Joint Committee on the draft Financial Services Bill

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AEGON – written evidence

About AEGON

AEGON is one of the UK's leading providers of pensions, life insurance, investments and annuities**.** We also own two large national distribution businesses, Origen and Positive Solutions.

With headquarters in Edinburgh, AEGON employs approximately 3,500 people in the UK and helps around two million customers to secure their long-term financial futures.

We're part of the AEGON Group, one of the world's largest financial services organisations, with a presence in more than 20 countries.

1. **Is the separation of prudential and conduct regulation into a "twin peaks" system the right approach?**

   We don't believe there is a single 'correct' approach. Integrated regulators like the FSA, and twin peaks models such as that proposed by the government, both have advantages and disadvantages. We look for a regulatory framework which will:

   - secure a framework for effective competition;
   - protect consumers and engender trust and confidence in financial services; and
   - ensure that the UK remains internationally competitive.

2. **What lessons can be learnt from the approach of other countries to regulation of the financial sector?**

   Our experience as part of a global group makes us keenly aware of the different nature of markets across the world and of the difficulties of reading across from one to another. We would be wary of simply seeking to replicate in the UK, regulatory systems (or aspects of them) designed for a different market. As one of the leading world financial services markets, the UK market poses singular challenges which require unique solutions.

3. **Is it appropriate to make such major changes to the regulatory system by way of amending legislation, rather than starting afresh?**

   We have no direct comment to make on this. It is the end point that matters rather than the process of arriving at it. Indeed, legislation can in any case only takes us so far. The real test is how it is implemented in practice. It is important that Parliament continue to review the performance of regulators to assess how effectively the legislative powers are being used.

4. **Are the accountability and governance arrangements for the Bank of England, FPC, PRA and FCA satisfactory?**

   Broadly, we believe the arrangements set out in the draft Bill are satisfactory.

5. **Are the FPC's objectives the right ones? Is the concept of financial stability adequately understood for the FPC to be able to perform against its objectives?**

   We have no comment to make on this.

6. **Should the FPC be limited in the actions it can take which might affect the growth of the financial sector?**

   We have no comment to make on this.

7. **How will the interaction between macro-prudential and monetary policies be handled by the FPC and the MPC?**

   We have no comment to make on this.

8. **Has the right balance been struck between the powers of the FPC and the powers of the Treasury?**

   We have no comment to make on this.

9. **Can Parliament take an informed decision about the proposals for the FPC without details of the macro-prudential tools at its disposal?**

   We have no comment to make on this.

10. **Does the draft Bill adequately deal with the risks posed by the shadow banking system?**

    We have no comment to make on this.

11. **Are the PRA's objectives clear and appropriate?**

    The Government has included a specific 'insurance objective' in the PRA's remit in the draft Bill. The Bank of England and the FSA have jointly published separate documents setting out how they anticipate the FCA will approach the banking and insurance sectors respectively. We welcome the acknowledgement that insurance presents different prudential risks from banking. It will be important for regulators to work with the industry as they develop their approach further.

12. **Are there any risks in the Government's proposed 'judgement-based' regulation?**

    There are inevitably risks attached to any regulatory approach and no system can completely remove that risk. Judgement-based regulation carries the obvious risk that the regulators' judgement will be faulty. Indeed, it is clear from the comments of senior regulators that they accept errors will be made.

    Given this is the case, regulators should be wary of building up expectations for the new approach. Regulators have rightly said that isolated instances of misconduct should not be taken as showing the approach has failed. Equally, these isolated instances should not

be interpreted as thematic problems requiring cross-industry solutions when in reality they are particular to a small number of firms or individuals within them.

We believe the best way of mitigating these risks is for regulators to maintain effective dialogue with the industry and consumers. We are pleased that the FSA's Consumer and Practitioner Panels will continue under the new system but are concerned that they sit exclusively within the FCA and do not have a direct 'line of sight' to the PRA.

We also believe better use could be made of the FSA's existing Retail Conduct Risk Outlook (RCRO) approach.

13. Is the Government's proposed approach to 'orderly' firm failure satisfactory?

We have no comment to make on this.

14. Given that the PRA and the FCA will inherit FSA staff does the draft Bill do enough to ensure a new regulatory culture and a more proactive approach to regulation? Will these two new bodies have staff with the appropriate skill and expertise?

It is not clear to us that legislation is the mechanism by which a new culture can be instilled within an organisation. Ultimately it will be for the senior management of the FCA to foster a new culture within the organisation. This will need ongoing attention and scrutiny by Parliament and others.

There are already clear indications that regulators are taking a more proactive approach. The level of supervision such an approach requires in the long term, however, will very probably require the FCA to increase staff resource in this area. Naturally, we are keen that supervisory staff are of the highest calibre but we are concerned at the cost implications of paying enough staff the right sort of salary to attract such high calibre candidates.

Regulators will need to demonstrate on an ongoing basis that these increased costs are proportionate to the risks posed. If risks reduce over time, so too should the staffing levels and costs of regulation.

15. Are the FCA's primary objectives appropriate? Is significant emphasis given to the promotion of competition?

We agree with the Government's view that the duty to promote competition does not necessarily need to take primacy over other objectives. Nonetheless, we are not wholly convinced that the combination of a strategic objective, several operational objectives, and a wide range of regulatory principles and 'have regards', lends itself to clarity in the minds of regulators, firms or consumers as to how these ought to be prioritised and applied in practice, especially on those occasions where they are – or appear to be – in conflict with one another.

The FSA's recent paper, outlining the FCA's future approach, seeks to provide further clarification. Again, we look forward to discussing this further with 'shadow' FCA officials as they continue to develop their approach.

16. Are the responsibilities of the FCA towards the regulation of markets appropriate?

The Government's proposals seem to us to strike a good balance of powers and duties between the FCA and the competition authorities. As with many aspects of the Government's proposals, though, the proof of the pudding will be in the eating: it will be up to the FCA and the relevant competition authorities to ensure that the arrangements work in practice.

17. Does the draft Bill strike the right balance between the responsibilities of consumers and firms? Are the FCA's new powers in the area of consumer protection appropriate?

We are pleased that the FCA's consumer objective, as drafted, requires the FCA to have regard to "the needs that consumers may have for advice and accurate information; (and) the general principle that consumers should take responsibility for their decisions."

We also support the Government's desire to see a "clear focus on consumer outcomes". We would welcome further recognition from the Government and regulators that consumer outcomes are not always best served by an approach which seeks to remove all risk of detriment.

We hope greater clarity will emerge as to how the proposed 'differentiated approach' will operate in practice and on what basis sectors, firms, products and consumers will be differentiated. We accept, for example, that, given the wide definition of consumers in the draft legislation, regulators will need to treat different groups of consumers differently for some purposes. While regulators' judgment will play a part in this, we believe they should attempt to do this on a consistent basis rather than simply 'as the mood takes them' or in response to external exigencies.

We have some comments on the specific powers proposed for the FCA:

- **Product intervention**

We have responded separately to the FSA's consultation on how it will use its product intervention powers. In that response, we expressed our belief that the FCA could achieve many of the intentions behind this by extending the concept of the Retail Conduct Risk Outlook (RCRO) and suggested that it might move from an annual report to a more dynamic communications medium, with a specific element of consultation with industry.

- **Financial promotions**

We support the principle of transparency around the FCA's powers relating to prevention of misleading financial promotions and welcome the safeguards outlined in the White Paper around the publication of enforcement action. However, we remain concerned that publication may become a default mechanism. We believe at each case should be considered on its merits against a set of agreed criteria, which should include the impact on consumer trust and confidence.

- **Early publication of disciplinary action**

Likewise, we welcome the safeguards around the publication of warning notices. It is important that firms and individuals are held to account but equally it would run counter

to the FCA's strategic objective of promoting confidence in financial markets, if consumers' trust was unnecessarily undermined.

18. Are the prudential regulatory responsibilities of the FCA towards FCA-only regulated firms given sufficient emphasis and detail?

The AEGON UK group includes two large distribution businesses, Origen and Positive Solutions. As part of AEGON UK, they will be subject to PRA regulation, while comparable firms will be prudentially regulated by the FCA. It will be important for regulators to work together to ensure that FCA-only regulated firms are not unduly benefited or penalised relative to comparable dual-regulated firms.

19. Will the new regulatory arrangements reduce the risk and cost of dealing with mis-selling of financial products?

We are of the view that at least some of the aims established for the FCA could have been delivered by improvements within the existing framework. Ultimately, although the framework is important, it is the quality of regulation that matters most.

As indicated above, we do have concerns about the cost implications of the FCA's more intrusive supervisory approach. The question posed by the Committee will be an important test of whether that is an effective approach.

20. Are the proposals for co-ordination between the PRA and FCA clear and adequate? What would be the advantages and disadvantages of having a Single Point of Contact and/or a joint rule book for dual-regulated firms?

We are pleased that the draft Bill and recent documents published by the FSA have taken on board some of the concerns expressed by many in the industry around the potential for overlap and conflict between regulators.

We have ongoing concerns that the processes around authorisation and approvals for dual-regulated firms will prove unnecessarily burdensome. We will be expecting further clarification from regulators how they envisage these processes working.

There is a particular concern, as noted above, that firms which would 'normally' be regulated exclusively by the FCA, but which form part of larger groups which are PRA-regulated, will be treated differently from similar 'stand-alone' firms.

We are also unclear as to how the power for the FCA to designate Significant Influence Functions independently of the PRA will work in practice.

We would like to see a formal mechanism put in place to ensure the FCA and the PRA consult with practitioners and, where appropriate, consumers (possibly through the relevant Panels) when they review their Memorandum of Understanding.

21. How do the proposals in the draft Bill fit within the new European regulatory regime? What freedoms and constraints will the UK have to operate within that regime?

In our response to earlier consultations, we highlighted this issue and argued that the new regulators should have a more explicit responsibility for ensuring UK interests are

protected and advanced in Europe. Clearly, a cross-sectoral 'twin peaks' approach does not sit entirely comfortably with the regulatory structure adopted by the EU, with integrated sectoral regulators. It will be a challenge to ensure that UK representatives are fully aware of all the issues they are required to deal with.

The latest White Paper and the draft Bill are, disappointingly, largely silent on this issue but the latest FSA document on the FCA's future approach, gives a clear acknowledgement of this issue and we look forward to developing an effective *modus operandi*.

22. Does the draft Bill contain any proposals or omissions, not covered by the questions above, which cause concern?

We have sought to draw attention in the past to the wide range of current and future regulatory initiatives affecting financial products and distribution, emanating from HM Treasury, the FSA and the European Commission. We believe it is important to consider these issues, and their potential impacts on firms and consumers, in the round, to ensure the risk of unnecessary overlap and confusion is mitigated.

We are concerned that the transition to the new 'twin peaks' structure may prove an unwelcome distraction from these issues at precisely the time when regulatory oversight and co-ordination is most urgently needed.

September 2011

AGE UK – written evidence

Introduction

1. The draft Financial Services Bill is an important step forward. It has the potential to play a key role in improving consumer protection in UK financial services. It must also ensure that consumers can rightly have confidence in the system.

2. Age UK represents a wide range of consumer interests. People aged over 50 are a core market for the financial services industry and UK demographics predict that their importance will grow. The percentage of the total population who are over 60 is predicted to rise from 22% at present to nearly 29% in 2033 and 31% in 2058.[1] Analysis of the Financial Services Authority's (FSA) Baseline Survey of Financial Capability shows that those aged 50+:
   - make up a clear majority of the owners of many savings and investment products and are over-represented in terms of ownership of household insurance
   - hold their own in terms of life assurance and several banking products but are under-represented among holders of many credit products
   - continue to hold a significant number of financial products well into retirement
   - continue to be active purchasers of investment products[2]

3. At the same time, many older people are poorly served by the financial services market. Thirty-nine per cent of people who do not have access to a transactional bank account are over 65, whereas this age group only makes up a quarter of the population.[3] Age UK's recent research has also uncovered a potentially larger group of the 'under-banked', for example almost one fifth of people aged over 75 use someone else to access their day to day spending money.[4] This failure to meet older people's needs is seen both in physical infrastructure, such as ATM design but also in process, such as assumptions that people over a certain age lack the mental capacity to take financial decisions and so cannot be served.

4. Current regulation has failed older people in two main ways: (i) it has not provided adequate consumer protection resulting in a series of waves of major customer detriment, with approximately £15bn compensation paid to consumers since 1990[5]; and (ii) it has not ensured access to essential financial services. We are therefore concerned to ensure that the draft Financial Services Bill works for all consumers, from those with high financial capability and motivation to those who are more vulnerable and are currently excluded from the system. It must also meet the needs of those who may exist somewhere in between, who appear to be part of the system but are under-banked because they cannot access services they wish to use. Our comments focus on changes needed to achieve effective consumer protection and access to essential financial services.

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[1] National Population Projections, 2008 based, Office for National Statistics, 2009
[2] An Inclusive Approach to Financial Products, Beyond Financial Inclusion: involving older people by Age Concern, Annex 1
[3] Fourth Annual Report, Financial Inclusion Task Force 2009
[4] The Way We Pay; Payment systems and financial inclusion, Age UK 2011
[5] Financial Conduct Authority Approach to Regulation, June 2011, para 2.4

The objectives of the Financial Conduct Authority (FCA) and the role of competition

5. There is a tension between the FCA's strategic objective of protecting and enhancing confidence in the UK financial system, and its operational objectives of consumer protection, integrity and choice and efficiency. In order to meet its operational objective of consumer protection the FCA may need to take steps which reduce confidence in the industry in the short term, for example by publicising enforcement action. Part 1A should be amended to make clear that the strategic objective is balanced by the operational objectives, so that the strategic objective is pursued only to the extent that is consistent with the operational objectives, especially the consumer protection objective.

6. The 'choice and efficiency' objective is not sufficient to ensure a competitive marketplace for all consumers. Choice does not necessarily benefit all consumers, particularly those who cannot take advantage of the choice available because they are poor or do not have access to good market information. We support calls for a stronger competition objective, provided that this is balanced by:
   - a clear statement of what the financial services market should look like in terms of consumer outcomes
   - stronger competition powers for FCA, in particular an amendment to s348 to ensure that the FCA can ensure a transparent marketplace
   - a power for FCA to conduct market studies
   - a right for consumer groups to formally bring consumer issues to the attention of the FCA
   - a requirement for FCA to have regard to financial inclusion
   - strong product intervention powers for when competition fails.

7. Competition can be an important tool in ensuring an effective and efficient market, however it is a tool not an outcome. The FCA must have a clear vision of what a competitive financial services market should look like. This should be based on consumer outcomes, rather than firm focused, so that the test as to whether the market is competitive is measured by factors such as how easy it is for consumers to switch products and whether the market innovates to meet consumer need. FCA will also need to consider value for money provided by financial services and products in assessing how well competition is operating.

8. The FSA's Product Intervention Discussion Paper highlights situations in which consumers are obstructed from making good decisions by the way in which products are sold. [6] This could be addressed by rule-making, however FCA must be prepared to make more far reaching rules for example on timing of fees, product bundling and some cross-subsidies. The FCA will need a stronger competition mandate to justify these steps.

9. The Product Intervention Discussion Paper makes clear that there are serious competition failings which cannot be addressed by consumer empowerment alone. Many products are bought only once and consumers will often not know that there is

[6] FSA DP11/01 Product Intervention

a problem with their product long after their decision to purchase. Rule making and firm specific powers are not designed to address these types of issue and more structural intervention may be needed. The FCA should therefore be given a power to conduct market studies. As the FCA is closer to the market it is appropriate that it can conduct the study and refer on to the Office of Fair Trading or the new Competition and Markets Authority if necessary.

10. Competition cannot be expected to work for customers that financial firms do not find profitable to serve. The FCA therefore needs a clear mandate to improve access to essential financial services.

11. Some financial services are essential services to which consumers must have access in order to participate fully and independently in UK society. For example, it is Government policy to encourage everyone to open a bank account, yet there is nothing to ensure that accounts will be available to everyone who needs them. In fact, we are currently seeing facilities reduced on basic bank accounts, for example RBS has just announced that basic bank account customers will only be able to use RBS cash machines and Post Office network and will not have access to the rest of the ATM network.

12. Access to essential financial services should be understood as more than just having a basic bank account. This should include issues previously covered by the Financial Inclusion Task Force but must go further. The recent cheques saga is a prime example. Consumer payment systems are vital infrastructure and should be regarded as utility services rather than retail products. The lack of access regulation has meant that the banks, through the Payments Council, have been able to unilaterally announce a target closure date for cheque clearing and take actions that could effectively undermine the cheque. The Payments Council's recent decision to abandon its cheque replacement programme has been achieved largely as a result of external pressure. It is unacceptable that vital infrastructure can be mis-managed in this way. The Government must accept the Treasury Select Committee's recommendation that cheques are brought within the formal regulatory system. These principles do not only apply to cheques, but also other consumer payment services. Government should specify other classes of essential financial services and products with respect to which the FCA should have an access mandate.

13. In addition to specific access regulation in respect of key products and services the Government could consider requiring the FCA to have regard to a financial inclusion code which could be set by the Treasury. Because this is a more flexible approach it could cover an area broader than essential services but help further social policy, for example increasing access to home contents insurance. Alternatively, the FCA could be given a socio-economic equality duty similar to that placed on local authorities and other Government bodies by the Equality Act 2010. Currently, FCA is not a listed body under clause 1(3) of the Act.

14. Financial inclusion and access mandates have been rejected in previous consultations on the grounds that the regulator would be taking over a social policy role from the Government. This is a groundless concern. The Government should set policy, however the FCA will play an important role in its implementation. It is therefore key that the FCA has both mandate and powers to do so.

Consumer responsibility, consumer protection and the rights of firms

15. The draft Bill does not go far enough to instil the appropriate balance between the responsibilities of firms and consumers. This draft Bill is presented following what the FSA's Chairman described in 2010 as 'a series of waves of major customer detriment'.[7] The FCA Approach to Regulation document gives a figure of approximately £15 billion compensation paid to consumers since 1990 (excluding payment protection insurance (PPI) compensation), with millions of consumers suffering detriment on a large scale.[8] PPI is an excellent example of how difficult it can be for a regulator to take action to protect consumers even in cases of gross detriment, and it is not a one-off. We can also consider other scandals, mortgage endowments (around £3bn compensation), pensions mis-selling (£11.8bn compensation), split capital investment trusts (£196m compensation).[9] The FSA accepts that it and its predecessor regulators were too slow to act. The FSA cites PPI as an example in which it started to use a more proactive approach. It was met by a judicial review from the British Bankers' Association.

16. The above examples demonstrate clearly that the balance needs to move towards much greater consumer protection.

17. This does not require that the FCA should be a 'consumer champion', but it does mean that the FCA should have necessary powers, designed to be used as swiftly and effectively as possible. Where safeguards are put in place for firms these must be balanced by transparency and mechanisms which allow consumers and consumer groups to challenge inaction. The consumer protection objective is not sufficient on its own to ensure this, as it is too easy for it to be trumped by specific, more detailed provisions safeguarding firms. For example s348 FSMA, Restrictions on disclosure of confidential information by the Authority could prevent the FCA achieving its transparency principle. Section 348 should be amended so that it is clear the FCA will be free to use transparency as envisaged in the regulatory principles.

18. We also welcome the new product intervention powers set out in s137C. They follow extensive consultation and discussion, including a review of recent mis-selling and other scandals. The new powers are clear and minimise uncertainty. Innovation should not be impeded as firms will be free to discuss proposals for new products with the FCA well in advance of seeking to market them if the product is potentially 'close to the line'.

19. These powers should, however, go further. They should apply to services, not simply products. Consumers do not distinguish between the two and services are often integral to the suitability of products.

20. We dispute arguments that the proactive approach and product intervention powers will reduce choice and innovation with negative effects for consumers. As stated in paragraph 6, choice and innovation do not always deliver positive outcomes for consumers, if they lead to confusion marketing of poor quality products.

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[7] Speech by Adair Turner, FSA Chairman, British Bankers' Association Conference, 13 July 2010

[8] Financial Conduct Authority Approach to Regulation, June 2011, para 2.4

[9] Described in greater detail in the FCA Approach Document, Ch 5.

21. The principle of consumer responsibility has provoked some discussion from industry during the consultation period. Some respondents have argued that the Government needs to focus less on disciplining the industry and more on ensuring consumers take responsibility for their actions. We disagree. Consumers inevitably take responsibility for their purchases. They are left with the product, even it is unsuitable and must invest considerable time and effort in any attempt to seek redress.

22. The increase in transparency, especially regarding publication of decisions on financial promotions and enforcement action is welcome. This should incentivise firms to take compliance seriously. Consumers have a right to know which firms do not. The use of the word 'consult' in Schedule 8 to the draft Bill, paragraph 24 is inappropriate. It is appropriate that the FCA give firms notice of an intention to publish an early warning notice and listen to representations from them, however, the notice period should not be a negotiation. An additional provision should be added in respect of both the new power to publish action taken in respect of misleading financial promotions (new section 137P) and to Schedule 8, requiring the FCA to include information in its annual report on how many times it has decided not to publish in respect of each new power. This is important to allow consumers and the Government to monitor the balance of disclosure and the extent to which transparency is achieved.

23. The Government is still consulting on provisions to permit consumer groups to formally bring consumer issues to the attention of the FCA.[10] This is a core provision and without it the balance between consumers and firms will barely have moved and will in fact have reversed. Consumer and other relevant groups should have a formal right to bring mass detriment to the attention of the FCA, with a legislative requirement for the FCA to respond publicly, in detail and within a reasonable time period. This will enable consumers and Parliament to challenge the FCA on its response to perceived detriment and should greatly enhance confidence in the FCA. Currently consumer groups can submit concerns to the FSA and receive no response at all. This undermines trust in the process and discourages consumer engagement. It also represents a key imbalance in the current system. Firms are able to challenge action, but consumers are powerless to challenge inaction.

24. In order to address this profound imbalance the provision should go further and require the FCA to investigate and act if there is reasonable evidence of mass detriment. We comment on the need for greater clarity on evidence requirements in paragraph 28 below.

25. It is vital that s404 FSMA remains. It has only just been passed into law and is an important consumer protection tool. If the FCA is unable to address consumer detriment effectively it will never gain the respect of consumers or industry and will be unable to act as a credible deterrent to consumer detriment.

26. The FCA's new responsibilities to take into account reports made to them by Money Advice Service (MAS) and the Financial Ombudsman Service (FOS) should also assist

[10] Box2.H A new approach to financial regulation: the blueprint for reform, June 2011

the FCA in striking an appropriate balance. MAS and FOS should have a thorough and up to date understanding of the relationship between consumers and firms. This knowledge of how consumers and firms are interacting in practice will enable the FCA to evaluate the effectiveness of its consumer protection work and also to set an appropriate agenda to address future conduct risks.

