behavioural biases;
— Consumers are engaged and able to compare the quality or performance of different financial products and firms;
— The price, quality and characteristics of products are transparent and easily comparable;
— Products do not include hidden charges or unfair contract terms;
— There are low barriers to market entry and exit (while preserving essential services for consumers);
— There are low barriers to switching (both real and perceived);
— Consumers are able to pursue effective and speedy redress where necessary; and
— Conflicts of interests between firms and their customers are removed or managed appropriately.

Various other bodies have made proposals for the FCA to have an operational objective to promote effective competition. The ICB suggested removing the efficiency and choice operational objective and replacing it with an operational objective of 'promoting effective competition for the benefit of consumers'.

Although this differs from our recommendations, we believe this solution is also a suitable way to address the concerns we have with the current drafting.

THE EXTENT TO WHICH CONSUMERS AND SMALL BUSINESS ARE SUFFERING DUE TO LACK OF COMPETITION

The financial crisis has exacerbated pre-existing competition issues which negatively impact many areas of consumer finance.

Authorised overdraft rates have steadily increased and are now close to a 16 year high at 19.38%.[25]

Some banks have switched to daily overdraft fees, substantially increasing the cost of authorised overdrafts. For example, in 2009, Halifax introduced an authorised overdraft policy of a minimum £1 per day fee for all of its current accounts. Ostensibly this is a simpler, more transparent overdraft policy.

However, a consumer would need to have an overdraft of nearly £2000 in order to pay less than the average authorised overdraft rate—according to the Bank of England, 95 per cent of overdrafts are below £2,000.

Changes in the mortgage market since the financial crisis have significantly affected the volume of lending and led to a significant growth in margins.

Existing large banks are significantly above minimum efficient scale and have little need to increase lending in order to increase their profitability.[26] Instead, large banks are focused on restricting overall lending to consumers and small business in order to compensate for investment bank losses.

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[25] Bank of England, Average quoted interest rate, Sterling overdraft, households.
[26] See evidence from John Fingleton to the Treasury Committee, Competition and Choice in retail banking Q 781.

I hope that you find these additional notes useful.

Peter Vicary-Smith
Chief Executive

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