27. We welcome the approach taken in clause 20, *Proceedings before Tribunal*, to require the Financial Services Tribunal to remit matters back to the decision maker rather than substituting its own opinion.

Judgment based approach

28. The main risk in the new regulatory approach is that the FCA does not act swiftly or effectively. There is insufficient detail on the judgment based approach to show whether it will help or hinder. Our key concern is that it will discourage action if the regulator requires an excessively high evidence threshold before acting. We agree that decisions should be rigorously evidence-based, however more detail should be provided on what constitutes sufficient evidence. This would help consumers provide information to the FCA in the most useful form and would also aid understanding of when the FCA is not able to take something forward for lack of evidence. The evidence required should be reasonable and not impossible to obtain, otherwise consumer bodies, which have no right to demand information from firms, will never be able to make a viable case for the FCA to take action.

Culture of the regulators

29. Currently there is too much reliance on changing the culture of the FCA in order to ensure that the new approach is effective. Culture is vital and the current FSA and shadow FCA do appear committed to the more proactive approach, however this needs to be strongly under-pinned in legislation to ensure durability over time and a robust response to likely challenge from industry.

30. Challenge from external bodies will also be critical in ensuring a new regulatory approach. "Group think" has previously been identified as a real risk in regulation, especially in relation to spotting emerging issues.

31. The provisions regarding panel representation for the FCA are therefore strongly welcomed. However, the Treasury should legislate for similar Panel representation for the Prudential Regulatory Authority (PRA). The Panel system has worked well for the FSA and no reasons have been given as to why it would not work well for the PRA. At a time of such upheaval there is real advantage in using a system which is already familiar and tested. Consultation is an important part of governance and accountability. Given that real consultation will necessarily involve challenge it should not be left to the discretion of the PRA to determine how it occurs.

32. The PRA should also have a requirement to consult consumers, this will allow otherwise unforeseen impacts to be picked up early. It will also ensure that engagement is not simply reactive, but also helps the regulators to set appropriate agendas. The PRA will take decisions which will have significant impact on consumers (e.g. loan to value ratios) and consulting with the FCA is not equivalent to direct engagement with consumers. It is therefore important that as a minimum the Consumer Panel is able to advise the PRA.

Should the FPC be limited in the actions it can take which might affect the growth of the financial sector?

33. No. Whilst it is right that the FPC should be aware of the importance of the financial sector to the UK economy this should not outweigh the financial stability objective. The general principle that regulation should be proportionate to the risks involved should be sufficient to ensure appropriate balance. The UK needs a sustainable financial sector and if the FPC finds this requires limitation of unsustainable growth then it should be free to act in the interests of long term sustainable growth for the economy as a whole.

Are the PRA's objectives clear and appropriate?

34. We are concerned that an excessive focus on stability will encourage regulators to subordinate consumer protection to maintaining firms in business, therefore we support the clarification added by the Treasury that the PRA is not tasked with ensuring zero failure. It is important that the PRA does not seek to ensure continuity of service simply by keeping all firms afloat. However the possibility of allowing firms to fail requires that the Financial Services Compensation Scheme (FSCS) remains in operation and effective. If this scheme is not robust and adequate it would be necessary for the PRA to take a different approach to relevant firms. The future of the scheme is therefore critical to the PRA as currently envisaged.

Will the new regulatory arrangements reduce the risk and cost of dealing with miss-selling of financial products?

35. The new arrangements have the potential to reduce costs if they are used proactively. They do not guarantee reduced costs in themselves.

Does the draft Bill contain any proposals or omissions, not covered by the questions above, which cause concern?

36. The Government is still consulting on key provisions regarding the Financial Ombudsman Service (FOS). FOS is a critical part of the consumer protection landscape and must not be weakened. We are aware of a range of criticisms of FOS on the grounds that it has become too influential and acts as a quasi regulator. If FOS has increased in influence it is because of the number of complaints it receives. FOS does not generate complaints and it cannot be penalised for doing its job. In particular FOS must remain free to consumers at point of access.

37. We strongly support proposals to require FOS to publish its decisions. These are an important complement to the FCA's enhanced transparency powers and will help both consumers and firms to make better decisions regarding complaints. FOS should be required to publish the name of the firm involved, unless FOS considers it would be inappropriate. The name of the consumer should not be published as this will deter consumers from taking complaints to FOS.

September 2011

Association for Financial Markets in Europe (AFME) – written evidence

1 Introduction

1.1 The Association for Financial Markets in Europe (AFME) welcomes the opportunity to give evidence to the Joint Committee on the draft Financial Services Bill (the Joint Committee).

1.2 The draft Financial Services Bill (the draft Bill) will create a new UK framework for financial regulation and establish regulatory authorities with wide ranging powers. It is also a complex, and amending, legislative proposal that tries to strike the right balances between, amongst other things:

(a) empowering regulators and providing appropriate checks and balances (including rights of appeal for regulated firms and accountabilities to Parliament); and

(b) enshrining sufficient detail with respect to the operation of the new framework whilst giving the new regulators freedom to determine the specific operational arrangements.

However, as we will highlight in our evidence, there are concerns that in a number of areas, these balances have not been struck appropriately. Hence, we very much welcomed the Government's decision to publish a draft Bill for pre-legislative scrutiny and believe that the Joint Committee's report – particularly given the Committee's decision to take evidence from interested parties on a number of contentious policy issues – will play a very important role in improving the quality of the new legislation (in particular, the Bill to be introduced into Parliament in 2012).

1.3 AFME represents a broad array of European and global participants in the wholesale financial markets; (our members comprise pan EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants). In giving evidence to the Joint Committee, AFME will, therefore, focus on wholesale financial services issues as well as more general issues of concern to our members, the majority of which will be regulated by both the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) (i.e. "dual regulated firms").

1.4 We would be happy to provide further and better particulars on any points raised in this evidence.

2 Executive summary

2.1 There can be little doubt that the United Kingdom's (UK's) system of financial regulation – in particular the tripartite system involving the Financial Services Authority (FSA), the Bank of England (the Bank) and HM Treasury (the Treasury) – was found wanting when tested by the financial crisis.

2.2 The House of Lords Select Committee on Economic Affairs' 2nd Report of Session 2008-09 on Banking Supervision and Regulation, summed up the failure of regulation and supervision as follows:
"*Why did the framework of regulation and supervision, in Britain and elsewhere, fail to fulfil its principal purpose of avoiding or mitigating financial crisis? There are many reasons, including:*

- *the application of the regulations themselves contributed to the crisis and made it worse when it came because, among other things, they had a pro-cyclical bias, did not pay enough attention to liquidity, had built-in reliance on ratings agency opinions and were wide open to regulatory arbitrage;*
- *the tripartite authorities in the United Kingdom (Bank of England, Financial Services Authority (FSA) and Treasury) failed to maintain financial stability and were found wanting in dealing with the crisis, in part because the roles of the three parties were not well enough defined and it was not clear who was in charge;*
- *too little attention was paid in the United Kingdom to macro-prudential supervision (oversight of the aggregate impact on financial stability of individual banks' actions); only the Bank of England and the FSA were in a position to assess it;*
- *the FSA concentrated on its responsibility for conduct-of-business supervision (concerned mainly with consumer protection) and did not pay full attention to micro-prudential supervision (the solvency and sustainability of individual banks);*
- *the FSA had an inadequate understanding of the complexity and limitations of the risk assessment models used by the banks it was supervising.*

It seems clear that the causes of the crisis were not simply management failure at some (but by no means all) banks but also commensurate failures in regulation and supervision, together with shortcomings on the part of the ratings agencies."

2.3 There can also be little doubt that reform was needed, but opinion was – and still is - divided on how the tripartite system should be reformed to correct the weaknesses identified. It is, we believe, universally agreed that, in the UK as in a number of other countries, macro-prudential oversight had been missing; it is also widely recognised that there are natural synergies between macro-prudential regulation and the role of the Bank. Indeed, even before the Government was elected, the Economic Affairs Committee[11] recommended that "*the Government should as a matter of priority revisit the tripartite supervisory system in the United Kingdom. It should return responsibility for macro-prudential supervision to the Bank of England, with executive powers to be exercised through a broader-based Financial Stability Committee (FSC), including substantial representation from the FSA and the Treasury. This arrangement would be consistent with the Bank's enhanced statutory responsibility for financial stability. The Bank must have adequate institution-specific information to function effectively during a financial crisis. At the same time, the Government should give further thought to where responsibility for micro-prudential supervision should lie.*"

2.4 It is on the last point – where responsibility for micro-prudential supervision should lie – that most differences of opinion arose and, indeed, still arise,

[11] House of Lords Select Committee on Economic Affairs' 2nd Report of Session 2008-09 on Banking Supervision and Regulation

particularly at an academic level. However, whilst AFME recognises that there were a number of different options for regulatory reform, from a practical perspective, we do not believe that it serves a useful purpose now to debate the respective strengths and weaknesses of these possible models. As a decision has been made by the Government, AFME members are now focused on, and engaged with, the need to ensure that the framework for financial regulation that is to be set out in the new legislation delivers clear, consistent and effective regulation, within the context of the wider system of European Union (EU) financial regulation and the global nature of the financial markets. AFME members are also concerned to ensure that the new and enhanced regulatory powers – the need for which we recognise – are appropriately prescribed and that the new legislation includes due process and reasonable checks and balances. Whilst we believe that the quality of the legislation is more important than keeping to an agreed, but nevertheless facultative, timetable, it is also important to minimise this period of uncertainty for the markets and firms.

3 Specific questions

3.1 We note that the Joint Committee is interested, specifically, in whether the draft legislation will or could better:

- prevent another financial crisis,
- handle a financial crisis,
- deal with bank failure and protect the public purse.

3.2 History, it is said, never repeats itself and certainly crises tend to reinvent themselves; hence, in legislating to prevent the last crisis, one must be mindful that the next crisis could – and probably will – have very different characteristics. With that in mind, it is important to 'future proof' any new legislation and/or regulation by trying to identify, and resolve, potential fault lines.

3.3 AFME believe that the Financial Policy Committee (FPC), if it operates effectively, is capable of *identifying* the next crisis at a far earlier stage. However, given the ability of financial markets to transmit instability globally and the fact that the next crisis might not arise in the UK, it is vital that the FPC coordinates with EU, national and international bodies with responsibilities for macro-prudential regulation; in particular, the European Systemic Regulation Board (ESRB), the US Financial Stability Oversight Council (FSOC) and the Financial Stability Board (FSB).

3.4 No regulatory framework can guarantee to prevent a crisis any more than it can guarantee zero failure of firms. Whether a crisis can be "*prevented*" or mitigated by the UK authorities, will depend on, amongst other things, whether or not the risks identified arise within the scope of UK regulation; the effectiveness of the FPC's macro-prudential tools; the quality of UK regulation, and the effectiveness of regulatory coordination (both domestically and internationally).

3.5 The FSA's Handbook is sometimes criticised for its voluminous nature and embedded within its provisions are the rules that were designed to prevent past regulatory failings from reoccurring. History, however, has taught us that adding layer upon layer of regulation whilst at the same time effectively fossilizing earlier provisions does not prevent crises or regulatory failures: indeed, complexity of regulation may distract from the bigger issues.

3.6 The draft Bill introduces a new approach to regulation, which assigns clear responsibilities and allows regulators to develop approaches based on judgement, however, the quality of regulation will, ultimately, depend upon the quality of the regulators and regulatory data to which they have access together with the effectiveness of the arrangements that are put in place to coordinate the new framework, both internationally and domestically. As we will discuss in our evidence, AFME members are of the strong opinion that the legislation should provide a mechanism for coordination and that, in particular, further thought needs to be given with respect to the coordination of, amongst other things, rule-making, the approval regime and EU and international engagement.

3.7 As the Joint Committee will be aware, significant work has been carried on, post-Lehman Brothers, to create a Special Resolution Regime for banks and a Special Administration Regime for investment banks. Centralising responsibility for micro-prudential supervision and the Special Resolution Regime within the "Bank Group" will, we believe, create operational issues that will need to be managed (see our response to Q4), but provided the relationship between the Bank, the PRA and the Treasury is effective, the UK should far better equipped to coordinate a response to a future crisis and protect customers in the event of a future bank failure. However, given the FCA's responsibly for the regulation of client assets and client asset protection, the FCA's role in relation to, in particular, dual-regulated firms' recovery and resolutions plans and, in general, the crisis management arrangements, needs to be clarified and, we believe, enhanced.

3.8 We note that the Joint Committee is also interested specifically in whether the proposals in the draft Bill will increase or decrease the risk of regulatory arbitrage. This raises a vital point: the need for a global level playing field. Given that financial instability can be global, there needs to be a coordinated international regulatory approach both to achieve financial stability and to avoid regulatory arbitrate: a key objective of this approach should be international consistency, which, in turn provides competitive neutrality. We believe that the UK regulators should be given a duty to evaluate how proposed approaches to achieving their statutory objectives would fit in a global context and, in so far as is compatible with their objectives and statutory duties, maintain international consistency. We discuss this issue in more detail in our response to Q22 below.

4 Detailed questions

4.1 We turn now to the detailed question of interest to the Joint Committee. Whilst we are responding to a number of questions in order, our priority issues include:

- Q21 European integration
- Q22 New and enhanced regulatory powers
- Q20 PRA and FCA coordination e.g. for dual-regulated firms
- Q16 Market regulation
- Q12 Judgement-led regulation
- Q4 and Q6: macro-prudential regulation

We are conscious of the fact that we raise some of our concerns – for example, coordination – in response to a number of the Joint Committee's questions. However, given the cross-cutting nature of some of the framework issues, we believe that such repetition is unavoidable and, we trust, excusable.

Q3. Is it appropriate to make such major changes to the regulatory system by way of amending legislation, rather than starting afresh?

AFME strongly supports the Government's decision to give effect to the new regulatory framework by amending the Financial Services and Markets Act 2000 (FSMA) rather than repealing FSMA, redrafting it and re-enacting it in full. Whilst a new, self-contained, Act might be the purist choice, in practice, opening FSMA to debate, particularly at this time, would have significantly extended the length of the legislative process and, hence, the period of uncertainty for markets and firms. There would also have been a risk that amendments might have been tabled in relation to sections of FSMA that do not need to be altered – possibly reopening old debates – thus taking focus and, crucially, Parliamentary time away from the new provisions, a number of which warrant careful scrutiny (e.g. to ensure that there is due process in relation to the new or enhanced regulatory powers). In moving forward, it is always important to learn the lessons of the past and the passage of the Financial Services and Markets Bill serves as a reminder of what one could reasonably have expected had the Government chosen to redraft and re-enact FSMA in its entirety

Q4. Are the accountability and governance arrangements for the Bank of England, FPC, PRA and FCA satisfactory?

The FPC, whilst it will not regulate individual firms, may well have the greatest and most significant impact of all the new regulatory bodies: on the financial services sector; on the UK economy; and, on the consumers of financial services. Given the formidable powers of direction to be given to the FPC and the macro-prudential tools that are likely to be at its disposal, we remain concerned with respect to the arrangements for accountability and governance for the FPC, both in its own right and as part of the Bank at large.

As the Joint Committee will be aware, AFME submitted evidence to the Treasury Committee's inquiry into the accountability of the Bank of

England, which highlighted a number of areas of concern, including the balance of external versus internal members, the perceived independence of external members – and on this point we continue to believe that the CEO of the FCA should not be regarded as an external member – and the breadth of financial sector expertise available to the FPC. In addition, given the Bank's enhanced financial stability objective and the FPC's powers and wide ranging remit, we also question whether the FPC should be a Committee of the Bank, on an equal footing to the Monetary Policy Committee (MPC)?

This is clearly a complex but – given the significant new powers to be given to the Bank and the significant new responsibilities to be placed on its key staff – critical issue, which may also need to be addressed by the Joint Committee following publication of the Treasury Committee's report.

With respect to the PRA, we would question the extent to which the PRA will, in practice, have true operational independence. Hence, in addition to the non-executive director majority, the PRA's governance arrangements will need to ensure that the PRA's operations, to the extent appropriate, are distinct from the Bank and include, in some areas, firewalls. We believe that this operational separation should be enshrined in the new legislation.

In particular, the PRA will be responsible for triggering a failing firm's entry into the Bank's Special Resolution Regime but the PRA's chair – in the capacity of Governor of the Bank – will also have responsibility for the Bank's Special Resolution Unit (SRU). It is important that there are clear procedures for ensuring that the PRA can operate independently in reaching supervisory judgments on the firms it regulates (as opposed to day-to-day communication on matters relating to, for example, policy and technical issues).

Q5. Are the FPC's objectives the right ones? Is the concept of financial stability adequately understood for the FPC to be able to perform against its objectives?

Whilst the FPC's objective appears sensible, to ensure accountability we believe that a definition of financial stability is needed, against which the FPC and the Bank can be judged. Whilst we recognise that there is no universally agreed definition of financial stability, there are a number of good working definitions in current usage that could be considered as the basis for a statutory definition (which, to ensure a greater degree of flexibility, could be set out in secondary legislation, possibly with the FPC's macro-prudential toolkit).

It is important to recognise that, given the global inter-connectedness of the financial markets and the cross-border nature of financial services, macro-prudential regulation cannot be 100% effective if operating purely at a domestic level. Whilst this should not, of course, prevent the

development of domestic macro-prudential regulation, in time there needs to be a global early warning system – created by linking the new domestic macro-prudential regulators – which monitors and reports on pre-determined indicators; such a system should be self reinforcing and allow for evaluation, as experience of macro-prudential regulation builds.

Hence, notwithstanding the need to have an objective that is measurable and upon which the FPC is accountable to Parliament, we also believe that the new legislation should give the FPC an explicit general duty to coordinate with the ESRB and work with other international macro-prudential bodies such as the FSB and its US counterpart, the FSOC. This is in addition to the higher level general duty in new section 9E of Bank of England Act 1998 (inserted by clause 3 of the draft Bill), to "*have regard to…(c) the international obligations of the United Kingdom, particularly where relevant to the exercise of the powers of the Committee in relation to the FCA and the PRA*."

Q6. Should the FPC be limited in the actions it can take which might affect the growth of the financial sector?

AFME believes strongly that the FPC should be given a positive – rather than the current negative – duty in respect of giving due weight to economic growth, as it must be recognised that steps to enhance financial stability can run counter to economic growth.

We note, in this regard that the objectives for the ESRB state that, inter alia: "*It shall contribute to the smooth functioning of the internal market and thereby ensure a sustainable contribution of the financial sector to economic growth*". The FPC could, likewise, be required – except where it conflicted with its objective – to exercise its regulatory functions in a way that enables the financial services sector to make a sustainable contribution to medium and long term economic growth.

The duty in relation to economic growth, as currently drafted, also has a subjective element, which has implications for proper accountability. The FPC is able to form its own "*opinion*" as to whether a course of action might "*be likely to have a significant adverse effect on the capacity of the financial sector to contribute to the growth of the UK economy in the medium or long term*." If the negatively drafted duty is to be retained, in the interests of accountability we believe that Parliament – in particular the Treasury Committee – should be able to form its own view on whether or not the FPC exercised its functions in a way that was reasonably "*likely to have a significant adverse effect…*" on economic growth i.e. a reasonableness test should replace the more subjective "opinion" of the FPC formula used currently, thereby assisting Parliament to assess the FPC's actions and hold it accountable for, inter alia, the socio-economic effect of the macro-prudential tools it deploys.

Q9. Can Parliament take an informed decision about the proposals for the FPC without details of the macro-prudential tools at its disposal?

In an ideal world, the proposals for the FPC should include its macro-prudential toolkit, even if this is to be laid down in secondary legislation at a later stage. However, given that the FSB, the Bank for International Settlements (BIS) and the International Monetary Fund (IMF) are still working jointly on the G20 commitment to develop macro-prudential tools, it is important that the UK seeks to develop and implement international, rather than UK-centric or bilateral, solutions, even if that means a slight delay to allow a consensus to be reached.

In principle, however, we do believe that it *is* possible to make an informed decision on the proposals for the FPC absent the final toolkit. The individual macro-prudential tools themselves may be complex but the biggest issue is how the likely consequences of the tools will be assessed by the FPC, the checks and balances over their deployment and how the FPC will account to Parliament for their use, including any unintended socio-economic consequences (which may not become evident for some while after the use of a macro-prudential tool) as well as the intended effects.

For example:

- under new section 9L(2) of FSMA (inserted by clause 3 of the draft Bill), the Treasury will have the power where necessary, by "*reason of urgency*", to bring into force new tools without consulting Parliament. We consider that this power should be more tightly circumscribed to reflect that Parliamentary scrutiny should occur in <u>all</u> except the most exceptional circumstances and that the Treasury should provide a report on the circumstance to Parliament, in the event an order is laid after it has been made.
- given the untested nature of many of the tools, we believe that the secondary legislation made under new section 9K(4) of the Bank of England Act 1998 (inserted by clause 3 of the draft Bill), should *always* require the FPC to maintain a policy statement in relation to the use of each tool and that the policy statement should articulate the potential socio-economic impacts of individual tools.

The FSB, the BIS and IMF have recognised that one of the challenges is the "*design of appropriate governance arrangements for the exercise of the macroprudential policy powers."*[12] If possible, we believe that the Bill should be aligned with the outcome of this work.

AFME stands ready to provide technical input on the FPC's proposed macro-prudential tools and awaits the publication of the draft secondary legislation, which will set out these tools, with interest. In the meantime, as already noted, how the tools are actually used in practice,

[12] The joint, FSB, Bank for International Settlements and IMF, February 2011 update to the G20 finance ministers and central bank governors on "Macroprudential policy tools and frameworks".

the checks and balances over their deployment and the FPC's accountabilities to Parliament, are all issues that have significant ramifications for the economy, financial services and individual consumers.

Q10. Does the draft Bill adequately deal with the risks posed by the shadow banking system?

We believe that the FPC should, if operating effectively, be well placed to identify and monitor risks arising from outside the regulated sector. In the event that such risks are identified, the FPC will be able to make a recommendation to Treasury, under new section 9N(2)(b) of the Bank of England Act 1988 (as amended by clause 3 of the draft Bill) that the activities be brought within scope of regulation. However, given that the risks may arise outside the UK – and hence, beyond the scope of UK regulation – we believe that, as discussed above, it is vital that the FPC be placed under a legislative duty to coordinate with the ESRB, third country counterparts, such as the US FSOC, and international bodies, such as the FSB, to seek to ensure a consistent international approach is taken.

Q11. Are the PRA's objectives clear and appropriate?

We support the PRA's financial stability objective, in new section 2B(2) of FSMA (inserted by clause 5 of the draft Bill), which focuses on the firms it regulates rather than the financial stability of the wider financial system (which would overlap with the responsibilities of the FPC). We also support new section 2H of FSMA (inserted by clause 5 of the draft Bill), under which the PRA must issue guidance setting out how it will interpret its objective in relation to different kinds of firms or regulated activity.

That said, we note that the PRA's general objective is: "*promoting the safety and soundness of PRA-authorised persons*" while new section 2B(5) of FSMA (inserted by clause 5 of the draft Bill), provides that: "*In this Act "PRA-authorised person" means an authorised person who has permission –*
(a) given under Part 4A, or
(b) resulting from any other provisions of this Act,
to carry on regulated activities that consist of or include one or more PRA-regulated activities."
The definition of PRA-authorised person will, therefore, include incoming EEA firms establishing branches in, or providing cross-border services into, the UK, which are automatically authorised under Schedule 3 to FSMA to carry on PRA-regulated activities.

Given that the single market directives afford limited powers to Host State competent authorities and, in particular, prudential regulation is reserved to the Home State competent authority, it is important that the drafting of the PRA's financial stability objective does not create an expectation as regards non-UK authorised EEA firms that is undeliverable in practice. Host and Home State competent authorities will need to work together closely, in supervisory colleges, to supervise

EEA groups and EEA firms that have exercised their rights to passport. Unless there is a change to the single market directives' passporting mechanisms and the Home/Host state division of responsibilities, we do not believe it would be appropriate for a Host State competent authority to challenge areas of regulation reserved to Home State competent authorities, however well intentioned. We also believe that the credibility of the PRA might be damaged if it appeared to promise (to the general public and to Parliament) a level of regulatory scrutiny of incoming EEA firms that it, ultimately, did not have the power to deliver.

In summary, we consider that the definition of 'PRA-authorised person' is potentially misleading and should be refined. We suggest that the current approach to distinguishing 'FSA authorised and regulated' and 'FSA regulated firms' be continued i.e. using 'PRA-regulated person' when referring to the PRA's regulatory oversight (although, as discussed, this is limited in respect of incoming EEA firms) and 'PRA-authorised person' when referring to firms actually authorised by the PRA under Part 4A FSMA.

Q12. Are there any risks in the Government's proposed 'judgement-based' regulation?

We welcome the concept of judgement-led regulation, particularly since more mechanistic approaches can focus on detail to the exclusion of the 'bigger picture'. However, we do have concerns regarding both the ability of the new regulators to deliver the approach in practice and the safeguards that will be available for firms.

First, judgement-led regulation is predicated on, amongst other things, the quality of staff and data. Supervisors will need to have sufficient knowledge and understanding to make, often complex, judgements on the firms they regulate and will need to have access to well-targeted, reliable, data. For example, to challenge a firm's business model a supervisor will require a depth of industry experience, the skills to be able to explain and debate with the firm's senior management and an understanding of models used by similar firms. Hence, the quality of supervisors and supervisory data will be of critical importance to the effectiveness of judgement-led supervision.

Second, we have concerns relating to the transparency and fairness of decision making and the mechanisms available to firms to escalate disagreements and concerns. It will, therefore, be vital for the PRA (and the FCA) to have sufficiently robust internal procedures in relation to the review of judgements and consistency of approach and, where the judgements do not trigger supervisory notices (for example, in relation to capital held by firms under Pillar II), due processes that give firms an opportunity to escalate differences of opinion and concerns within the PRA.

Whilst we recognise that the internal decision-making procedures for routine judgements <u>not</u> triggering statutory notices will be for the PRA

(and the FCA) to design and implement, we believe that the new legislation should enshrine the key principles and provide safeguards in relation to regulators' discretionary powers. For example, the new legislation could enshrine principles such as internal reviews to ensure consistency and, for material decisions, the separation of the ultimate decision-makers from the firms' supervision teams and require regulators to develop an escalation procedure for firms wishing to raise issues with independent PRA technical experts and/or members of the PRA management team. We also believe that the PRA and the FCA should be required by the new legislation to publish statements of their policy in relation to the supervision of firms.

Q13. *Is the Government's proposed approach to 'orderly' firm failure satisfactory?*
Whilst the high-level approach appears sensible, it will need to be dovetailed into the forthcoming crisis management proposals from the EU Commission and the FSB's work on Systemically Important Financial Institutions. As a point of detail, we believe that the FCA, as the regulator with responsibility for the regulation of client assets, should have a formalised role in relation to dual-regulated firms' the recovery and resolution plans.

Q14. *Given that the PRA and the FCA will inherit FSA staff does the draft Bill do enough to ensure a new regulatory culture and a more proactive approach to regulation? Will these two new bodies have staff with the appropriate skill and expertise?*
Whilst we do not see this as an issue for primary legislation, we believe that the new regulators should do more to promote the attractiveness of regulation as a career; including hiring more high quality, experienced, industry professionals, and investing in a rigorous, in depth, training program. We believe that the UK should have a formal secondment programme to the European Supervisory Authorities (ESAs) - as well as to firms - which would enhance the perception of regulation as a career; leading to better supervision and improved continuity between firms and regulators.

Q15. *Are the FCA's primary objectives appropriate? Is significant emphasis given to the promotion of competition?*
Overall, we believe that the FCA's primary objectives are appropriate[13]. In respect of the additional competition powers given to the FCA, we believe that the balance appears to be about right: i.e. the FCA will have more tools available without becoming a competition or economic regulator.

In practice, integrating the new competition duty into the work of the FCA is likely to identify a number of philosophical and practical issues. In particular, the interaction between this new duty and the FCA's operational objectives requires greater clarity but we believe that this

[13] See our response to Q16 re the UK Listing Authority.

clarity will be largely achieved by better definition of the FCA's role in relation to competition (e.g. to enshrine the Government's intention that the FCA will not be an economic (price) regulator).

Q16. Are the responsibilities of the FCA towards the regulation of markets appropriate?

AFME strongly supported the Government's decision to retain the UK Listing Authority (UKLA) within the FCA and we believe that this will ensure that the FCA's Markets Division continues to be an effective and efficient regulator of both the primary and secondary markets.

However, we share the concern, expressed by the IMF in their paper, United Kingdom: The Future of Regulation and Supervision Technical Note,[14] that: "*The new Financial Conduct Authority (FCA), with its broad remit, is subject to some of the lack of clarity present in the current mandate of the FSA. Ways should be found (such as greater clarity in how the remit of the various parts of the FCA are expressed or the internal senior management structure within the FCA) to ensure that* market regulation and supervision, *[our emphasis] and prudential supervision of FCA firms, do not become diluted.*" Given the FCA's understandable focus on consumer protection, it is vital that its role as a primary and secondary market regulator is not overshadowed or diminished. It is also vital that there is effective coordination between the FCA and the Bank in relation to the regulation of systemically important infrastructure.

In respect of the primary markets, the UKLA, as the competent authority for listing will have different priorities to the FCA and, therefore, whilst we understand the rationale for bringing the legislative framework for listing and other primary market regulation "*more fully under the general FSMA-legislative framework",* we remain concerned that all the implications of the proposal may not have been considered fully. In particular, we believe that:

- the UKLA, like other listing authorities – such as the Australian Stock Exchange – should continue to have a competitiveness focus;
- the FCA's operational objectives are not sufficiently tailored for a listing authority nor appropriate for a primary market regulator; and
- the 'have regards to' duties set out in section 73 of FSMA remain appropriate for the specialised regulatory function which the UKLA carries out, which is neither prudential nor conduct based and their removal may create legal uncertainty.

In short we believe that the FCA, when acting in its capacity as the UKLA, should continue to have a separate operational objective and a separate set of 'have regard to' factors, which are more closely aligned to those set out in section 73 of FSMA. We also have concerns regarding the new powers over sponsors and issuers (e.g. the proposed introduction of reports by skilled persons) and the impact that the

[14] Produced in connection with the IMF's Financial Sector Assessment Program Update on the United Kingdom (IMF Country Report No 11/230).

frequent use of such powers, at lower levels of materiality, could have on the UK's primary markets.

Q17. Does the draft Bill strike the right balance between the responsibilities of consumers and firms? Are the FCA's new powers in the area of consumer protection appropriate?

We recognise that the definition of "*consumer*" in the draft Bill is changing only in relation to listed activities and that, under FSMA, eligible counterparties and professional clients are already defined as consumers. The Markets in Financial Instruments Directive (MiFID), however, applies a differentiated approach to conduct of business regulation depending on the categorisation of the client and the FSA has also applied a differentiated approach to wholesale market regulation that reflects the different users of, and risks inherent in, these markets.

Whilst we recognise the need to review the current FSA approach and identify and regulate direct linkages between the wholesale and retail markets (e.g. in relation to product design), we are concerned that the current emphasis on the wider definition of consumer might lead to disproportionate and inappropriate regulation of wholesale market activity.

The definition of consumer in new section 1C of FSMA (inserted by clause 5 of the draft Bill) includes all natural and legal persons "*…whether acting in course of trade, business or profession…*" whereas other UK statutes and EU Directives define consumers as, broadly speaking, natural and legal persons <u>not</u> acting in the course of trade, business or profession. For example, in the European Commission Expert Group's feasibility study on the new European contract law for businesses and consumers, the potential European contract law instrument definitions include:

> *"'consumer' means any natural person who is acting for purposes which are outside his or her trade, business, craft or profession"*[15]
> *"'business' means any natural or legal person who is acting for purposes relating to that person's trade, business, craft or profession."*

We believe that the concerns regarding the regulation of the wholesale markets could be ameliorated by recognition, in the FCA's consumer protection objective in section 1C(2)(b) of FSMA (inserted by section 5 of the draft Bill), of the need for appropriately differentiated regulation of wholesale market participants that are acting in the course of business (not least if authorised to carry on financial services business) e.g.: in addition to having regard to, inter alia, "*…the differing degrees of experience and expertise that different consumers may have*" we believe that the FCA should also consider whether consumers are acting in the course of a (financial services-related) trade, business or profession.

[15] Part I Introductory provisions, Chapter 1 General Section 1 Application of the instrument, Article 2: Definitions "A European contract law for consumers and businesses: Publication of the results of the feasibility study carried out by the Expert Group on European contract law for stakeholders' and legal practitioners' feedback" May 2011

Q20. Are the proposals for co-ordination between the PRA and FCA clear and adequate? What would be the advantages and disadvantages of having a Single Point of Contact and/or a joint rule book for dual-regulated firms?

Coordination, both domestically and internationally, is undoubtedly one of the most complex aspects of the proposals and, particularly given that it could represent a "fault line" in the new framework, its effectiveness, in practice, is a major concern, particularly for dual-regulated firms. We welcome, therefore, the focus that the Treasury has given to regulatory coordination and regulatory processes and their engagement with the industry and whilst we believe that the provisions in the draft Bill are significantly enhanced, given the inherent complexities, there is, as we discuss in more detail below, still a need for further improvement.

A mechanism for coordination

We recognise that there is a distinction between the statutory duty to coordinate, which we strongly support, and the operational arrangements that the regulators need to put in place to discharge that duty and a fine balance to be struck between legal prescription and operational flexibility. We understand why the Government does not "*believe it would be appropriate to set out operational matters for the PRA and FCA in primary legislation*", however, as a number of our remaining concerns relate to how the arrangements will work in practice, we question whether the duty to coordinate is sufficiently robust and whether there is a need for provisions in the new legislation to provide points of references (for example, a duty for the PRA to consult the FCA on the adequacy of the recovery and resolution plans for dual-regulated firms that hold client assets).

At an operational level, effective and efficient coordination between the PRA and the FCA – particularly in respect of dual-regulated firms – is one of our members' key concerns. As noted previously, the relationship between the PRA and the FCA is a potential fault line which, if not properly addressed, will cause significant operational – and, hence, financial – issues for firms, and could potentially undermine the foundations of the new framework and, possibly, even the attractiveness of the UK as an international finance centre.

AFME believes strongly that a joint coordinating committee should be mandated in the new legislation, for example: to coordinate rule-making (particularly in relation to the over-arching regulatory standards and systems and controls) and regulatory processes in relation to dual-regulated firms (such as authorisation, approval, change of controller) and to facilitate mutual recognition as the regulatory approaches diverge. We also believe strongly that this joint coordination committee (or a separate sub-committee) should coordinate the UK's EU and international stakeholder relationships, including the key relationships with the ESAs (in particular the European Securities and Markets Authority (ESMA)). We would envisage that this would include:

- actively monitoring and coordinating the UK's short term engagement with EU and international stakeholders (e.g. participation in EU and international meetings, working groups;
- ensuring that the right UK stakeholders are involved or have been consulted); providing strategic direction in relation to the UK's medium and long term EU and international relationships;
- developing UK positions in respect of regulatory proposals that concern more than one regulatory authority; and
- providing a central point of UK contact.

On this point we would note that:

- The IMF Technical Note, referred to in our response to Q16, also found that: "*While the proposals have built in a variety of cooperation and coordination mechanisms, the experience in certain other countries suggests the need for a forum for formal and/or informal relationship building, cooperation, and coordination. These relationships will be necessary for effective operation of the framework, especially in a crisis. A clear locus for all regulatory agencies to interact might also assist the United Kingdom in interacting effectively with the new European Financial Stability Board (EFSB) and with the European Supervisory Authorities (ESAs).*"

- In France, the establishment of a 'Pôle commun' (joint committee) between the ACP and the AMF is mandated by legislation with the detail set out in an MOU. Whilst there is a greater overlap of responsibilities for consumer protection between the ACP and the AMF, the joint committee plays an important and effective role as a mechanism for coordination. We believe that this French model serves as a helpful example for the UK.

- In Australia, "*The Council of Financial Regulators (the Council) is the co-ordinating body for Australia's main financial regulatory agencies. Its membership is comprised of the Reserve Bank of Australia, which chairs the Council; the Australian Prudential Regulation Authority (APRA); the Australian Securities and Investments Commission (ASIC); and the Australian Treasury.*" Whilst the Council is a non-statutory body established by charter, it is mandated by the MOUs that are in place between the individual regulators, for example, the MOU between APRA and ASIC provides that: "*A joint Co-ordination Committee will be established to facilitate close cooperation between APRA and ASIC. The Committee will operate according to a Charter and be responsible for ensuring the appropriate arrangements are in place for matters such as co-ordinating information-sharing, joint inspections or task forces, referral of cases and enforcement action or major supervisory intervention. It will also co-ordinate operational matters such as administrative arrangements to avoid duplication, statistical collections, joint research*

work or training or industry consultation, and participation in international fora."
The Council's role is *"to contribute to the efficiency and effectiveness of financial regulation by providing a high-level forum for co-operation and collaboration among its members. It operates as an informal body in which members are able to share information and views, discuss regulatory reforms or issues where responsibilities overlap and, if the need arises, co-ordinate responses to potential threats to financial stability. The Council also has a role in advising the Government on the adequacy of Australia's financial system architecture in light of ongoing developments. These arrangements provide a flexible, low-cost approach to co-ordination among the main financial regulatory agencies.*"[16] In particular, the Charter provides that the Council shall provide a forum for "harmonising regulatory and reporting requirements, paying close attention to the need to keep regulatory costs to a minimum."

- The Joint Committee of the ESAs serves "*as a forum in which the three European Supervisory Authorities shall cooperate regularly and closely and ensure cross-sectoral consistency among them. The Joint Committee shall ensure cross-sectoral consistency of work and reaching joint positions where appropriate, in particular regarding the area of supervision of financial conglomerates, accounting and auditing; micro-prudential analyses of cross-sectoral developments, risks and vulnerabilities for financial stability; retail investment products; measures combating money laundering; and information exchange with the European Systemic Risk Board (ESRB) and developing the relationship between the ESRB and the ESAs.*"[17]

Whilst we understand that the Government wishes to provide the regulators with the flexibility to determine their own arrangements for co-ordination at an operational level, the 'Pôle commun' in France, referred to above, is enshrined in legislative and provides, amongst other things, an operational gateway to the French regulators. We would ask the Joint Committee to consider the EU and international examples of coordination mechanisms and the case for enshrining a "clear locus" for coordination, at a framework level, within the new legislation.

Rule-making and regulatory processes: issues for dual-regulated firms

As we have noted, coordination between the PRA and FCA and achieving clarity with respect to regulatory processes and overarching regulatory standards is one of the most complex aspects of the Government's proposals (not least because there is a grey area between prudential regulation and conduct regulation) and this is a significant concern to dual-regulated firms in particular. The new legislation, therefore, needs to set out clearly the PRA's and FCA's: responsibilities

[16] http://www.rba.gov.au/fin-stability/reg-framework/cfr.html

[17] Decision of the Joint Committee of the European Banking Authority, European Insurance and Occupational Pensions Authority, and European Securities and Markets Authority adopting the Rules of Procedure of the Joint Committee of the European Supervisory Authorities.

for each regulatory process; rulemaking powers in areas where their scope overlaps in relation to dual-regulated firms (e.g. in respect of the over-arching high-level regulatory standards such as Senior Management Arrangements Systems and Controls (SYSC) and the Statements of Principle and Code of Practice for approved persons); and duties of coordination.

We consider it vital that the development of rules by the PRA and the FCA, in areas where their scope overlaps in relation to dual-regulated firms, is coordinated so that the rules are compatible. We are of the opinion that these coordination mechanisms have to be 'hardwired' in the new legislation; in particular, there should be clear and effective processes for making *joint* (PRA and FCA) rules and guidance in relation to the overarching high-level regulatory standards such as SYSC and common regulatory processes (c.f. the FSA's Supervision manual). This set of joint rules should overarch and form part of both the PRA and the FCA's handbooks, thereby creating cohesive and consistent regulatory processes.

In relation to the approved persons regime, we believe that it is appropriate that both the PRA and the FCA should have the power to designate significant influence functions (SIFs) and issue Statements of Principle and Codes of Practice in respect of, and determine applications for, these controlled functions. However, given that both the PRA and the FCA will have jurisdiction over persons approved to perform significant influence functions in dual regulated firms (for example, the CEO), we believe that the approvals process and the operation of the PRA and FCA approved persons regimes – in particular, the scope of the respective Statements of Principle and Codes of Practice to which the approved persons will be subject – requires further clarification, within the new legislation, to avoid overlap and legal uncertainties.

In particular, we note that the draft Bill does not include a provision in section 60 (Application for approval), to ensure that the PRA and FCA will consult each other in relation to applications for SIF roles (e.g. an application for a CF1(director) role). Such a provision is, however, included in section 63 of FSMA as amended by subsection 1C (introduced by clause 11 of the draft Bill); we believe that the provision should be replicated in relation to initial applications for approval to require the FCA's consent to an application.

This is an issue that was also identified by the IMF Technical Note (referred to in our response to Q16): *"It is proposed to split lead responsibilities for approval in dual-regulated firms. Accordingly, the PRA would have the lead on functions related to prudential matters and the FCA on matters relating to interface with customers. It is proposed that the lead would consult with the other in areas of interest but would have the final say. Both regulators would retain authority to ban an approved person working in a regulated firm. Given the importance of the approved person's regime to the U.K. regulatory and supervisory structure, a possible alternative could be to*

adopt a system of dual approval for certain key positions, with coordinated and harmonized information requests and assessment processes."

Given that persons approved to perform SIF roles will have to comply with the separate Statements of Principle and Codes of Practice issued by PRA and the FCA, it is also vital that there is coordination between the PRA and the FCA regarding the drafting of these Principles and Codes, so that the duties of these approved persons – in relation to the prudential and conduct aspects of their roles – remain compatible. This is an issue that should be resolved through a rule-making coordination mechanism (see our comments above on a joint coordinating committee).

Single point of contact

We believe that the Memorandum of Understanding (MoU) between the PRA and the FCA, which is required by the draft Bill and which we support, should enshrine, as a principle, the desirability of establishing a designated lead supervisor to act as a single point of contact for dual-regulated firms. We appreciate that the PRA and FCA will be separate regulators, pursuing different objectives, and in asking for a lead supervisor we are not trying to negate the development of a twin peaks system; rather, we believe that allocating each dual-regulated firm a lead supervisor chimes with the PRA and FCA's statutory duty to coordinate. Furthermore, allocating lead responsibility for the supervision of each dual-regulated firm to a specific supervisor or supervisory team – who could coordinate a domestic college of regulators and operational processes such as data sharing and co-ordination of supervisory visits – would help ensure that regulators will continue to have a holistic view of firms.

In responding to Treasury consultations on the new approach to financial regulation, AFME and a number of other trade associations advocated and strongly supported the establishment of a shared services function that would provide a common 'back office' for both the PRA and the FCA and, in particular, perform regulatory processes and provide IT and data warehousing for both authorities. As well as providing a single point of contact dual regulated firms in respect of the processing of applications for authorisation, approval and other regulatory processes (e.g. change of control and notifications), a common back office would also provide considerable synergies, assist with information requests and information flows and provide clarity to firms – helping to avoid unnecessary divergence between the authorities - at an administrative level. This is particularly important for, *inter alia,* financial groups, as they may need to submit the same applications/information to both the PRA and the FCA in respect of individual group companies (for example, applications for approval for a direction of PRA and a FCA-authorised group companies and changes of control). We would ask the Joint Committee to consider the merits of providing the foundations for such an approach in the new legislation.

Q21. How do the proposals in the draft Bill fit within the new European regulatory regime? What freedoms and constraints will the UK have to operate within that **regime?**

AFME wishes to stress the importance of ensuring that the new UK regulatory framework dovetails with both the EU regulatory and supervisory framework and the reforms under way internationally.

As a European trade association, AFME considers that, notwithstanding the statutory objectives that focus on the protection of the UK financial system and consumers (regardless of where resident) – for which the regulators will be, quite rightly, directly accountable to Parliament – it is crucial that the UK regulatory framework is more outward facing, recognising explicitly EU obligations and constraints; reflecting the desirability of level international playing fields and consistent international good practice; and, facilitating mutual cooperation.

The new legislation and, to a greater extent, the regulators themselves need to set the UK regulatory framework within the context of the over-arching European and international regulatory framework – most notably the ESAs and the ESRB – and explain the points of interaction and coordination e.g. by giving greater granularity on how the regulators will seek to work with Home State competent authorities to regulate EU branches and international active financial groups. Whilst it is understandable that the Treasury sought, first, to design a regulatory framework for the UK and then perfect the detail, including dovetailing with the EU supervisory framework, it is now time to pull the threads together and – to the extent it is possible given the significant regulatory changes under way in the EU – integrate the regulatory frameworks as they currently stand. We also believe that the PRA and the FCA should be given a statutory duty to coordinate with the ESAs and international standard setters.

In relation to the freedoms and constraints arising from EU regulation of financial services, as the Joint Committee will be aware, the Treaty of Rome enshrines rights to provide services throughout the EU (extended to the EEA by the 'EEA Agreement'). These basic 'Treaty rights' are elaborated upon, in the financial services sector, by the 'single market directives' (including MiFID and, the Banking Consolidation Directive (BCD)), which provide mechanisms for 'passporting' – distinguishing the provision of services on a cross-border basis into another Member State and the provision of services from a branch established in another Member State - and detail the responsibilities of the Home and Host Member States.

In summary:

- Prudential regulation is reserved to the Home State competent authority;
- The provision of cross-border services into another Member State is regulated by the Home State;

- In respect of the establishment of a branch in another Member State, Host States are limited in relation to the business conduct rules that they can apply to the 'incoming EEA firm':
    - for an investment firm passporting under MiFID, the Directive provides limited, specified, exceptions from Home State responsibility;
    - for a credit institution passporting under the BCD, the Directive provides that Host States can make rules in the "general good."
- A Host State cannot prevent an EEA firm from providing services into, or establishing a branch in, their Member State, provided consent has been given by the EEA firm's Home State competent authority for the specific activities and services to be carried on in the Host State. In prescribed circumstances, Host States do, however, have emergency powers to take action against incoming EEA firms that are in breach of single market provisions reserved to Home States.

We believe that the new legislation and the regulators themselves should recognise explicitly where the extent and use of their powers is modified or limited by EU regulation and how the domestic and EU regimes will interrelate. For example:

- how will an ESRB warning or recommendation for remedial action, made under article 3(2)(c) and (d) of ESRB Regulation 1092/2010[18] to the EU or the UK, be addressed by the FPC?
- how would exercise of an EU product intervention power – by the Commission or by the ESAs – interact with use of the FCA's proposed product intervention rule-making power?

There is also a need for clarity about the extent of the powers available to a UK regulator in relation to both incoming EEA firms and third country firms (including the degree of reliance on EEA or third country regulators) in order to set realistic expectations of what UK regulation can and cannot deliver. For example, client assets will be regulated and supervised by the FCA but as client assets regulation is reserved to Home State competent authorities, the client asset protection offered by incoming EEA firms will be dependent on their Home State regulatory regime.

Both MiFID and the BCD are, however, subject to significant amendments in the new legislation proposed by the Commission; the latter being repealed and re-enacted, in the light of Basel III, in the 4th Capital Requirements Directive (CRD4). It is vital that, notwithstanding the domestic agenda, the UK continues to take an active role in relation to both the MiFID review proposals and the CRD4 proposals. The Government emphasised, in the consultation document, *A new approach to financial regulation: building a stronger system*, the need for the UK to have a single, coherent and consistent strategy for both EU and

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[18] Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board.

international engagement, notwithstanding the differences in scope between domestic and EU supervisory authorities, and has stated its desire to see the UK continue to play a key role in the development and implementation of international financial regulation. We believe, therefore, that the FSA's international division should continue as part of the joint coordinating committee, which, as discussed above, serves not only the interests of the PRA and the FCA but the Bank of England *per se*, and other UK stakeholders such as The Pensions Regulator and the Financial Reporting Council (e.g. by developing UK positions and coordinating UK input into EU and international work streams that cross-cut the UK regulatory framework).

Q22. Does the draft Bill contain any proposals or omissions, not covered by the questions above, which cause concern?

New and enhanced regulatory powers and duties

We would ask the Joint Committee to consider the new or enhanced regulatory powers – including the powers to make product intervention rules, publish Warning Notices, require skilled persons reports, make individual supervisory judgements and require the withdrawal of financial promotions – and, in particular, whether the rights of firms (and third parties) are appropriately safeguarded (without recourse to judicial review), particularly given the proposed change to the powers of the Upper Tribunal in relation to decisions involving "supervisory assessments". We also believe that the Joint Committee should consider whether there should be greater legal certainty in respect of how a number of the regulatory powers and duties will be used by the regulators – for example, the power to make product intervention rules.

In particular, AFME has significant concerns regarding publically disclosing ongoing enforcement action, which is an exercise of a regulator's administrative – and not criminal – jurisdiction. Our detailed representations to the Treasury on this point are set out in Annex II to this evidence: in summary, we are concerned that the power is not appropriately drafted; that the regulators should have to satisfy a higher evidential test before its use and that there should be greater safeguards for firms and individuals. We are also concerned that the FCA's product intervention rulemaking powers are too broadly drawn and require greater specificity e.g. to clarify that the rules do not have ex post facto effect and to limit the "relevant agreements or obligations" which the rules can prohibit or restrict, to those connected with financial services.

International consistency

As we discussed in paragraph 3.8, we consider it crucial that UK regulators should have regard to the international consistency of the UK's financial services industry.

We acknowledge the Government's position on this issue but believe that the point we have been trying to distinguish may have become obfuscated by the negative connotations now associated with the more

general use of the word 'competitiveness'. Hence, as discussed previously, we believe that 'international alignment' or 'international consistency' might better describe the outcome we are seeking. In short, to seek to ensure level–playing fields for internationally active firms, we remain of the strong opinion that the new UK regulators should be under a duty, only in so far is compatible with their strategic and operational objectives and when not constrained by EU regulation, to consider whether new regulation is internationally consistent and, when choosing between a number of equally viable regulatory approaches, select the approach which is the most internationally aligned/consistent.

Proceeding on these lines recognises that wholesale financial markets are global, however, it is also important to recognise that competition between financial centres (particularly those in emerging markets) is strong and, post the crisis, becoming stronger. In responding to the February 2011 Treasury consultation document, *A new approach to financial regulation: building a stronger system,* we found that a number of international regulators have been given specific responsibilities in respect of competitiveness: broadly speaking, in the sample of regulators we considered, (see Annex I to this evidence) these responsibilities could be divided into two, not necessarily mutually exclusive, categories:

- promoting/enhancing competitiveness (e.g. China, Hong Kong and Singapore); or
- maintaining/sustaining competitiveness (e.g. Hong Kong and Switzerland).

We understand the view that *promoting / enhancing* the competitiveness of the UK financial services industry is incompatible with the role of a regulator. However, in an increasingly competitive global market place and given the ease with which financial services businesses could relocate or even change their head quarters, it is vital that European capital markets, including the UK's leading financial centre, are promoted effectively. As this is not the role of a regulator, it is vital for the UK economy that the Government continues to ensure that the domestic financial services sector is promoted effectively and also contributes to the promotion of European capital markets.

We consider in addition, however, that, given the importance of ensuring that regulation does not does not unduly limit the services available to small businesses and clients and/or damage the ability of financial markets to contribute to economic growth (e.g. through inappropriate super-equivalence), provided it is framed appropriately, *maintaining/sustaining* competitiveness is a legitimate duty for a regulator. For example, the Swiss Financial Market Supervisory Authority (FINMA), financial market supervision[19]: "*contributes to sustaining the reputation and competitiveness of Switzerland's financial centre*." In, particular, in exercising its regulatory powers, FINMA:

> "*…takes into account in particular of:…*

[19] Article 5 of the Federal Act on the Swiss Financial Market Supervisory Authority, Financial Market Supervision Act.

> *b. the effect that regulation has on competition, innovative ability and the international competitiveness of Switzerland's financial centre;…"*

As we proposed, in responding to the Treasury consultation document discussed above, we believe that a new *international regulatory* principle could be developed, along similar lines, for both the PRA and the FCA; whilst we have not considered in detail how this might be drafted, we have been contemplating, for example, a formula such as:

> *…the need to take into account the effect of regulation on the reputation and international competitiveness of the UK's financial markets and the desirability of preventing regulatory arbitrage.*

Moreover, and returning to the need to integrate the UK and EU regulatory frameworks, such a duty would chime with the European supervisory framework, within which an ESA, such as the European Banking Authority, should *"take due account of the impact of its activities on competition and innovation within the internal market, on the Union's global competitiveness, on financial inclusion, and on the Union's new strategy for jobs and growth.*"[20]

APPENDIX I: Competitiveness: a sample of regulatory authorities

APPENDIX II: Publication of Warning Notices

ANNEX I
Competitiveness: a sample of regulatory authorities

Country	*Regulator*	*Objectives [emphasis added]*	*Legislation*
Hong Kong	Securities and Futures Authority	"The regulatory objectives of the Commission are- (a) **to maintain and promote** the fairness, efficiency, **competitiveness**, transparency and orderliness of the securities and futures industry…"	Section 4 (Regulatory objectives of Commission) of the Securities and Futures Ordinance
Australia	Prudential Regulation Authority	"(2) In performing and exercising its functions and powers, APRA is to balance the objectives of financial safety and efficiency, competition, contestability and **competitive neutrality** and, in balancing these objectives, is to promote	Section 8 (Purpose for establishing APRA) to the Australian Prudential Regulation Authority Act 1998,

[20] Recital 13 of Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC

		financial system stability in Australia."	
Singapore	Monetary Authority of Singapore	"4. —(1) The principal objects of the Authority shall be — (a) to maintain price stability conducive to sustainable growth of the economy; (b) to foster a sound and reputable financial centre; (c) to ensure prudent and effective management of the official foreign reserves of Singapore; and (d) **to grow Singapore as an internationally competitive financial centre."**	Section 4 (Principal objects and functions of Authority) Monetary Authority of Singapore Act
Switzerland	Swiss Financial Market Supervisory Authority	"In accordance with the financial market acts, financial market supervision has the objectives of protecting creditors, investors, and insured persons as well as ensuring the proper functioning of the financial market. It thus contributes to **sustaining the reputation and competitiveness** of Switzerland's financial centre." 2 It exercises its regulatory powers only to the extent required by its supervisory objectives. In doing so, it takes account in particular of: a. the costs that the supervised persons and entities incur due to regulation; b**. the effect that regulation has on competition, innovative ability and the international competitiveness of Switzerland's financial centre;** c. the various business activities and risks incurred by the supervised persons and entities; and d. the international minimum	Article 5 (Objectives of financial market supervision) of the Federal Act on the Swiss Financial Market Supervisory Authority (Financial Market Supervision Act, FINMSA)

		standards.	
China	CBRC	a. Promote the financial stability and facilitate financial innovation at the same time; b. **Enhance the international competitiveness** of the Chinese banking sector;	*Supervisory and regulatory criteria of the CBRC (from website)*

ANNEX II

Publication of Warning Notices

- **Extract from AFME response to HM Treasury White Paper: A new approach to financial regulation: the blueprint for reform**

  We welcome the changes the Government has made to the proposal to give the FCA the power – but not the duty or presumption – to publish warning notices; these changes go *some* way to reflecting *some* of concerns raised in our response to the February 2011 condoc (e.g. limiting the power to enforcement not supervisory decisions). We also welcome the Government's statement that it expects the FCA to address the issues raised in consultation responses in setting its policy re the exercise of the power. However, our significant concerns relating to the principle of publically disclosing ongoing enforcement action before the subject of that action has had an opportunity to make formal representations, as set out in our response to the previous condoc, remain extant.

  Notwithstanding, we agree that transparency with respect to the commencement of enforcement proceedings may, in *egregious* cases with probable consumer detriment, enhance consumer protection. However, we believe that it is *vital* to draw a distinction, in the legislation, between cases where urgent (early) publication is necessary in the interests of consumer protection (e.g. cases involving unauthorised investment business or systemic miss-selling) and other enforcement cases where the cost (to firms) of public disclosure may outweigh any benefit.

  On this point, we would refer the Treasury to the case of Re (S) v X [2011] EWHC 1645 (Admin), a judicial review permission hearing in which the Court gave permission to judicially review X's decision to publish a decision notice pursuant to section 391 of FSMA (as amended by the Financial Services Act 2010. The claimants had challenged the FSA's decision to publish, seeking an injunction preventing publication until their claim is determined, which was also granted.

  Key points in the judgment include:

  - *"X makes its decision and communicates it by decision notice. In the proceedings before the Upper Tribunal, it will seek to defend that decision. No doubt X considers that its decision is right. No doubt also it is for that reason amongst others that X considers that the decision should be published. But where a reference has been made to the Upper Tribunal it will be for the Upper Tribunal to decide whether the decision notice is right. The maker of the decision has no general basis for publishing a decision notice that may be wrong."*
  - *"Further, if delay is considered to be a problem, the fact is that the reference will have been made within 28 days and there seems to me to be no good reason why, if an*

application is made to the Upper Tribunal for any order relating to confidentiality, X should not seek an early direction hearing to have that matter resolved. If it does so, then any danger of further unjustified delay in the publication of a decision notice will be resolved by a judicial body competent to deal with it. In those circumstances, it seems to me arguable that X has entirely failed to make out its case for publication by it in circumstances in which, ex hypothesi, the case is not one in which it thought that urgent publication, regardless of the decision to refer, was necessary in the interests of the public."

We believe that this judgment highlights the need to separately distinguish, in the Bill, cases in respect of which there is a compelling need to publish and other cas**es.**

In the US, when the SEC files criminal charges their complaint is made public. However, a Warning Notice should be compared with a 'Wells Notice' and not a complaint. A Wells Notice may be issued by the SEC under its enforcement procedures (but not mandated by statute), to advise persons under investigation: that it is considering recommending or intends to recommend civil enforcement action; of the potential violations upon which the recommendation is based; and, that arguments or evidence may be submitted to the SEC. A Wells Notice is *not* published by the SEC but listed firms may have to disclose under market disciplines.

The SEC, however, separately distinguishes cases where there is a need for urgent action in the public interest. When determining whether to issue a Wells Notice, the SEC enforcement manual states that staffers should consider, inter alia: "*Whether immediate enforcement action is necessary for the protection of investors. If prompt enforcement action is necessary to protect investors, providing a Wells notice and waiting for a submission may not be practical (for example, a recommendation to file an emergency action requesting a temporary restraining order and asset freeze to stop an ongoing fraud). In addition, providing a Wells notice may alert potential defendants to the possible asset freeze and put at risk the investor funds that the recommendation is intended to protect."*

Where enforcement action does not involve urgent consumer protection issues, we believe that, instead of the publication of a Warning Notice, it is appropriate to rely on market disciplines for the publication of relevant information to the market (and, hence, to clients and investors).

An argument is also made that the publication of a Warning Notice is consistent with a criminal charge. It is, however, <u>not</u> apt to compare criminal law with the exercise by a regulator of an administrative jurisdiction. Notwithstanding, as discussed in our response to the February 2011 condoc, the evidential test set out currently in FSA's DEPP requires a far lower standard of proof than the Code for Crown Prosecutors i.e. there is higher standard of proof in relation to criminal charges and the Code sets evidential and public interest tests. It is also noteworthy that a charge is subject to review/approval by the Crown Prosecution Service (CPS), whereas a Warning Notice, despite being reviewed by the Regulatory Decisions Committee – which is, of course, an FSA committee – is more akin, in procedural terms, to a caution, as it is issued at the sole discretion of the FSA without an independent review.

We continue to believe that if the FCA is empowered to publish Warning Notices, the FCA should be required, by the Bill, to meet a *higher standard of proof* (as per the

Code of Crown Prosecutors) in cases where the power is to be exercised. There should also be a statutory requirement for the FCA to publish a Code of Practice, covering the drafting of the statement – for example, the summary of the warning notice should be succinct, must refer to allegations and being subject to due process and must state facts and not use emotive language – and related press statements and media briefings. It will also be important to ensure there is *fully* independent (CPS-type) legal review and input up to the point of publication. An equally prominent statement should be issued by the FCA if the case is closed or not proven.

The case of Re (S) v X [2011] EWHC 1645 (Admin), discussed above, also raises interesting questions regarding the ability of a regulator such as the FCA to nullify, by publishing a Warning Notice, the Tribunal's powers to make orders prohibiting the disclosure or publication of documents or information under Rule 14 of, and Rule 3 of Schedule 3 to, The Tribunal Procedure (Upper Tribunal) Rules 2008 (the Tribunal's Procedural Rules): "[the respondent's] *submission is that in cases where no proper argument for confidentiality has been made, X is in as good a position to decide on publication as the Tribunal is. I find that position difficult to accept. It is arguably wrong."*

Whilst the judge was not persuaded, in this case, of arguments relating to the European Convention on Human Rights (ECHR), we feel that the fact that Warning Notices preceed the formal hearings – notwithstanding any opportunity to comment on a draft of the investigation report – is likely to add considerable weight to ECHR arguments.

As discussed above, we welcome the safeguards that the Government has now included in the draft Bill: i.e. the power to publish is expressed in section 391(1) of FSMA (as amended by paragraph 24(2) of Schedule 8 to the draft Bill), as a discretion and not a duty with no presumption of publication and the FCA may not publish where section 391 (6A)(a), (b) or (c) apply (as inserted by paragraph 24(6) of Schedule 8 to the draft Bill). However, in addition, we believe that:

- Given that reputational damage will inevitably flow from publication, the parties served with notice of publication would inevitably claim publication was unfair. We are, therefore, unsure what additional unfairness must be proved and what other factors the FCA would take into account under 391(6)(a) of FSMA (as amended by paragraph 24(2) of Schedule 8 to the draft Bill). Hence, we believe that there should be greater specificity in the legislation as to when the FCA would be prevented from publishing a Warning Notice on the grounds that it was, inter alia, "unfair to the person with respect to whom the action was taken…"; an objective measure of unfairness is also needed;
- Whilst section 391(1)(c) of FSMA (as amended by paragraph 24(2) of Schedule 8 to the draft Bill), provides that the FCA must consult the persons to whom the notice is given or copied prior to possible publication, we believe that the Bill should provide specifically for a formal Maxwellisation process;
- There should be an effective and efficient right of appeal to the Tribunal in relation to the FCA's decision to publish a Warning Notice and that an FCA decision to publish should be subject to scrutiny by the Tribunal as part of any appeal relating to the case itself;
- Any legal or natural person named in the Warning Notice should have the right to make their own statements to the media, i.e. it must be clear that the person/firm is free to comment publically (including claiming that the FCA action

is wrong or misconceived and referencing pertinent facts not included in the Warning Notice) if a Warning Notice is published.

In summary, we agree that the FCA should have the power, in the interests of consumer protection, to warn of pending enforcement action. However, we believe that the Bill should set out the circumstances in which the power may be used (which should be clearly linked to consumer protection); require a *higher standard of proof* (as per the Code of Crown Prosecutors) in the cases where the FCA is exercising its power to publish Warning Notices; require the FCA to publish a Code of Practice; and provide greater specificity in respect of the safeguards. The discretion to publish a Warning Notice should only be exercised if the statutory tests can be satisfied, showing publication was necessary to protect consumers.

Without further refinement and clarity in the Bill, we believe that the FCA may face costly and time-consuming litigation when they seek to use the power (a concern also expressed by Margaret Cole in a 27th June Reuters interview), as firms and individuals are likely to turn to the judicial system to protect their reputations.

- **Extract from AFME response to HM Treasury consultation document: A new approach to financial regulation: building a stronger system**

We recognise that there is a fine balance to be struck between public policy and individual rights. However, we are extremely concerned that the proposal to publish warning notices does not strike the right balance and risks creating unfairness to individuals and firms that are the subject of enforcement action by the FCA and the PRA.

As the Government will be aware, the Financial Services Act 2010 amended*, inter alia,* section 391(4) of FSMA, which now requires the FSA to publish: "*information about the matter to which a decision notice or final notice relates as it considers appropriate*". This amendment was designed to give greater transparency to the FSA's concerns, as prior to the amendment, the FSA could only publish final notices and, in the case of referrals, had to await the Upper Tribunal's determination of a case – a process obviously outside the FSA's control - before publication. To date, however, the FSA has not used this new power and the benefit - of the FSA being able to publish its determination at the conclusion of its own enforcement and decision making process - remains untested. We believe that it is unreasonable to introduce further changes, which have the potential to impose significantly higher reputation costs on firms and individuals, before ascertaining whether the Financial Services Act amendment introduces sufficient transparency.

Nevertheless, it is proposed in paragraph 4.87 of the condoc, to give the FCA the power "*to allow for publication of the fact that a warning notice has been issued, and a summary of the notice".* Notwithstanding the "*safeguard to ensure that there is procedural fairness for affected firms and individuals*" discussed in paragraph 4.89 of the condoc, we have a number of *significant concerns.*

Firstly, by way of background, it is important to note that:

- A warning notice marks the commencement of formal enforcement proceedings and will set out (often following an investigation or a 'section 166' report from an

independent 'skilled person') the FSA's case against a firm or individual (the defendant). Whilst the FSA's case and the wording of the warning notice will have been reviewed by the FSA's independent decision makers, the RDC, the firm or individual that is the subject of the enforcement action will *not* have had an opportunity to make their case and/or correct errors, omissions and misunderstandings in the FSA's case.

- A decision notice, however, is usually issued after a case has been heard in full by the RDC and, therefore, includes the defendant's case – both written and, if made, oral representations – and reflects any changes to the FSA's case that have been made by the RDC as a result of factual corrections and the testing of both sides of the case. It is important to note that a number of cases are dropped by the RDC following the hearing (no published figures are available but some estimates point to ¼ to 1/3 of cases being dropped by the RDC). We assume that the Government is aware of the precise statistics. Moreover, as a result of due process, decision notices often look significantly different to warning notices and may contain a reversal of the FSA's position.

We agree that there may be circumstances involving significant potential consumer loss or detriment, which the FCA may wish to publicise as a matter of urgency, for example, unauthorised investment business, boiler room fraud. However, we are disturbed to note the "*expectation…that the regulator will publish the fact that a warning notice has been issued, unless doing so would not be compatible with its operational or strategic objectives.*" If the FCA is to have such a power, we believe, instead, that it should only be used *in extremis,* subject to robust safeguards.

To give the FCA a "*discretion*" to publish warning notices but to set such a high expectation as regards publication raises a number of serious issues, including:

- ***Fairness:*** to introduce such a power, new and robust, protections need to be in place to ensure that individuals and firms are given a fair hearing, as required under the European Convention on Human Rights (ECHR). We do not believe that the safeguards, as expressed in the condoc, are sufficient and given that the individuals and firms have had no access to due process at the time of publication of the Warning Notice, we question whether the process is ECHR compliant?
- ***Reputational damage:*** In most cases, simply publishing the fact that a warning notice has been issued will be enough to significantly damage a firm's or individual's reputation. Publishing a notice of discontinuance, if the FCA decides to take no further action, would be too little too late to repair unjustified reputational damage, particularly since any media coverage of the publication of the warning notice will still be accessible via searches of the Internet.
- ***Concurrent civil litigation:*** There is a risk that publication of a warning notice may cause many of the firm's clients and counterparties to contact it and ask for clarification or greater protection or to terminate their relationship; this might impede or even prevent the firm from being able to try to rectify the potential problem and/or cause further problems (e.g. by reducing liquidity). There is also a risk that the firm will face civil litigation (e.g. from customers seeking damages) at the same time as it is defending itself against the regulatory action.
- ***Significantly lower test than for criminal prosecution.*** Whilst some might compare a warning notice to a charge in a criminal prosecution, the tests the FSA has to satisfy to issue a warning notice are *significantly* lower than the tests for prosecution.

The Decision Procedures and Penalties Manual (DEPP) provides guidance (DEPP 2.2.3.G) that, when determining whether to accept the FSA's recommendation to issue a warning notice, the independent FSA decision maker will:

> *"(1) consider whether the material on which the recommendation is based is* ***adequate*** *to support it; the decision maker may seek additional information about or clarification of the recommendation, which may necessitate additional work by the relevant FSA staff;*
> *(2) satisfy itself that the action recommended is* ***appropriate*** *in all the circumstances;*
> *(3) decide whether to give the notice and the terms of any notice given." [emphasis added]*

In contrast, a prosecutor decides whether a person should be charged with a criminal offence in accordance with the Code for Crown prosecutors. In general, a prosecutor may only start or continue a prosecution if the case passes both stages of the 'Full Code Test':

- *The evidential stage:* the prosecutor must be "*satisfied that there is* ***sufficient evidence to provide a realistic prospect of conviction****…"* and "*must consider what the defence case may be, and how it is likely to affect the prospect of conviction."* [emphasis added]
- *Public interest stage*: the prosecution must be in the public interest.

We are also concerned that the publication of warning notices may result in behavioural changes that might not necessarily be welcomed:

- the FCA may come under pressure, which may in turn be felt by individual investigators, to continue with enforcement action rather than face the reputational risk and the loss of credibility which may be inherent in dropping a case;
- firms may come under pressure to enter into a settlement – and agree the wording of the statutory notices that reflect the terms of the settlement - due to the reputational risk of trying to make their case; but
- individuals named in action against firms that settle may be more inclined to contest to clear their names.

The FSA's published accounts, in relation to enforcement cases, show:

	09/10	08/09	07/08
Cases open at 01 Apr	198	187	125
Opened during year	89	165	151
Closed during year	114	153	90
Still open at 31 Mar	173	199	186
Private Warnings	?	38	13

Between 1 April 2009 and 31 March 2010, of the 114 cases closed during the year, 79 cases resulted in public disciplinary action (of which 48 by executive settlement), therefore, 35 cases were closed after the warning notice stage. Whilst we do not know how many of these cases resulted in private warnings or how many were 'dropped', one can conclude that 30% of cases under the current system did not result in a public outcome in 2009/10 and, hence, would have been prejudiced by the early publication of the warning notice proposed in the condoc in a way that would have not been justified by the sanction ultimately imposed. In addition, all the settled

cases that resulted in a financial penalty were settled in the first stage (i.e. before a warning notice is issued); hence the proposed power to publish a warning notice would not have been required in these cases.

Between 1 April 2008 and 31 March 2009, 71 cases were concluded by executive settlement. During that period, 118 cases were referred to the RDC. Over three-quarters of cases with a disciplinary outcome settled before reaching the RDC and almost all cases involving a financial penalty were settled during the first settlement stage (i.e. before the issue of a warning notice); hence, the proposed power to publish a warning notice would not have been required in these cases.

Between 1 April 2007 and 31 March 2008, 36 cases were concluded by executive settlement. During that period, 15 cases were referred to the RDC. Approximately three-quarters of cases with a disciplinary outcome settled before reaching the RDC and almost all cases involving a financial penalty settled during the first settlement stage (i.e. before the issue of a warning notice); again, the power to publish warning notices would not have been required in these cases.

Hence, whilst we can understand the objectives, we are not convinced of the case for the FCA to have an unfettered power to publish warning notices. We would, therefore, urge the Government to *reconsider* its proposals as we believe that other options are available to enhance transparency and protect consumers. For example:

- To *enhance transparency,* the FCA could publish alerts/statements relating to enforcement action it has initiated, without naming individuals or the firms concerned or pre-judging the final outcome. Such statements could include generic summaries that would serve to highlight the practices and/or behaviours that the FCA deems unacceptable. Whilst annonymising warning notices would, in principle, protect the names of the defendants, we would be concerned by the significant risk that the defendants would be identified – or even incorrectly identified - by market rumour and speculation. This would have implications for listed firms and, if the issues concern liquidity, possibly even financial stability. In such cases the FCA should not publish summaries.
- *To protect consumers*, individual approved persons could be suspended– rather than have the FCA publish their names – and in egregious cases, the FCA could use the formal intervention powers in Part XXV of FSMA, which we assume will be given to the FCA.

Moreover, we believe that the FCA should be subject to a 'fair reporting' duty (particularly in respect of media briefings for enforcement action) and should be required to follow the "maxwellisation" process (i.e. give those named an opportunity to review and challenge proposed text) in respect of any statutory notices etc that it publishes.

September 2011

Association for Financial Markets in Europe; Association of Private Client Investment; British Private Equity and Venture Capital Association; Investment Management Association and National Association of Pension Funds – oral evidence (QQ 351-437)

TUESDAY 18 OCTOBER 2011

Evidence heard in Public | Questions 351 - 437

Members present:

Mr Peter Lilley (Chairman)
Mr Nicholas Brown
Baroness Drake
Mr David Laws
Lord Maples
Lord McFall of Alcluith
David Mowat
Lord Newby
Mr David Ruffley
Lord Skidelsky
Baroness Wheatcroft

Examination of Witnesses

Witnesses: **Mr Peter Beales**, Association for Financial Markets in Europe (AFME), and **Mr Mark Florman**, British Private Equity and Venture Capital Association (BVCA), examined.

Chairman: Good afternoon. I thank our two witnesses for coming here today and appearing before the Committee. I ask Mr Brown to lead off the questioning.

Q351 Mr Brown: What we are doing here is a pre-legislative scrutiny exercise. We are trying to get a feel for how the Bill would work in practice. Is it your view that the Bill, if enacted, would help prevent a further banking crisis? Is there anything that we should be doing or recommending to Parliament that we have not thought of, or that has not been thought of, in the Bill? Is there something else you would like to see done that is not proposed?

Association for Financial Markets in Europe; Association of Private Client Investment; British Private Equity and Venture Capital Association; Investment Management Association and National Association of Pension Funds – oral evidence (QQ 351-437)

Mr Beales: My name is Peter Beales. I represent AFME, which is an association established to represent, in Europe, firms active in the capital markets. My particular position there is managing director for policy. I run our compliance team. It was thought that I was perhaps the appropriate person to come today because it is the compliance departments that have the closest relationship with the regulators. I can draw on that expertise, but there may be other areas which you want to explore where I am less familiar.

We feel that the legislation is a very helpful development. The focus on prudential regulation was found to be wanting in the previous regime and a major thrust of this legislation is to rebalance the focus, both by separating prudential regulation from conduct regulation but also through establishing the FPC. The Treasury are clearly listening to views expressed on the previous consultations, both from the industry and consumer side. We still think there is some more work to be done on the Bill, both in terms of the relationship with European regulators, which, from AFME's point of view, will be a rather important test of the success of this measure, but also in terms of the accountability of the regulatory bodies, some of their powers, due process and those kinds of issues which the Treasury is exploring, but we do not think they have quite reached the drafting finality that we are seeking. I think there is important work for your Committee here.

Q352 Mr Brown: That is a very helpful answer, if I may say so. Do you want to add anything, Mr Florman?

Mr Florman: I would support everything that Peter has just said. I am Mark Florman, the Chief Executive of the British Venture Capital Association. The members of the association are private equity firms and venture capital firms, so we have very little to do with banking as such. I cannot really comment on financial risk and banking risk, but I think, overall, the Bill is excellent and a great improvement on the past. The comments that Peter has made, which I will not repeat, I endorse completely.

Q353 Mr Brown: Do you envisage it working in practice?

Mr Florman: Yes, I do. From the private equity and venture capital community's point of view, we are hoping for a relatively seamless transfer of power from the FSA to the FCA. The team within the FSA is already identified to move over to the FCA so that should work. We know the team. They are an excellent group of people. They are engaged at the moment in working on the new legislation for private equity in Europe, the AIFMD, with their European counterpart ESMA. The relationship there is also quite good. This Bill also fits with where we are in reality in looking at regulation for our sector in Europe.

Q354 Mr Brown: Do either of you want to sound any warning note to us? Is there anything you would draw to our attention that you would recommend we thought about and suggested to Government that needed adjusting?

Mr Beales: A key question for us—and this is where the difference between the firms that the organisations we represent will come through—is that most of our members will be dual- regulated. They will be prudentially regulated by the PRA and market and business conduct regulated by FCA. There are lots of issues for them as to how this will work in

practice. The development of the memoranda of understanding, which are designed to ensure integrated, dovetailed regulation between the authorities, is very much a good first step, but there are areas where more needs to be done.

Just to give you an example, on the management of international issues, where FCA will be representing the UK in ESMA but there may be prudential subjects there which ESMA will be looking at—for example, ESMA has responsibility for credit rating agencies—there needs to be a proper process for ensuring that the bodies whose views need to be held in that forum are properly co-ordinated. Our suggestion for that is that there should be a joint committee formally established within the context of the Bill to ensure that a coordination process happens in practice rather than simply being an aspiration.

Mr Brown: That is helpful.

Q355 Lord Skidelsky: I have a supplementary to the first question. Would this Bill make it less likely that another financial crisis would originate in the banking sector? I think both witnesses said that they thought it would be helpful in that respect. Would the help consist of changes in structure or the acquisition of new tools? Which do you regard as the most important element in that? How would you divide it up if you had to put a number?

Mr Beales: I don't think I am going to put a number.

Lord Skidelsky: I didn't think you would.

Mr Beales: It seems to us that the introduction of a macro-economic, macro-prudential regulator is a key element of this legislation. This is not just a British development, of course; it is a worldwide recognition of the deficiencies that went before. That probably is the key element of the new structure in terms of seeking to prevent a future crisis. Almost by definition, it is the tools that that body has as much as its powers that will determine its success. I guess the answer to your question is that the shift of focus to macro-prudential regulation is the key thing here. Putting a number to it, it is 70% or 75% perhaps, or something like that.

On the tools, plenty of work is still to be done. It is important that the approach we take in the UK fits with the work that the FSB are taking forward and the regime that will be established in Europe, because so much of the risk that arises in the large firms is globally originated and not just UK originated. We will need to ensure not just that our authorities have the powers that are needed in a domestic context but that they have powers they can use to head off developing international risk.

Q356 David Mowat: On that subject, as you say, things are likely to happen at a European level as well as at a UK level. Do you consider there to be an issue here with the fact that the European structure for regulation that is being set up is sector specific, while what we are doing in the UK—the twin peaks structure—is a sort of matrix that straddles sectors so that it is rather difficult to see accountability and clarity within that, or not?

Mr Beales: My analysis of the European legislative pattern is slightly different. It is neutral on who does the work. The Directives require certain measures to be in place. I say "the Directives", but a lot of the measures will take the form of regulations so they will be

directly applicable. They are neutral as to who does the regulation. For example, in France they sort of have a twin peaks model; there is a conduct of business regulator and there is a prudential regulator; but the measures themselves are silent on it. When it comes to the level 2 committees—the European supervisory authorities—again, they are driven by the kind of business for which they have responsibility. ESMA is primarily going to be a conduct of business and market regulator, but it also has responsibility for accounting and listing and so on. EBA will be prudentially focused, but its responsibilities, because of the way EU legislation works, will extend to investment firms as well as to banks. I do not think our model is hugely out of kilter from the overriding structure that they are adopting in Europe. Our problem, if problem it is, is that the scope of those ESAs does not wholly dovetail with the scope of our new authorities. It is not a bad fit but it is not a perfect fit, which is why it will be important to ensure that we do not miss or underplay issues.

Q357 David Mowat: Could you give an example of where the scope is different?

Mr Beales: Yes. Credit rating agencies are a good example. ESMA has formal responsibility for licensing credit rating agencies. Traditionally, in the UK, one regarded the work of agencies as a prudential matter because their ratings are so linked to bank capital. There you have an authority whose focus is primarily conduct of business dealing with a matter which will have huge prudential implications.

Q358 Baroness Drake: Staying with the European issue for the moment, the Capital Requirements Directive IV is seeking to achieve maximum harmonisation across the EU and, as such, looks to be setting requirements that cannot be exceeded without explicit European clearance. Our own Bank of England and Treasury are clearly concerned at that, in the sense that it could restrict the UK regulators' ability to deploy macro-prudential tools or to force UK institutions to hold more capital. There is clearly a tension there. Are you concerned that the UK will not have enough freedom to set its own micro and macro-prudential policies?

Mr Beales: We are trying to tease out exactly the impact of CRD IV. One of the difficulties is that because it is implementing Basel—it does other things as well but that is primarily what it is there to do—there are elements of Basel which still are not settled, one of which is the counter-cyclical capital buffer element. Somehow or other the EU Directive and Regulation have to have provisions that leave that door open to the final Basel settlement. It is not clear to me that the Commission quite have that language right. Let us assume that language of the kind that is needed was introduced. It seems to me that that would considerably reduce the force of the argument that our hands are, so to speak, tied.

Now we are getting into the Basel arcanery, and I should emphasise that I am not a prudential MD at AFME, but the other element is that there is the Pillar 2 arrangement, which allows regulators to impose additional standards if they feel the minimum standards do not pass muster. I am told by my prudential colleagues that it is quite clear that that element remains in Basel and will be reflected in the EU measure.

Q359 Baroness Drake: In that sense, that is a sort of bottom-up measure, whereas the debate is around top-down. What I am pushing you for a view on is that, if the kind of

interpretation that appears to be coming out of Europe at the moment is that any variation from the rule book requires clearance, what is your feeling about the concerns that would have in terms of the UK's ability to manage its own macro-prudential challenge?

Mr Beales: If we felt that the measure prevented the kind of powers that this draft Bill envisages being exercised from being exercised, we would be concerned. We would add our voice to that of the Government saying that that cannot be the right outcome. But—and this is perhaps a theme that will emerge later—it is very important as we are developing our own tools that we do this with an eye to what the emerging international consensus is. These are not contradictory, but it is important, in pressing for the former, not to lose sight of the latter.

Q360 Baroness Drake: Given these tensions between the fundamentals of the proposed Government reforms which would give these powers to the regulators and what may come out of the European Directives, do you think that the way in which it is proposed within the Bill that the regulators co-ordinate with the European authorities is sufficient or the right way to make sure that UK interests are sufficiently exerted at the table and that influence is sufficiently deployed?

Mr Florman: I will answer that from the perspective of private equity and the experience that I have had over the past year with the AIFMD. It is very important looking forward to protect our sovereign use of macro-prudential rights and instruments in the implementation of different Directives. The trend, globally, appears to be to co-ordinate a large number of initiatives and pieces of legislation, some of which are going to cause great difficulty to our private equity industry in Britain.

An example of that is Solvency II, which, on the face of it, as applied to the Pensions Fund Directive, will lead to pensioners, insurance companies and others who would be subjected to this finding that the capital weighting that they must apply to equities and to long-term equity, i.e. private equity, is very significant indeed. They will therefore adjust their behaviour. They are likely to sell their investments in this area and find that they are less prone to making long-term commitments and investments in European industry.

There are a number of secondary and possibly tertiary effects of pieces of legislation in Europe and globally that could have a detrimental impact on issues within the UK. To have a macro-prudential approach here which protects UK sovereignty is very important. The related point here is that we need to engage very early as legislation is considered. In AIFMD, it covers hedge funds, real estate funds and other forms of asset, private equity and venture capital. ESMA and the predecessor to ESMA recommended to the Commission that that piece of legislation was divided into four or five separate groups so that each industry could be regulated appropriately and proportionately. I understand that the Commission went back to ESMA and their predecessor and said, "No, let's bundle it all together and consider just one Directive." It has been extremely complicated to achieve now a level of regulation that is appropriate and proportionate for British venture capital. We are very close to doing it because we have worked closely with the FSA and with ESMA, and they have engaged with us. There was a risk at one point where this legislation could damage us quite significantly because it was being considered at too high a level in a way.

Q361 Baroness Drake: Do you think the proposals for engaging Europe in the Bill would allow that influence that you have articulated to be sustained, or do you think it would weaken?

Mr Florman: I think so. If the FCA going forward was to have private equity and venture capital practitioners on the governing body of the FCA, that would also help. As they engage with ESMA, both ESMA and the FCA can make reference to those from the industry and guide them. The master legislation will cover all alternative types of investment fund and so we need those practitioners there.

Mr Beales: The structure is helpful but we do consider that establishing a formal joint committee to plan advocacy strategy in Brussels is needed. Early intervention is important, but ultimately these are qualified majority voting proposals and we only have so many votes. We need to do more about co-ordinating alliances with other member states. Speaking for AFME, one of the reasons we were established was to see whether we could assist in that kind of work. We are beginning to do that but this can be an uphill struggle. Structural changes will help but they will not necessarily always deliver the right answer.

Q362 Mr Laws: On the FPC and its objectives, obviously some people have criticised the definition of the objective and whether it is clear enough. Barclays in their submission to this Inquiry commented to us: "As it is currently proposed, the FPC will be using untested tools to achieve an undefined concept", in terms of the objective. Do you have any sympathy with that view?

Mr Florman: We are not in the banking business, but I know that there is an impact for private equity because we need to work closely with banks. The counter to macro-prudential supervision and overall systemic risk oversight is to ensure that the industry functions, works and continues to lend money. The overall objective has been proposed to maintain a sustainable supply of credit. That is also a very valid thought to make sure that banks continue to behave, to lend and to be part of industry. There are almost two aspects, and, if we go overboard in regulation in all aspects of financial services, we can find that we create an effect that we did not anticipate.

Mr Beales: We feel that elements of the Bill should be amended to require the FPC to explain how it envisages using the tools and there should be a reporting mechanism so that when a tool is applied there is a method of assessing how that works in practice, both good and bad effects. More can be done—not to circumscribe what it does but to make what it does explicable and capable of being judged.

Q363 Mr Laws: Are you content with the way the objective is defined at the moment?

Mr Beales: Given that the nature of macro-prudential regulation is still being explored, this is going to be a definition that we have to revisit in any case. Hopefully, the international consensus will be emerging sufficiently for us to know whether the Bill fits with it when this is debated formally.

Q364 Mr Laws: So far we have this interim FPC which has met twice over recently months. It does not have the full powers yet but it can make various recommendations. So far, it has made at least two significant ones. First, it is advised the FSA to support improved disclosure of the UK banks' exposure to European sovereign debt at the first meeting. In the second meeting, it recommended that banks should take any opportunity they had to strengthen their levels of capital and liquidity without constraining lending to the wider economy. Do you agree with the recommendations that have been made to date? Do they tell us anything about the challenges or conflicts that the FPC is going to have in doing a decent job?

Mr Beales: We are fully supportive of the initiatives that are afoot internationally to increase banks' financial resources. The recommendation on that, as you describe it, encompasses increasing capital at apt moments rather than going for it straight away. That is how I understood the interim FPC's report. I guess that that is right as well. Whether it provides an insight yet into how the Committee will work when it has its full powers, it is too early to say. We read the minutes, asked the question and did not find a satisfactory answer. It is very good that the Committee is beginning to share its thinking with us. This is a helpful step when the legislation is still to pass through Parliament.

Q365 Mr Laws: Do you think anybody has paid any attention at all to the recommendations made to date, or do you think people are not really bothered?

Mr Beales: On the disclosure side, the EBA is envisaging looking at the stress test results again. The material is there for that to be done. On the capital side, banks have started to plan for the CRD IV and Basel requirements. That involves a very significant increase in capital in the next three to four years. Whether there is additional to be done on that front I am not sure.

Q366 Mr Laws: Mark, do you want to add anything to that?

Mr Florman: It does not really affect our industry directly, but the FPC should keep an eye very closely, as I said before, on other European legislation, in particular the Pensions Directive, and the impact that some of those expectations which are now built into the market could have on actions of banks and other participants in the financial services industry in the UK at the moment. Merely the thought of Solvency II being imposed on the Pensions Fund Directive is already beginning to change behaviour. The FPC is in the right place doing the right job, and I would encourage them to look out to Europe and look at what else is going on quickly to see how that affects the UK.

Q367 Lord Skidelsky: I have a supplementary question going back to Mr Laws' question on the evidence from Barclays. They argue that the objective should not be to maintain financial stability, which they say is an undefined concept, but to maintain a sustainable supply of credit which can be defined—neither too much nor too little, basically. That is point one. That is very difficult given the inherent uncertainties in investment. But, subject to that, the objective should be to support the economic policy of Her Majesty's Government, including its objectives for growth and employment, which in fact is a way of giving guidance on what the sustainable supply of credit is. Do you think that would give a sharper definition to what

the objectives of the FPC should be? Financial stability, other than just preventing crises, is very vague, is it not?

Mr Beales: Broadly, that would provide a signpost. There are perhaps two caveats. One is that we need our macro-definition to fit with whatever the international consensus is. The international consensus may go for a different formulation. It is also conceivable that financial stability risks could arise other than from developments in the credit markets. There could be infrastructural difficulties, for example. One needs a formula that at least encompasses that kind of development, even if the focus is not strictly on it.

Q368 Lord Newby: Macro-prudential tools have been talked about to a certain extent and everybody is grappling with how they might be used. I wanted to tempt you to put on the hat of the members of the FPC for a minute, if I might, and ask you to contemplate what macro-prudential tools you think are likely to be most effective in preserving financial stability. In particular, which tools do you see can most effectively be applied to your members?

Mr Beales: We are now entering the territory which is not in my immediate expertise. We have an inventory which we could share with you of macro-prudential tools, but we are not in the position yet of assessing what is the most apt for any given condition. We can certainly share that with you. I am happy to send it to the clerk and provide some commentary on how the tools would work.

A key thing is tools that bear on over-availability of credit in one way or another. That can include counter-cyclical provisioning. Different tools will be designed for similar ends and therefore judging what is the most efficacious is a difficult matter. If I may, I will just leave it that we will provide our inventory.

Q369 Lord Newby: Are you talking to the Treasury about your inventory?

Mr Beales: Yes, because part of the drawing-up of this was in response to a Treasury consultation paper.

Mr Florman: With respect to private equity and venture capital, the framework under which a fund manager can raise new funds needs absolute certainty because you are inviting your limited partner investors, institutional investors and pension funds to make a commitment for 10 or possible 12 years to a programme of investment in Europe. You need absolute certainty at the beginning when you sign the limited partnership agreement document that the framework for operating a private equity fund manager will exist for at least a certain number of years. The uncertainty around the framework for the industry is extremely unhelpful because people stop fundraising. It is only relevant at the macro-prudential level to the extent that uncertainty leads global capital from China, America and elsewhere to cease making commitments in Europe because of the uncertainty in Europe. The more stable and certain that is, the better for our industry.

Mr Beales: I would like to mention a drafting point which I think is quite relevant in this context. There is this ability within the draft Bill for the Treasury to make recommendations to the FPC. It seems to me that that is quite an important safeguard. It allows the remit to evolve as we learn and as we go along.

Q370 Lord McFall: The implementation of the macro-prudential tools is the key. Do you see buy-in from the industry being necessary for that, because it could have quite an effect on the way the market conducts itself?

Mr Beales: Yes; that is a fundamental issue. At large, the industry recognises that we need a macro-prudential regulatory framework to prevent another crisis, if we can. Depending on the business line that one is in, there will be views on whether the use of a particular tool was apt or not. The restraint built into the draft Bill about the capacity of the financial services industry to contribute to economic growth is quite an important element of the decision-making process that the FPC will go through. But, by and large, if firms understand the thinking behind the application of a particular tool both before and after the event - so the kind of analysis that we are seeking and which I referred to earlier on is in place - and there is a process of discussing with the industry the thinking as that evolves, to which the Treasury consultation has contributed, there should be industry support for this structure.

Q371 Lord McFall: Mark, you mentioned about deals being signed up for 12 or 14 years and that if you are going to have macro-prudential tools there has to be a global dimension to that at the UK level. Is that correct?

Mr Florman: Yes; that is right. A typical fund is 10 years, and it can extend to 12 years. As investors make that commitment, they would like to see that we have a stable framework. At the moment much of the capital heading towards Europe is coming from China, Canada and Australasia. The uncertainty over where we stand as a continent is leading people to not make those decisions. We need a stable framework, and we are close with ESMA. We are probably literally a few weeks away from having a directive that is going to be quite unacceptable to private equity and venture capital. We have managed to talk through many of the misunderstandings that existed at the beginning because we were lumped in with hedge funds. We are very close to that. For the future, the FCA, with whom we have a very good relationship with the team, as I referred to earlier, should have full engagement with ESMA so that there is no difference between what is being thought of at the European level versus the UK level.

Chairman: Was there another point on macro-prudential that you wanted to raise, Lord Skidelsky, or not?

Q372 Lord Skidelsky: Yes. I was struck by HM Treasury in their report on a new approach. I quote: "In many cases, banks built up excessive leverage while still showing strong risk-weighted capital ratios, due in part to the incorrect risk-weights attached to certain assets." Charles Goodhart, in a paper we received, makes the point as well that the pricing of risk-weighted capital assets is subject to political pressure, financial manipulation and so on.

Given that, does it make any sense to impose fixed capital ratios or fixed leverage limits on a target or a variable which is subject to so much uncertainty? Would it not be better to give more discretion to the regulatory authority in the use of its judgment on both of those matters: capital ratios and leverage limits?

Mr Beales: It is recognised that there are differences in treatment of RWAs in both European countries and globally. As I understand it, although as I say this is not my area of expertise, in a way the next Basel exercise is to examine the difference in treatment and to try and limit it, in which case your wobbly population will become less and hopefully significantly less.

The Pillar II structure does give the regulator the scope for saying, "Even though you are above the minimum, I still don't think you are sufficiently above the minimum because of the nature of the assets that you have." There is scope for making those kinds of judgments. Perhaps the point is that there needs to be a greater regulatory consensus about the need to address those issues. My impression is that that consensus is emerging.

Q373 Mr Ruffley: Mr Beales, how important is the shadow banking industry for your members?

Mr Beales: It depends how you define it. Hedge funds are important clients of our members. Our members provide a range of financial services. To the extent that there are kinds of firms that fall into the shadow banking category, they would be regarded as customers. There is some recognition that tougher capital regulation will, at the margin, create incentives for movement of business out of the regulated banking sector to others, which is why it is important that we have built within the Bill this capacity to alter the perimeter that establishes the systemically important. We can redefine that population if it is felt that we need to. The Financial Stability Board is doing some good work on defining these questions. My understanding is that some quite significant international data collection is going on to establish the current size of the shadow banking system.

Q374 Mr Ruffley: Are you confident that the new regulatory structure set out in this Bill will be adequate in regulating these unauthorised activities?

Mr Beales: It has the capacity to alter, through a secondary process, the definition of the regulatory community. That, though, may only be part of the answer because business is international. If a development within a particular sector occurs overseas and we have no ability to influence it, our machinery formally might not have the power that it needed, but we are very significantly influential in international discussions. I feel that the international community would move forward in harmony in defining where the bulge was emerging and where, therefore, the scope of regulation perhaps needed to change.

Q375 Mr Ruffley: You are quite confident, because, up until now, that kind of common-sense and pragmatic approach, looking at where the bulge is, that mentality, was not in evidence really up until the crash or even until recently.

Mr Beales: I agree.

Q376 Mr Ruffley: What confidence do you have, given your experience in the markets, that regulators will be quick off the mark and on their toes, given that they will be up against some extremely sophisticated players? On the international level, what do you think is being

done? You mentioned the FSB and other bits of work, but do you get a sense that anyone is really gripping how we regulate or potentially regulate parts of the shadow banking industry?

Mr Beales: I think, yes, it is being gripped. The Financial Stability Board project is a serious one and the member countries are committed. You make a good point. At the moment everyone is attentive to these issues because of what we have just been through. The test point is when a generation changes. There are serious steps also being taken to ensure through mutual assessments, IMF assessments and so on—of which the UK has just had one—to ensure that there is an independent assessment of whether standards are being maintained or not. Provided that that is exercised diligently, and I do not think there is any reason to think that it will not be, that should provide a check for the kind of slippage that might otherwise occur.

Q377 Baroness Wheatcroft: I would like to develop that theme a little, if I may. We are talking about the quality of regulators and regulation. We are moving towards judgment-based regulation. Do you think the regulators will be capable of exercising that judgment?

Mr Beales: They certainly could be. A good question is how we try to assist to ensure that they are. There is no doubt that there are some very able people. The question is whether there are enough of them. I would have thought that working as a regulator should be more attractive as a career. It may be that moving prudential regulation to the Bank will help on that front because it creates a broader set of career options. More can be done on the secondment front. The SEC, for example, has a significant industry inflow. If you work at the SEC, it is regarded as an important addition to your career. There are measures of that kind that we should actively explore.

Q378 Baroness Wheatcroft: Is that a formal secondment arrangement through the industry?

Mr Beales: Yes.

Q379 Baroness Wheatcroft: That does not exist at the moment.

Mr Beales: No. Some firms do it. There are quite a lot of secondments from the professional firms, the law firms in particular, but the interchange that seems to exist in the US between the firms and the SEC is something we should explore as to whether we can extend that principle here.

Q380 Baroness Wheatcroft: I am sure that that is a step in the right direction but the overarching problem does seem to be one of remuneration. Can you see any way round that?

Mr Beales: This is a difficult question, of course. I have no inside-track insight into the current bonus round. It must be the case that if one particular sector remunerates better than the public sector then you are likely to have seepage. One way you deal with that is by ensuring that the exchange of staff is much, much greater so there are not two separate camps in this way. Beyond that I cannot say.

Q381 Baroness Wheatcroft: Thank you. Mr Florman, do you have any thoughts on this? You have been a banker in your time.

Mr Florman: Yes; I have. In France they also have an exchange between the private and public sector. It is seen as an honour to leave the private sector, whichever part of industry you are in, and spend some time in the public sector. It is a great credit on your CV and it is a great part of career progression. Perhaps we undervalue that in this country. An exchange between a sector being regulated and the regulator would be a very good idea. In my experience of negotiating the AIFM Directive across Europe on behalf of the entire European industry I have come across regulators who are overworked and completely overwhelmed with political pressure from the EU Commission and elsewhere and yet are extraordinarily bright people. What they need—and this is the experience I have been through during the summer—is much more time and resource. There is a willingness to engage with us completely but there never seems to be enough time. Some of the great problems we have had in the AIFM Directive are that there was not enough preparation at the beginning with the industry. Building a bond between the industry itself and the regulator at an early stage would be a very wise thing to do.

Q382 Baroness Wheatcroft: I would like to ask both of you whether the current structure of the new regulatory authorities involves the industry enough. Are the practitioner panels going to be sufficiently listened to? Should there be more representatives on the regulatory bodies?

Mr Florman: As I understand it at the moment, the FCA does not have a space for a practitioner from venture capital or private equity. I would obviously recommend that.

Mr Beales: The PRA, of course, is not to have a practitioner panel. The draft Bill simply refers in general terms to arrangements to consult. We think there should be a practitioner panel for prudential regulation and it should be the same panel, the reason being that the FCA is going to do a lot of prudential regulation; it is just not the systemically important firms. The practitioner panel at the FCA will be covering prudential matters and it seems to us that its remit should simply be broadened to extend it to the PRA.

The point about early consultation with practitioners is absolutely essential to robust regulation. One of the tests—and Mark has been referring to it—is getting this more understood in Brussels. For a period it was, and then, with the crisis, they lost sight of it all. For example, they just do not conduct proper impact assessments on measures. Had they conducted an impact assessment, not necessarily cost-benefit but just an impact assessment at large, of the AIFMD as initially proposed, they would have stopped short. They would have thought, "This is not a measure that flies." We need to encourage that kind of participation both in Europe and at home. We very much welcome the decision to establish a markets practitioner panel in the FCA. That may help a little bit on your side as well by focusing it a bit, because I think the current practitioner panel's remit was in a way too broad. That will help.

Q383 Baroness Wheatcroft: Do you have any concerns that during this interim period, while the Bill goes through and these bodies are formally structured, that the FCA—FSA as was—is losing good people and some of its potential judgment?

Mr Beales: There were some departures that we were sorry to read about.

Q384 Baroness Wheatcroft: Was that on a large scale or a small scale?

Mr Beales: Not on a large scale, but people who we dealt with, one knew and who understood the industry. That did not mean that they were over-influenced by us; it just meant that when they had a conversation with you they would be starting at the right level of understanding.

Q385 Baroness Wheatcroft: Is that continuing?

Mr Beales: No; I don't think so. A "wave" is too strong a word, but there were four or five people who departed quite closely to each other, which made it a bit more noticeable perhaps than it otherwise would have been. I am not conscious of anyone else.

Mr Florman: The FSA, and now the FCA, with respect to the private equity and venture capital industry, is by far and away the best regulator in Europe—I hesitate before saying that in Europe but I am happy to say it here—because there is a deep and long understanding of the industry going back 30 years. Therefore, the value of the people there in Europe is quite extraordinary. From our industry we would welcome a reaching out to Brussels, to the EU Commission and to ESMA as they have been doing, but that is an extremely valuable engagement. If we were to relive AIFMD, I would say the Treasury and the British Government with the FSA should act early and be engaged in Europe as quickly as possible because there is so much expertise here. We were a little bit shy or reluctant at one point to come forward.

Q386 Lord Maples: I want to ask mainly Mr Beales, though I would be happy for your thoughts, too, Mr Florman, a couple of questions about risk in investment banking. Can your members live with the ring fence that is proposed by Vickers, or is it going to depend on whether they are in both camps?

Mr Beales: On the ICB front, I should say by way of foreword that being a European organisation we regard it as primarily a UK initiative. Although we submitted comments to the ICB, it was not a major piece of work for us and it only affects a limited number of our members. It is important I emphasise this because it means we have not been in close contact with the firms affected; they have other fora where they debate these issues. That said, my impression is that the way the ring fencing will work is that it requires certain forms of business to be ring-fenced and other kinds of business not to be within the ring fence, but beyond that there is a degree of flexibility as to what goes in and what goes out. It should assist the banks to adjust to it, but none the less there are significant costs associated with introducing these rules. Our starting point was that, given the range of regulatory reforms that were already in train, it was not clear to us that this additional safeguard was needed. Equally, it was not clear to us that the sort of merits to customers of the universal banking model were truly given weight. I cannot answer definitively.

Q387 Lord Maples: What is behind it is for the benefit of the taxpayers. Hopefully, the taxpayers will never again get caught in the position they were in 2008 and that this would help to reinforce that. Because we have a big investment banking industry in this country, we are interested in the extent to which it can live with this proposal. You are saying you think there is enough flexibility there to make that good.

Mr Beales: My reading of the report suggests that those propositions were brought forward with that hope in mind, but I cannot speak for the four or five banks involved.

Q388 Lord Maples: But it is only four or five, is it not?

Mr Beales: Yes, but they are large, important banks, of course. It is important for the London markets. There is no doubt about it.

Q389 Lord Maples: I have one other question on risk. One of the arguments for rescuing investment banks when they got into trouble in 2008 was that the counterparty risks were so complex and pervasive that, if one was allowed to go down, it would pull others with it because there are so many contracts out there and you don't know where they are. Can we remove that problem by taking a series of what one might call micro- measures? A lot of these contracts would become standardised and traded on exchanges so that they have a price and you knew what it was, and perhaps naked swaps should not be allowed rather in the way that insurance law does not allow you to insure the risk unless you have an insurable interest. Do you think these sort of things can go a long way to removing this risk of a Government being asked to help to bail out an investment bank that gets into trouble because of the counterparty risk complexity?

Mr Beales: A major thrust of international regulation now is to make large firms resolvable. That certainly encompasses the point about standardising products and having clearing and settlement requirements so there is less OTC business. We are also requiring a lot of extra capital, which means that, even though a firm which gets into difficulties has this adverse impact on its counterparties, they should be in a better place to take those costs. The short answer to the question is yes, we can reduce the risk.

Q390 Lord McFall: Following on from Baroness Wheatcroft's point about the FSA, if my memory serves me correctly, Clive Briault, Sally Dewar, Jon Pain and Dan Waters, who were the senior executives there at the beginning, have left, and Thomas Huertas, who gave evidence to our Committee, I believe is leaving the FSA as well. That institutional memory at a senior level has gone. That has to be a real worry. If I had one suggestion for the industry, it is to ensure that it seconds people at a senior level to the FSA, and not just at a junior level, and it is seen like in France that we are having a pride in public service. If we do not do that, then the industry is always a step ahead of the FSA, and we will get ourselves into the same problems as we had before. I see that as a fundamental problem.

Mr Beales: I can certainly take that observation back from this Committee and share it with our board, which we will do.

Mr Florman: That is an excellent suggestion, if I may say. That institutional memory that has been lost must not be lost again. I know that in my previous business life I always tried to keep institutional memory by forming informal advisory boards to keep the skills that we have there. We are going to find that this is repeated unless we can build a very strong FCA in partnership with the industry now and make sure that the people who are leading it are properly appreciated.

Q391 David Mowat: I refer to competitiveness and the draft Bill. It does not talk very much in any of the bodies about the need to promote competitiveness. Do you think that is an error?

Mr Beales: We would like the legislation to make reference to competitiveness but perhaps not as an objective, for example. If you are looking at options for new rules in a particular field and the models that you have developed all seem to have the kind of results that you are seeking, but one of them is more likely to damage the competitiveness of firms in London than another, the legislation should require you to go for the less damaging option. In that way the legislation could more clearly address the point than it currently does.

We would put it differently. In our eyes, it is about assessing any development in the UK against the international consensus. That is the test that needs to be made. There is a competitiveness element to it, but it is also to do with ensuring that the regulators move forward on a single front.

Q392 David Mowat: You would define the answer to the question on competiveness about making sure that we were not over-regulated here vis-à-vis our competition rather than a particular need to do other matters. You would see it as a mechanism for not being overly regulated here.

Mr Beales: I think there should be a judgment on whether a particular regulation unnecessarily has that effect. That is perhaps the best way to put it.

Mr Florman: I would only be concerned relative to the rest of Europe as to the gold-plating history of legislation in the UK that comes from Europe. This particular Bill has little bearing on our industry, but, as a general point, to maintain Britain's competitiveness for the private equity and venture capital industry we want to make sure that the directive and future European directives don't get over-implemented here in the UK. The competitiveness generally within the sector is excellent. Each fund is raised and must fight for its own survival by delivering good returns to its investors. New funds are finding it more challenging now to be raised. That is partly because the AIFM Directive will make it more expensive and more costly for funds under the size of about €1 billion. My long-term fear on competitiveness generally, looking at all of the legislation in front of us, is that younger people will find it much harder to start venture capital firms and become entrepreneurs because of the weight and the cost of regulation that they are looking at. Compared to 10 years ago, the prospect is quite terrifying.

Q393 David Mowat: Do you think that the FCA should have a more specific mandate regarding getting more competition into the industry that they regulate, over and above regulation? It is just the need for more competition and the benefits that brings.

Mr Florman: In our industry it is competitive enough. In a way the natural regulator of private equity is its limited partner investors. The moment you mis-perform you are done for, so there is a strong sense of natural competition and the natural regulation comes from the LPs so, no, I would not have thought that is necessary.

Q394 Chairman: Could I ask one very brief final question of Mr Beales? It has been suggested that there is a danger of regulatory creep—of protective legislation creeping from retail operations to wholesale operations. Is that a concern of yours at all?

Mr Beales: Yes, it is a concern. The steps that have been taken within the FCA operationally are encouraging on that front. There is a particular element of this that we would seek. Adjusting the definition of "consumer" in the consumer protection objective would be helpful. For example, if someone is undertaking business with a firm and they are in the financial services business, they should not automatically be regarded as a retail consumer. They may be treated as such if the circumstances justify that.

The other area where we have a concern is on listing, where the proposition is that, effectively, the FCA's principles and objectives at large should apply to the listing authority rather than retaining the special regime that exists for listing currently. We think that is a mistake and there are very different issues as a listing regulator from a regulator of individual firms. We have asked the Treasury to revisit that proposal

Chairman: Thank you very much indeed. Thank you for all your evidence today and for coming and appearing before us. We are very grateful and it will be very helpful for our report.

Examination of Witnesses

Witnesses: **Mr Ian Cornwall**, Association of Private Client Investment Managers and Stockbrokers, **Mr Richard Saunders**, Investment Management Association, and **Mr David Paterson**, National Association of Pension Funds, examined.

Chairman: I welcome our three witnesses this afternoon. It is clear to us who you are, as long as you are sitting behind the right labels. We are very grateful to you for appearing before the Committee. I will ask Baroness Wheatcroft to start the proceedings with a fairly general question.

Q395 Baroness Wheatcroft: Good afternoon, gentlemen. Thank you for coming along. One of the things we are looking at is the Vickers report on banking. You are all investors. As a starting point, how do you feel it will influence your view of banking and the banking sector if the ring-fencing move goes ahead?

Mr Saunders: The IMA represents the investment management community at large in the UK. It is fair to say that there is a very wide spread of views among the investors. There is a spread of views among equity investors versus fixed income investors. Within both of those, particularly within equities, people find different views from people who hold banking stocks from people that do not hold them.

If I were to characterise it very over-simplistically, people who hold bank equities at the present time are probably a little bit nervous about ring fencing because they feel it may lead to some fall in the price longer term. People who do not hold bank equities are probably pretty positive about it. Indeed, there are those who would argue for even more radical steps because they believe that ring fencing or something related to it will lead to a more stable system which is more likely to be able to withstand the sort of shock we have seen in the last three years.

Fixed income investors are probably more favourable towards the idea of ring fencing. Again there is a spread of views within that group. Overall, the position the IMA has taken has been one of broad support for the Vickers proposals.

Mr Cornwall: Broadly speaking, we would share the same views as Dick in terms of the points he has made.

Mr Paterson: From the point of view of pension funds, they delegate most of their investment activities to investment management houses such as the IMA members. Our members tend not to have a specific view on the Vickers report as such. I personally see the ending of uncertainty as being a major plus for the industry and I don't think we are there by any means yet.

Q396 Baroness Wheatcroft: That being the case, do you think there would be any merit in bringing in a ring fence, if there were to be a ring fence, sooner rather than later?

Mr Saunders: I am not sure I would have a particular view on timing. It is important that it needs to be introduced in a way which does not create short-term disruption.

Q397 Baroness Wheatcroft: But does not uncertainty create that disruption anyhow?

Mr Saunders: Not if it is clear what the path is and what the end game is. If there is clarity over where we are going, then the length of the transition period is not necessarily an issue.

Mr Paterson: I agree with that. It sums it up very well.

Q398 Baroness Wheatcroft: Do you think, if a ring fence were to be brought in, investors might of their own volition push the banks towards actual separation?

Mr Saunders: It is possible. I would not put it any more strongly than that. I do not think at this stage that anybody has thought it through that far ahead. When people look at the issue, they are looking at it in terms of what is the best way to prevent the sort of shock that we have seen over the last three years.

Q399 Mr Brown: Do you regard the regulatory regime that we have under consideration as a Committee as an improvement on what went before? If you do, what do you think the improving features of it are? Is there anything you would want to say to us about things that have been left out so far—things that you would like to see in it that are not there?

Mr Saunders: In principle, I think the twin peaks approach has quite a lot to commend it. There is not necessarily inherent logic in having conduct regulation and prudential regulation under one roof, since the objectives of the two are completely different. Prudential regulation is about the prudent management and overall stability of balance-sheet businesses—banks and insurers—whereas conduct regulation is about consumer issues, market integrity, market abuse and so on. They are quite different sets of issues and they can come in conflict. There are times when the interests of consumer protection may not point in the direction that a banking regulator would want to go.

In principle, it could be better than what we have today. The challenge is in getting from here to there and the disruption involved in that process. We have seen a number of senior level departures from the FSA already; so there is a big challenge in managing that process through.

In terms of what is not covered, I would mention two things which are in our memorandum. The first is that the discussion there has been up to now has not looked at the role of the Financial Services Compensation Scheme. There is at least a question there whether it should not itself acquire some additional powers which would enable it to operate a little like the FDIC does in the United States.

The second thing that we feel is missing from the Bill is perhaps a slightly more technical issue, which is the current structure of so-called permissions—the permissions which are granted to firms to conduct business—which are given effect by a piece of secondary legislation called the Regulated Activities Order. Those permissions date from a time before the establishment of the FSA and, indeed, in some cases even before the establishment of SIB. They bear no relation now to the actual legislation under which financial firms operate these days, which is European legislation—the MiFI Directive and so on. There is a need for a thorough overhaul of that and that is something we would have liked to have seen in the legislation.

Mr Cornwall: Most of my firms will be entirely regulated by the FCA. Our main concern in the context of twin peaks is to make sure that the PRA in its engagement in Europe recognises that the Capital Requirements Directive and the prudential requirements that originate from Europe apply to investment firms, particularly some very small firms. We are very keen to make sure that the FCA actively works with the PRA to make sure that the needs of all firms that are subject to prudential requirements are taken into account in developments in European prudential regulation.

Mr Paterson: On the pension funds, the occupational side is regulated by the Pensions

Regulator and therefore falls outside the scope of the Bill, which puts us in the position of being consumers of financial services products rather than creators of them. We are in a different position from my two colleagues here. Reflecting on the way in which the regulations are planned to change, if anything, that helps us as consumers.

Q400 Mr Brown: Do you worry about the contestability of the new arrangements? If there is a long-term tension between yourselves and the regulatory regime, how would you air it? Are they not judge and jury in their own cause? Accountability to Parliament is not being changed; it is through Ministers and through reporting to the Treasury Select Committee. Would you like to see something else or are you content with the arrangements as they stand?

Mr Saunders: That is certainly an issue here. The accountability lines are unchanged, as you say. Some of us do have a question as to whether there is sufficient accountability for the FSA now. That is not in terms of individual supervisory decisions. That clearly has to sit with the independent regulator. Simply laying an annual report before Parliament is a very formal process. It does not allow the sort of detailed interrogation that one might want to see about how the regulator has fulfilled its duties.

We have a current instance at the moment where, within the investment intermediary space, there have been a number of firm failures which have led to the payment of approximately £½ billion of compensation to investors over the last three years. That £½ billion has been financed by the industry and, what is more, by parts of the industry that had nothing to do with where those failures arose. One does not argue with that. The taxpayer should not be expected to fund the compensation, but there is at least a question, where the regulator, admittedly, is not running a zero failure regime—we don't want a zero-failure regime—whether those firms were actually regulated and supervised as effectively as they might have been. Right now there seems to be no mechanism for raising that question.

What that mechanism should be is difficult. We have a complaints commissioner, but I am not sure that the complaints commissioner has the terms of reference to pick up that sort of thing. The Treasury has a power to order an independent inquiry, but that is seen as something of a nuclear option. We wonder whether there is not scope for developing more internal processes within the regulators. We have, for example, the Regulatory Decisions Committee, whose activities were beefed up following a case where Legal & General challenged an FSA decision and won their case. As a result, the Regulatory Decisions Committee role was enhanced.

We have wondered whether there is more scope for making more use of non-executive directors of the FSA for that kind of oversight role and for that investigative role to look into particular cases and ask whether lessons could or should be learnt from them.

Mr Cornwall: The issue of the compensation scheme is one that has caused us a number of concerns. The main concern is that at the moment there is not a mechanism to see if there are any lessons that can be learned to mitigate future risks, both from the industry and from the regulatory supervisory approach. It is the only time that claims are made on the basis of law. There have been well publicised cases where the industry suspects there may have been supervisory failures which has led to a failure to take appropriate and/or timely supervisory action. Again, we do not advocate a "no default" regime, but with the scale of the pay-outs it is not unreasonable to say, "Are there any lessons that both the supervisors and the industry can learn from those pay-outs?"

There needs to be a mindset in future as to whether there are actions we can jointly take to mitigate future hits on the compensation scheme. Hits on the compensation scheme

undermine consumer confidence. It is costing the industry a huge amount of money, and there is a sense of frustration that compensation is being paid, but we are not looking at what happened and why. We have suggested in the past, for example, that for the major claims perhaps the Northern Rock investigation provided a model whereby the internal audit people at the FSA can periodically review major claims and give some assurance on an open and transparent basis as to whether or not the supervisory procedures were followed and whether there are any actions they can take in future to mitigate future hits.

Mr Paterson: We take a slightly different view, in the sense that the operation and effective business plan consultation process before the year starts, reviewing what has gone wrong and what has happened the previous year, provides a much more robust regime for examining better ways of constructing regulatory regimes. We do not have the same interest as my colleagues obviously in the compensation scheme. If you talk to your stakeholders early and at some length, that helps to work out a better way through the problems that may have arisen in the previous years.

Mr Brown: That is very helpful; thank you.

Q401 David Mowat: Just to develop this point about accountability of the FCA, you have talked about lessons learned. What else can be done to make the thing more accountable to industry and consumers, or stakeholders generally?

Mr Saunders: Personally, I am not sure that the FCA or the PRA should be accountable to the industry or to consumers. Ultimately, it has to be accountable to Parliament as a creature of legislation. There needs to be a review mechanism and a mechanism for learning lessons from episodes, which we do not have in the Bill at the moment. There is also a role for internal processes, be it internal audit, as Ian has suggested, or NEDs.

Mr Cornwall: We would like to see more internal challenge in the formation of some of the major policies that hit the industry. There are more checks and balances they could build into the system: perhaps more internal challenge and perhaps a role for directors within the FCA that have not been directly involved in formulating the policy, and perhaps a role on larger policy areas for non-exec directors. When you are submitting responses to fairly lengthy and complicated consultations, the people reviewing those responses are often the same people who have written the consultation paper. In terms of the internal arrangements, there is scope for more internal challenges.

Q402 David Mowat: When you say "internal challenges", do you mean from within the organisation itself?

Mr Cornwall: Yes.

Q403 David Mowat: That is a Government issue about how they are structured. That is what you are saying.

Mr Cornwall: Yes. Another area where accountability to the industry does need to be strengthened is the whole issue of cost. People are very concerned about the cost of regulation. At the moment we have a consultation paper for FSA fees. Effectively, there are

very little historic trends. In the past, subscriptions have been increased to finance large IT projects to reduce costs overall, but there is very little accountability back as to whether those IT projects have been delivered on time, on budget and subsequently delivered the costs. Now is the time for FCA to think about how, three or five years out, it can generate information that gives us historic trends. It is fair to say at the moment, in the annual consultation process with FSA, there is not a lot of information there that is historic and enables us to form a judgment when we are responding to consultation processes.

Q404 David Mowat: What would your proposal be on costs? Is it just that you would have more data available so you could look at historic trends? Is that all?

Mr Cornwall: Yes. For example, in terms of presentation, one of the issues is that the Money Advice Service will be an integral part of the FSA's budget. That is about £42 million. We would like to see that stripped out so that you are actually looking at the costs of regulation. We would also like to see the Money Advice Service as a process more like the Financial Ombudsman Service and the Financial Services Compensation scheme where there is more engagement with the industry as to what the costs and budgets are. The industry does feel one step removed, whereas the Financial Ombudsman Service and the Financial Services Compensation Scheme, to their credit, are reasonably good on an annual basis of briefing us on their costs and their proposals for the future year.

Mr Saunders: Building on Ian's point about internal challenge, another idea that is worth exploring is the publication of dissenting opinions or votes at board level. This is done routinely with the Securities & Exchange Commission in the US and with the Monetary Policy Committee of the Bank of England. That could be another avenue to explore for introducing better internal accountability.

Q405 David Mowat: One way of doing that also would be to have more public meetings like the SEC has. Is that something that you have thought about and that you would welcome?

Mr Saunders: Yes.

Mr Paterson: It is very important that you think about these things from the point of view of the consumer. In a sense I represent one tiny part of them. Therefore, producing reports which are transparent to the consumer, be it the individual or the pension schemes, and which gets rid of the opacity which dogs this industry would be valuable. You would get through a lot of the jargon which confuses people and get to the things that really matter for consumers in the financial services sector. A lot of work can be done there and the FCA can do a huge amount to help that.

Q406 David Mowat: I have one final question of Mr Cornwall about an earlier answer that you gave. I want to make sure that I understood it. It was about the interaction with European regulation. You were saying that you were concerned that the FCA would not be representing you but the prudential body would.

Mr Cornwall: I was saying that the FCA will effectively have the business knowledge as to how the Capital Requirements Directives impact on smaller investment firms. We are saying it is very important that they engage the PRA, who will be our lead at the European Banking Authority, to make sure the discussions are not entirely bank-centric and that people remember that there are two-partner firms with five staff that are caught by the Capital Requirements Directive and not just global banks.

Q407 David Mowat: The problem occurs because the organisational structure of the European structure and the UK structure was completely different; we have to choose one or other to represent you and, therefore, you get those anomalies.

Mr Cornwall: Yes; we are not arguing with the representation. We just want to make sure that the PRA, when they are briefed, is fully aware of the needs of all the constituents that are caught by the directive and not just banks.

Mr Saunders: On that point I would add that the constitution of the European supervisory authorities does allow for a second competent authority to attend meetings. It would be perfectly possible, if the EBA were discussing capital requirements, for the FCA to go along with the PRA. It is important that that sort of co-ordination should happen.

Q408 David Mowat: Yes. The point I was making is that the anomaly is caused by the fact that the structures are different and, therefore, in a way, you are flailing around to make it fit.

Mr Saunders: Yes, but I think our structure is better.

Q409 Lord Skidelsky: On internal challenge, people have been saying for years that the Court should be more transparent and less opaque. Whose responsibility is it to produce these more transparent and less opaque reports? It is something one has heard endlessly and they get more complicated than ever before. Secondly, in your experience, how effective are non-executive directors in producing internal challenges?

Mr Paterson: I think it is the responsibility of the organisation that is publishing the document to make sure it is something that the reader can understand and which meets those objectives.

Q410 Lord Skidelsky: Do those organisations ever employ someone who has a degree in English?

Mr Paterson: Some do and some don't. I have just finished judging an annual report competition for ICSA and there were some very good examples of English, which were very understandable. That brings me on to the second point: do non-executive directors challenge company execs properly? It varies enormously in our experience. I meet a lot of non-execs who take their role very seriously indeed. It is a tough job to do properly, as many of you around this table know.

Q411 Lord McFall: To take up that point, David, because it has some relevance to you, can individuals who have signed up to defined contribution schemes understand what the risk is for them or understand a portfolio?

Mr Paterson: They have an investment in a fund, so I think "portfolio" is probably the wrong description. This is a real challenge for the industry, whether it is the trust-based schemes—

Q412 Lord McFall: Is the answer no?

Mr Paterson: I was about to say that the occupational schemes which we represent have a real job to do to produce funds which their members can understand. In the contract-based world it is even more difficult. It is a challenge.

Q413 Lord McFall: My question was perhaps a bit unfair. As you know, I undertook a working party for you which I chaired. The NAPF have said that people don't understand it, and therefore there is a big job to do. The reason I am asking that is because we have the Financial Conduct Authority. Although the Financial Conduct Authority is said to be about consumer issues, it has been made clear that that is not its primary objective. Who is going to pick up this issue of complexity so that the consumer does understand and the asymmetry of knowledge that presently exists within the industry is demolished? If it is not the FCA, who is it?

Mr Paterson: It is part of the FCA brief, as I understand it.

Q414 Lord McFall: What advice do you have for the FCA?

Mr Paterson: That is a big question. The industry has a key responsibility to provide its customers with information which adequately reflects the risks and the objectives of products which they are being sold. Pension trustees, whom I represent, sit as intermediaries in that process. It is very important that they are able to stand behind the funds that they are offering their members with confidence that they are the right kind of funds for their kind of members.

Q415 Lord McFall: Does there need to be a psychological change in the industry for pension trustees to say that they are on the side of the consumer rather than being part of the financial services industry?

Mr Paterson: Pension trustees do see themselves as being on the side of the consumer. There is no benefit to them from a particular fund selection. There is a downside from fund selection rather than an upside, so I think they are on the same side. But they are facing the challenge of producing funds which are appropriate to a range of different types of investors with different time frames, different risk appetites and so on. It is a difficult challenge.

Q416 Lord McFall: My last point is to the rest of the panel. Do you agree that we are at ground zero in terms of consumers understanding what challenges they face in the information that is given to them?

Mr Saunders: Consumers vary enormously from people that have very little idea indeed through to people who have quite a sophisticated understanding. In terms of the role of regulation, yes, there is a role for regulation here. Within the UCITS Directives, which govern European mutual funds, there are very strict requirements about the so-called "key investor document"—the two-page document giving the basic information about the fund. As regards the risks in any investment it is inevitably complicated. It needs to be expressed clearly and explained properly, of course, but at the end of the day it cannot be dumbed down completely. There are complicated trade-offs in any investment from which, ultimately, there is no getting away. I do not think the industry ever sets out to confuse its clients.

Mr Cornwall: As an industry, we have done a reasonable amount of work to try and make sure that investors are aware. We produce a booklet trying to explain risk in a manner which individuals can understand and a simple one-pager trying to explain to investors how they can get the service they are expecting by engaging, by looking at the documentation and asking questions they do not understand. It is a difficult problem, particularly when you are dealing with complex products. It is also dependent on the knowledge and experience of the client base to which you are providing services.

Q417 Lord McFall: So you would disagree with the Chairman of the International Accounting Standards Board when he says that mis-selling is in the DNA of the financial services industry.

Mr Saunders: Yes, I would.

Mr Cornwall: I would, yes.

Q418 Lord Newby: I will go on to the question of warning notices. Do your organisations support or oppose the introduction of early warning notices which are published at the start of disciplinary action?

Mr Cornwall: We are nervous about warning notices. We put in a submission which identified a number of issues. Our nervousness on warning notices stems from the fact that the warning notice is directed at the firm. Normally, what happens after a warning notice is issued is that, if enforcement action arises, it will result in a final notice which will bring closure and in effect will explain what the firm has done to address their shortcomings and whether or not any consumer detriment has arisen. We are unclear what happens where the warning notice does not result in any enforcement action. It seems to us that, if the proposals go ahead, greater thought in the future is going to have to be given to the content of the notice of discontinuance, which is the document that is issued in the event that warning notices do not result in enforcement actions. In a sense they now need to bring closure to consumers.

The other difficulty is the actual timeline for investigations. For example, in relation to enforcement investigation, if, after nine months, it is clear there has been no consumer detriment but none the less there is still a viable enforcement case, it could be another 18

months before the final notice is published. In that instance should there be some publication that brings closure at an earlier stage?

The great unknown from the firm's point of view—and one of the submissions from Herbert Smith said that about 30% of all cases do not result in a final enforcement—is reputational damage caused to a firm as a result of a warning notice being issued when it subsequently transpires that there was not consumer detriment or the evidence, once it had been challenged by the firm, had been reviewed. One does not know the consequences of that.

Mr Saunders: There is a balance here. On the one hand, the warning notice could be seen as treating somebody as guilty until proven innocent. On the other hand, there is a legitimate concern to protect investors or consumers. If there is a firm which the regulator has good reason to believe is not behaving properly, is it fair that consumers should be kept in the dark about this?

As Ian has suggested, the answer has to lie around putting process and safeguards around this. You would need to involve the Regulatory Decisions Committee, for example. As Ian has said, there needs to be a-symmetry about announcing that action is not going to be pursued and so on. There needs to be more process around than simply saying, "We can put these notices out."

Mr Paterson: Pension funds sit in a slightly privileged position, in that the due diligence being done by their advisers should identify these issues at quite an early stage. A standard question is, "Have you been inspected recently and have you been criticised by the regulator for anything of which we ought to be aware?" It is slightly before the warning notice period, but we would expect to hear about these things, particularly for the larger funds, at a very early point.

Q419 Lord Newby: Subject to the caveats that you have mentioned, all of which it seems to me are relatively easily dealt with, like the timetable and publishing a discontinuance notice, and they accepted the proposals in your submission, do you think you could live with the concept of warning notices? It would not be a huge detriment.

Mr Cornwall: We are still very nervous of the scenario where a warning notice is being issued against a small firm and no notice of discontinuance has been issued saying that no action is being taken. Over a six, nine or 12-month period that firm has suffered reputational damage. The trouble is that we do not know what the impact is going to be, particularly on the small firms, where they are issued with a warning notice and whether that will directly impact on their business. We just don't know. Larger firms with a national brand are probably better placed to withstand a warning notice, but it is difficult to assess what impact that will have on smaller firms in a local area.

Q420 David Mowat: But, equally, the argument the other way, as you have said, is that, if in 70% of cases the action does lead to disciplinary action, if no warning notice is issued, consumers are running the risk of buying unsafe products or being inappropriately advised. That is the balance, is it not?

Mr Cornwall: The regulator already has other tools in his toolkit other than publicising warning notices if he thinks that consumer detriment has taken place. There are already other tools available to the regulator if that is happening.

Chairman: We now turn to a couple of questions which are specifically to Mr Paterson from Mr Ruffley and Baroness Drake.

Q421 Mr Ruffley: Mr Paterson, can you list any of the advantages of splitting regulation of personal pensions and occupational pensions between the FSA and the Pensions Regulator rather than the regulations sitting in one body?

Mr Paterson: I can see one advantage, and that is that occupational schemes are about more than simply a personal pension pot. They involve the whole gamut of the actuarial evaluation and administration of a defined benefits scheme and the risks which are attached to that. It is a much broader remit than simply a personal pension pot, which looks very like an insurance policy to all intents and purposes. That is the significant difference. It is not just about investments; it is about the much wider range of activities.

Q422 Mr Ruffley: Are there any other advantages?

Mr Paterson: None that occur to me immediately. It is not really my specialist area so you have me slightly on thin ice here. That is the one which comes to mind immediately.

Q423 Mr Ruffley: Do you think that the further splitting of the responsibility of what the FSA currently regulates responsibility between the FCA and the PRA will cause difficulty or do you not think it will make a difference at all?

Mr Paterson: No; I do not think it makes any difference.

Q424 Mr Ruffley: Why do you think that?

Mr Paterson: Because the FCA's remit is very clear and that fits with the investment part of the occupational pensions' brief. The other supervisory roles sit above that quite comfortably, so we do not think it affects us.

Q425 Mr Ruffley: Could you see any even theoretical advantages of having personal pensions and occupational pensions regulated by one body under one roof? Have you seen any arguments or, as a senior figure in the occupational pensions world, can you see any advantages in there being one regulator?

Mr Paterson: I would like to get back to you on that. Simpler and less regulation always appeals. Therefore, what you are suggesting is something which is intuitively rather interesting, but I cannot go any further than that.

Q426 Baroness Drake: I would like to follow up on that. We live in a world where, potentially, the employee in DB is going to get a better qualitative regulatory framework than the employee in money purchase or DC, because one comes under FCA and the other under TPR. That is not very satisfactory from a consumer's point of view. There are issues, especially when you move into an auto-enrolment world, about whether there should be a common regulatory approach on certain issues. At some point this is going to have to be addressed.

My particular concern is that in this expanding world of DC or money purchase there are very few barriers to new entrants coming into this DC market, which is rapidly expanding. We are looking to a world where it is almost inertia selling because of auto-enrolment. With regard to consumer protection, in terms of either the employer choice of scheme or those employees who have left their employer and have all these defaulted pots everywhere which are vulnerable, are the product intervention powers in the Bill of the FCA sufficient for them to intervene where pension investment products are not appropriate because so many players are entering in this market? Do you think those powers are sufficient and do you think there is a cultural disposition in the FSA, many of whom will transfer to the FCA, to exercise those powers to protect the employees in these money purchase schemes?

Mr Paterson: It is a big question. The first point I would make is that we have to distinguish between contract-based and trust-based schemes. Essentially, our members are about trust-based schemes where you have the trustee there to hopefully provide some guidance to scheme members as to what sort of funds fit that particular segment of the work force that have invested in the DC funds under their watch. With contract-based schemes, there is obviously a much wider range of funds available. Having looked at some myself, it is very complicated. There is a difference there which is very important.

You would expect me to say this—and you know us very well—but we do favour the trust-based model. That is one which has been tested well and in which many employees have a lot of confidence because they see the role of trustees as being very important in helping to winnow out some of the least attractive of the various options which may be available through the insurance market.

Q427 Baroness Drake: You may prefer the trust-based model, but in the private sector the future is going to be the contract-based model. The challenge is how to protect the consumer in that contract-based provision and whether, culturally, the disposition of the FCA under the intervention powers they have are sufficient to protect the consumer or the member or worker in these products.

Mr Paterson: First of all, I dispute the fact that the future is contract-based. We think that trust-based schemes have a lot to offer and we would hope that employers would see them as being a valuable part of the benefits they are offering their work force. We are very much behind trust-based schemes, as you know. Contract-based schemes certainly have a bigger share of the market and are growing faster because it is a much easier option for many employers. It is not an area where the NAPF has historically been particularly involved. We have been big supporters of NEST, as you know, as a means of getting more people to save for a pension. I would hesitate to go beyond that, given that my expertise is really in the governance world rather than the strictly DC world of pensions.

Q428 Baroness Drake: Richard, do you have a view on protecting the consumer in the contract-based world?

Mr Saunders: Yes. I think it is very important. To a significant degree the difference between a contract-based scheme and a trust-based scheme from the point of view of the individual is a bit theoretical. I am not sure many people would be able to tell you whether their DC pension is trust-based or contract-based. To my mind that does raise a question. Coming back to Mr Ruffley's question, I do not have the answer to it, but it raises to me the question whether the regulatory interface between those two works. On the one hand, you have a sort of FCA primacy; on the other hand, you have a sort of TPR primacy. I don't know enough about how that interface works between the two regulators, but it certainly raises the question in my mind whether that is an ideal arrangement.

In terms of individuals who are in contract-based DC schemes, on one level they can take a fair degree of regulatory comfort in that the vehicles in which they are going to be invested are quite likely to be UCITS funds or equivalent life insurance vehicles which have a lot of regulatory safeguards around them. Where I think consumers in DC are potentially more vulnerable is on the question of asset allocation. Are they in the right funds in the first place for their own needs, their own age and so on? This is not an area in which, as we stand now, the FCA would regard itself as having a role at all. I may be wrong, but that is as I understand it. If anything, they would say that the design of a life-styling arrangement or whatever is taking place around a DC investor, if it is for anybody, would be for the Pensions Regulator rather than the FCA. There is a fuzziness and a lack of clarity between the two, yes.

Q429 Baroness Drake: If the Pensions Regulator was here, I am sure they would say it is not their role. There clearly seems to be a gap here between the terms of reference of the TPR and the powers of the FSA and the FCA, even with product intervention, as to the consumer protection in that space of money purchase and DC.

Mr Saunders: The product intervention powers themselves are extremely broad and can be used in all sorts of ways. The question is less whether the powers themselves are adequate as to whether the respective remit of the two regulators meshes in the best way.

Mr Paterson: I can add to that. A lot of it is to do with the way in which individual consumers are advised. The products themselves, by and large, are fit for a purpose. Whether it is your purpose or mine is a completely different matter. That is the gap.

Baroness Drake: But they are not going to be advised because they are going to be auto-enrolled. When they leave their employer, they are going to be defaulted into some contract-based provision because they are not going to stay with that employer. What is the regulatory protection in that situation if they are not advised, it does not come with auto-enrolment and when they leave that employer they default? Employers are not going to have a huge tail of ex-employees, so there is a space there where it is not clear what the consumer protection is.

Q430 Lord Maples: I have a couple of questions about governance. I want to leave aside banks and the Court of the Bank of England. The three institutions that are being set up do seem to me to have rather different governance arrangements. It seems to be envisaged, if I read it right, that the PRA and the FCA will have a majority of non-executive directors. In the PRA it explicitly says so; in the FCA it implies it, in that the majority of the appointments are by the Treasury. In the FPC it is five Bank of England staff essentially—the Governor, two deputies and two people appointed by him, and four non-execs.

You have all given a lot of thought, but particularly the National Association of Pension Funds, to issues of corporate governance. Do you think that it is right that there should be a majority of non-execs on the PRA and the FCA? If so, why should there not be a majority of non-execs on the Financial Policy Committee? If five of the nine votes essentially owe their careers to the Governor, is that not a distortion that ought to be corrected? I am interested in all your views, but perhaps yours to start with Mr Paterson because your Association has shown such an interest in corporate governance over the years.

Mr Paterson: My first response is that I have not thought about this, which makes it rather difficult. The model which we have seen developed in the UK, as you well know, is based around the notion that boards are most effectively supervised where there is a majority of non-executive directors.

Q431 Lord Maples: As a general principle.

Mr Paterson: As a general principle. You then have to ask yourself whether the top body in this particular situation is like an ordinary company board. Is that what is there to do, and therefore is it appropriate that it should have a majority of non-executives given the role it has to play? That is a question that I have not thought about and I do not have the answer.

Mr Saunders: Likewise, I do not think I have a huge insight to offer here. It seems to me rather a good question, if I may say so. It is right that the PRA and the FCA have majority non-executives. I would want to think a bit further about it. On the face of it, it seems to be a very reasonable question to ask. I am not sure I know the answer.

Mr Cornwall: I am with you on that. It is not something that we have discussed as a body per se. We see the FPC as being slightly remote it sets the economic environment within which our firms operate rather than directly impacting on them on a day-to-day regulatory sense given the nature of their activities.

Q432 Lord Maples: Can we go one step further? Theoretically, if somebody is appointed as a non-executive director of one of these organisations, and I am particularly thinking about the FPC here, is the model of the Monetary Policy Committee where members of it have considerable resources available to them and they are expected to devote a lot of time to it? My view is that it probably should be. Or, rather, is the model that you are a non-executive director of a commercial organisation? You are paid £30,000, £40,000 or £50,000 a year, whatever the going rate happens to be. You are expected to read the board papers, turn up at certain meetings and be on certain committees. But, if you are on something like the FPC or the Monetary Policy Committee, you are part of a body performing a very basic policy function. Regardless of whether there is a majority or a minority of non-execs on the FPC, if you were one of them, would you like to have resources available to you and be

expected to spend rather more time than a typical non-exec, or do you see it more as a typical non-exec role?

Mr Saunders: It is like the Monetary Policy Committee. It is a commitment. From what I have seen of the way that the shadow FPC is now operating with its members, that seems to be the model to which it appears to me, from the outside, to be working.

Mr Paterson: I would simply ask the question: is the MPC working as well as we want it to?

Chairman: You are not allowed to ask us questions. We have time for two minutes of questions from Baroness Wheatcroft and two minutes from Baroness Drake before we finish.

Q433 Baroness Wheatcroft: We do not know exactly what macro-prudential tools the FPC is going to have at its disposal, but your members could be affected by some of them. Have you had any representations from your members, or do you have any views yourself, about the tools that the FPC might use and those you would like it to use, and what form those might take, and those you would not like it to use?

Mr Saunders: My main message to the FPC would be: please remember that asset management is a very different business from banking. Asset managers do not use their balance sheets. Therefore, if the FPC is minded to take action on capital within the financial system, they should not do so in relation to asset managers because they are simply not relevant. I would hope that they have that message. I have not received any representations personally from any of my members about how they would like to see the FPC operating and what tools they would like them to use, no.

Mr Cornwall: No; we have not had any representation from members either on the FPC.

Q434 Baroness Wheatcroft: Do you have any views of your own about it?

Mr Cornwall: Basically, the view tends to be that people in our sector think the FPC is setting an economic landscape in which they operate as businesses. The point that was made about making sure the decisions of the FPC are not entire bank-centric or at least don't have unintended consequences on other sectors of the financial services is a point we would certainly support.

Mr Paterson: That very much ties in with our views. Pension funds have become, like insurance companies, too pro-cyclical in the way in which they are run for their own good. Therefore, looking at their longer-term objectives and thinking about what they are trying to achieve as investors is important for their long-term health and viability.

Q435 Baroness Wheatcroft: It is in all your interests that there should not be another financial crash on the scale of the one we have seen. If we are looking at those macro-prudential tools that might be brought into play if one appeared to be on the horizon, do you think a counter-cyclical buffer is perhaps the most effective one? Do you have any views? If you were advising the future FPC on what it should be looking at—we are still

waiting to see even the draft of what they might ask for—do you have any thoughts as to what you would like to see?

Mr Cornwall: Our thoughts are in terms of investment firms because we are being forced to consider counter-cyclical buffers, and in the context of an agency broker that is quite hard. When we are looking at some of the analysis on CRD IV, we are finding that some of the proposals designed to address some of the concerns of the banks potentially could impact on the capital adequacy requirements on investment firms. We are still trying to work through some of those proposals to try and understand the modelling.

Q436 Baroness Wheatcroft: As we know, standards are quite hard to identify anyhow.

Mr Cornwall: They are. In terms of what we do and the business risks we run, the buffer may be appropriate for a banking model, but it is hard to know whether it is appropriate for an agency broking model.

Mr Saunders: You are absolutely right. For all three of us it is very much in the interests of all our members that we should try and avoid the sort of crash that we have seen. Clearly, counter-cyclical buffers are a good idea. The problem is how you can tell when you are above trend. This is telling the Bank of England how to suck eggs now, but they need a lot of analysis. They need to be very proactive. There were warnings ahead of the 2007-08 continuing crisis which, on the whole, were ignored by policymakers. The analysis was there for people to pick up and use but they chose not to. One hopes they will have learnt profoundly from that exercise.

Chairman: Excuse me if I move straight to Baroness Drake for one pithy question on European structures.

Q437 Baroness Drake: I will keep it pithy. Capital Requirements Directive IV, maximum harmonisation and the aspiration across Europe are setting requirements that would appear to be saying they cannot be exceeded without explicit European clearance. Our own Bank of England and Treasury are concerned that that will restrict the UK regulators' ability to deploy the micro/macro-prudential tools that it wants and set the capital requirements that it wants. Are you concerned about that? Do you think there is a potential to seriously constrain UK regulators' ability to deploy the tools they want to deploy?

Mr Saunders: I would personally side with the Treasury on that. I am not sure, with very different banking systems across Europe and very different financial environments in different European countries, that it necessarily makes sense to have a maximum harmonisation directive on something like that. There may well be circumstances in which UK regulators might want to ratchet capital requirements higher, even temporarily, within the UK than the rest of Europe. I think that flexibility is appropriate.

Chairman: Thank you very much indeed, gentlemen. We are very grateful for your evidence. It will be extremely helpful to the Committee. As there is a vote in the Lords I will declare the Committee closed, or whatever I do in these circumstances. Thank you very much.

Association of British Credit Unions Limited (ABCUL) – written evidence

Executive Summary

1.1 We have significant concerns about the potential impact of the Financial Services Bill on the credit union sector in Britain. As deposit-takers, credit unions are to be dual-regulated by both the Prudential Regulatory Authority and the Financial Conduct Authority along with the major banks and building societies, investment banks and insurance companies. Credit unions are, however, a very small sector in comparison to the other dual-regulated sectors which raises significant questions in terms of ensuring proportionality.

1.2 ABCUL and its members have always been supportive of full prudential regulation of credit unions. The move to the Financial Services Authority from the Registry of Friendly Societies in 2002 led to significant benefits for the sector. However, this regulation is only effective if it properly takes account of the specific nature of the sector and balances any regulatory burden imposed proportionately against the benefit it provides.

1.3 Whilst we would not want to be regulated under a different framework to our fellow deposit-takers, it is vital that the particular features of credit unions as a small, co-operative, not-for-profit sector are taken into account through the development of the new regulatory framework. Otherwise the sector's development could be impeded which would run counter to the express policies of the UK Government who are clear in their support for the development of credit unions as a means for extending fair financial services to everyone in society and for the role that mutual financial services can play in creating a more diverse and therefore more stable financial services industry.

1.4 A recent analysis of the size of ABCUL member credit unions in the year October 2007 – September 2008 (the most recent year for which complete figures are available to us) the following features were found which demonstrate the size and scale of the sector:

- 1.4.1 56% had less than 1,000 member customers
- 1.4.2 53% had assets of less than £500,000
- 1.4.3 32% had no staff at all and relied entirely on volunteers to operate
- 1.4.4 82% generated less than £200,000 turnover
- 1.4.5 56% generated a pre-tax profit of less than £10,000
- 1.4.6 46% were unable to pay their depositors a dividend return on their savings

1.5 Whilst there is a significant minority of credit unions – in terms of number of institutions – that are much larger than this (with many millions of pounds in assets and tens of thousands of members), the figures above demonstrate how the great majority of credit unions are extremely small organisations. Not only, therefore, do they face a significant challenge in dealing with two regulators instead of one they also pose little or

no risk to the systemic stability of the financial services industry. Again, therefore, proportionality is the key concern for our sector as the move to the new regulatory structure evolves.

1.6 We have repeatedly made clear our concerns in this regard to HM Treasury in the consultations that have taken place so far. However, HMT's White Paper states the following in its Impact Assessment at point 39:

The PRA will also be responsible for prudentially supervising much smaller firms which take deposits or effect and carry out contracts of insurance. Almost all credit unions and some friendly societies and building societies would fall [sic] to be considered as small firms; many credit unions would be very small by any standard. Some investment firms regulated by the PRA may also be small firms although it is likely that they will be parts of groups that include a bank or insurance company. The transitional costs for these firms seem likely to be relatively less depending on the circumstances of the individual firm.

And further at point 45:

Consultation respondents were concerned that dual-regulated firms would face significantly higher costs and that these would disproportionately on [sic] smaller dual-regulated firms. In practice, this probably means that the smallest dual regulated firms would (e.g. credit unions) would [sic] not be much affected while the largest banks and insurance companies would not face significantly higher compliance costs in comparison with their current compliance costs. The effect could be greatest in smaller banks or proprietary trading firms.

1.7 It is unclear why HMT assert that the regulatory impact of the new framework on the smallest dual-regulated firms (such as credit unions) would be 'relatively less' or that it 'would not be much affected'. It seems to us, rather, that the economies of scale available to larger firms and the increased resource they are able to dedicate to regulatory compliance will mean that the larger a firm becomes the more equipped it will be to deal with an increased regulatory burden and the practical demands of dealing with two bodies instead of one. This is certainly the experience in our sector.

1.8 Similarly, there have been no guarantees given as to the fee increases that are likely to be required to fund the new regulatory framework. Already, between the original HMT consultation and the White Paper, cost estimates for implementing and transitioning to the new system have almost doubled from £400 million to £770 million. Similarly, even with the considerable thought that has been put into co-ordination between the new bodies and avoidance of duplication it would seem that there is little chance – with two sets of fixed-costs to cover and a halving of the institutional scale of the successor bodies – that the overall direct cost to financial services in regulatory fees will not have to increase. At present the FSA affords credit unions and small friendly societies a lower minimum fee than other firms in consideration of the inclusive services they provide and their diminutive scale but it would appear likely that this will come under threat with drastically increased transitional and ongoing costs for the new regulators to cover.

1.9 With these concerns in mind we have a series of specific recommendations that we would like to put forward which we feel would enhance the proportional treatment of credit unions as small, dual-regulated firms:

1.9.1 It is important that CREDS the specialist regulatory sourcebook which is to be implemented alongside the Legislative Reform (Industrial and Provident Societies and Credit Unions) Order which is currently before Parliament is retained. This has been developed specifically for credit unions and is constructed in a rules-based format which is more suitable than principle-based regulations which are more suited to larger, more complex organisations.

1.9.2 We propose that mechanisms are not only retained but strengthened for smaller firms – such as credit unions – to hold the new regulatory bodies to account. The Practitioner Panels should be retained for both bodies, the Smaller Businesses Panel should be put on a statutory footing for both and smaller firms should be given a voice in the governance structures of the new regulators.

1.9.3 A greater emphasis should be placed upon Cost Benefit Analysis (CBA) and this should be provided for in statute. Not only should individual regulatory developments be subject to CBA but regular, sector-wide assessments should be conducted to assess the overall impact of regulatory developments rather than ad hoc piecemeal assessments which only take account of one specific issue. This would put the statutory obligation to proportionality on a directly measurable footing.

1.9.4 A single point of contact is needed for dual-regulated firms to deal with both bodies. At present there are very complex proposals in place for different regulatory approvals and processes – approved persons authorisations, for example – which will be very difficult for small firms especially to negotiate and deal with without the creation of a single port of call through which all such issues are communicated and behind which the regulatory split is co-ordinated by the two bodies themselves. This would alleviate the resource-strain of dealing with two regulatory bodies.

1.9.5 Fees must not be allowed to rise significantly from the level that they are at present outside of reasonable incremental increases. It should not be the case that fees increase more rapidly than under the FSA. Regulatory fees are one of the key expenditures credit unions are required to meet and major increases brought on through the division of the FSA and behind-the-scenes duplications of function would add no value but put significant strain on the financial position of many small credit unions.

1.9.6 The costs of funding the Financial Services Compensation Scheme must be kept under control and set up such that they are proportionate to the risk that various sectors pose to the stability of the financial system as a whole. We have benefitted greatly from the FSCS's protection but current proposals under discussion – such as the EU proposal to pre-fund guarantee schemes – could leave our sector facing very serious difficulties.

1.10 We appreciate that HMT have stated their view that some of these proposals – such as the creation of a single point of contact for dual-regulated firms – are operational matters for the new bodies to decide. We do however feel that statutory measures could be taken to implement these recommendations in the interests of embedding the principles of proportionality throughout the statutory framework within which the new regulatory bodies will operate.

1.11 Credit unions play an invaluable role in providing fair access to financial services to the whole of society and in providing much-needed diversity of ownership having the effect of stabilising the financial system. Their promotion and development is Government policy. We therefore urge the committee and HMT to consider closely our concerns of proportionality and our recommendations to alleviate the risks that credit unions could be unduly burdened at present.

2. Introduction

2.1 We welcome the opportunity to respond to this consultation. ABCUL is the main trade association for credit unions in England, Scotland and Wales, and our members serve around 80% of Britain's credit union membership. Credit unions are not-for-profit, financial co-operatives owned and controlled by their members providing safe savings and affordable loan facilities. Increasingly a small number of credit unions offer more sophisticated products such as current accounts, ISAs, Child Trust Funds and mortgages.

2.2 At the end of March 2011, credit unions in Great Britain were providing financial services to 808,686 adult members and held more than £682 million in deposits with more than £586 million out on loan to members. An additional 114,709 young people were saving with credit unions.[21]

2.3 At 30 September 2010, the 325 credit unions belonging to ABCUL were managing around £512 million of members' savings on behalf of over 611,037 adult members.

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

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

2.5 Credit unions in Britain are small, co-operative financial institutions often extending financial services to those unfairly excluded from the financial services the majority take for granted. They are owned and controlled by a restricted membership and are operated for the sole benefit of this membership. The Credit Union Act 1979 sets down these operating principles in law.

2.6 In the past decade, British credit unions have trebled their membership and assets have expanded four-fold. As this growth has taken place, the role that credit unions can play – both in providing equitable financial services to the whole of their communities and providing diversity in the financial services sector – has been increasingly recognised by government and policy-makers.

[21] Figures from unaudited quarterly returns provided to the Financial Services Authority

3. Questions

3.1 We have chosen to answer only a selection of the questions put in the call for evidence – those that are directly relevant to credit unions and our concerns under the proposed regulatory structure.

1. Is the separation of prudential and conduct regulation into a "twin peaks" system the *right approach?*

3.2 We have no objection in principle to the creation of a "twin peaks" model of regulation and feel that it may well have the effect of increasing the overall stability of the financial services industry and averting the potential for a repeat of the financial crisis.

3.3 Our key concern, however, is not the effectiveness of "twin peaks" as a means of improving regulation at a macro-level but, instead, is its impact on those small firms which have not contributed to the financial crisis but which may suffer as a result of the new framework.

3.4 As we have explored above and come back to later, we feel that the "twin peaks" model of regulation – alongside the more intrusive regulatory philosophy proposed – whilst perhaps increasing financial stability will also have the effect of multiplying the burden of regulation. This is especially true for credit unions as a sector of very small firms which will be 'dual-regulated'.

3.5 Proportionality is vital to ensuring that whilst the new system has the desired effect of increasing the regulatory scrutiny of those firms which are systemically important to financial stability due to their size and complexity, it does not unduly burden small firms which pose little or no threat to financial stability, had no hand in creating the financial crisis and upon whose continued development the creation of a diverse and therefore more stable financial services industry depends.

4. Are the accountability and governance *arrangements for the Bank of England, FPC, PRA and FCA satisfactory?*

3.6 We are primarily concerned here with the PRA and the FCA's governance structures.

3.7 We feel that the mechanisms for industry to have a voice and hold the PRA to account should be covered by statute. As with the FCA currently, the PRA should be required by statute to set up the practitioner panels and a smaller business panel should be given statutory powers under this setup.

3.8 These practitioner panels should be given more powers to hold the regulators to account by having a power to force them to reconsider proposals which are damaging and in certain specified circumstances should be allowed to pass decisions upwards – perhaps to the FPC – for a ruling.

3.9 Similarly, small firms should be afforded a statutory voice in the governance framework of the regulators to ensure that their needs are taken full account of.

11. Are the PRA's objectives *clear and appropriate?*

3.10 The PRA's objectives and principles are clear. Our key concern, though, is how the PRA's statutory obligation to proportionality is both applied and assessed. At present it seems that whilst the proportionality principle is in place at a high-level, more practical arrangements for ensuring truly proportional regulation and supervision which could be dealt with through statute (a single point of contact, strong accountability to firms or wider application of CBAs, for example) are currently left to operational decisions which we feel is inappropriate and inconsistent.

3.11 We also support the PRA's obligation as proposed to ensuring that any new regulations do not unfairly disadvantage mutuals.

12. Are there any risks *in the Government's proposed 'judgement-based' regulation?*

3.12 In principle we have no issue with 'judgement-based' regulation which should have the effect of enhancing the robustness of regulatory supervision.

3.13 We do, however, feel that there are certain risks which might arise from this. First, there needs to be a robust, independent and accountable system for challenging judgements that are made without overly legalistic protocols being required. This way, judgements that are considered unfair or disproportionate can be fairly reviewed. Second, there is a concern that should 'judgement-based' regulation extend too far into the minutiae of regulatory and supervisory activity it could result in serious problems of clarity and understanding for small firms such as credit unions and could cause significant barriers to their development of new, innovative products. 'Judgement-based' regulation should be founded upon the same principles of proportionality as the regulatory bodies themselves.

13. Is the Government's *proposed approach to 'orderly' firm failure satisfactory?*

3.14 Whilst it is right to focus on the 'orderly' wind down of large, systemically important firms we have some specific concerns relating to the position of failing credit unions.

3.15 At present, where a credit union is failing and there is no immediately neighbouring credit union which is in a position to save it, the only option remaining to the credit union and the FSA is to allow the credit union to default and draw down upon the FSCS. This situation should be somewhat improved with the advent of the Legislative Reform (Industrial & Provident Societies and Credit Unions) Order – currently before Parliament – which will allow credit unions not operating in directly adjacent areas to step in and save failing credit unions. It will be further improved by the FSA acting more quickly in the case of a credit union starting to fail.

3.16 Despite the advantages of these legislative reforms, we feel that there is a case for considering the feasibility of a Stabilisation Fund for credit unions in Britain. ABCUL recently commissioned research by Liverpool John Moores University which looked at

credit union stabilisation regimes around the world – many of which are very successful at reducing the call on deposit guarantee schemes.

14. Given that the PRA and the FCA will inherit FSA staff does the draft Bill do enough to ensure a new regulatory culture and a more proactive approach to regulation? Will these two new bodies have staff with the appropriate skill and expertise?

3.17 We feel that the Bill is effective in demonstrating the change in culture and the more proactive approach desired by Government.

3.18 We are concerned, however, that whilst there are detailed and significant provisions made within the Bill regarding its more proactive culture, there are not sufficient provisions made to ensure that its activity and regulatory developments are proportionate. There is an overarching principle which makes proportionate treatment a regulatory obligation but practical measures could also be included which would benefit the implementation of this:

- 3.18.1 an obligation to retain specialist regulatory sourcebooks – such as CREDS – for at least the period of transition
- 3.18.2 a statutory voice for smaller firms within the PRA and in the governance structures of both bodies
- 3.18.3 a statutory obligation to conduct regular cost benefit analyses for the overall regulatory burden on different sectors rather than individually in relation to specific proposals
- 3.18.4 a single point of contact for dual-regulated firms to communicate with both regulators
- 3.18.5 an obligation to ensure that regulatory fees do not rise above a certain rate to ensure efficiency and minimum duplication between the two bodies.

3.19 As regards the skills of regulatory staff, it is vital that those staff responsible for credit unions within both the PRA and FCA are familiar with the credit union sector through experience in the FSA and elsewhere. As has been demonstrated above, credit unions present a unique challenge to the new regulatory framework and without a solid understanding of the sector's particular needs as small, community-based, mutuals we foresee significant problems for the credit union sector's transition to and ongoing supervision by the new regulatory bodies. We should say that we have a high degree of confidence in the current FSA team dealing with credit union supervision and policy.

15. Are the FCA's primary objectives appropriate? Is significant emphasis given to the promotion of competition?

3.20 We feel that the FCA's primary objectives, as with the PRA, are appropriate but feel that more could be done to ensure the proportionate treatment of all firms but particularly smaller firms. Ways in which this could be achieved have been explored extensively already.

20. Are the proposals for co-ordination between the PRA and FCA clear and adequate? What would be the advantages and disadvantages of having a Single Point of Contact and/or a joint rule book for dual-regulated firms?

3.21 We feel that the proposals for co-ordination between the PRA and FCA must be toughened to ensure that the new bodies minimise duplication and avoid a ballooning in fees and costs to firms. This might be achieved by restricting the level of annual fee increases which the two bodies are able to enact by statute.

3.22 As earlier set out, we strongly support a single point of contact for dual-regulated firms. This is especially important for smaller dual-regulated firms such as credit unions who are likely to find it very difficult to deal with two separate regulators. Were there to be a single point of contact in place credit unions would be much better able to understand how they need to fulfil their regulatory obligations and would not need to concern themselves with the subtleties of the split between PRA and FCA and the Memorandum of Understanding that will dictate this. As resource-poor organisations credit unions are likely to see their compliance costs rocket should they need to deal with two separate bodies and this will impede or even stifle-permanently their growth into the future.

3.22 A joint rulebook is an interesting concept and is likely to make it easier for credit unions to deal with two regulators therefore we would support it. However, of more acute concern is that the CREDS regulatory sourcebook be retained. This has only recently been developed with the proportionate treatment of credit unions as its key concern. Similarly, we feel that a single point of contact and behind the scenes co-ordination between the two bodies is a key priority to ensure that the new framework treats our sector proportionately. A joint rulebook would be a secondary concern behind the retention of CREDS and the creation of a single point of contact for firms.

August 2011

Association of British Credit Unions Limited (ABCUL); Association of Financial Mutuals; Building Societies Association; Association of Independent Financial Advisers; Institute of Financial Planning; International Regulatory Strategy Group; Financial Services Practitioner Panel; FSA Smaller Businesses Practitioner Panel; Financial Services Consumer Panel and Office of the Complaints Commissioner – oral evidence (QQ 438-557)

THURSDAY 20 OCTOBER 2011

Evidence heard in Private Questions 438 – 557

Members present:

Mr Peter Lilley (Chair)
Mr Nicholas Brown
Mr David Laws
Lord Maples
Lord Newby
Mr David Ruffley
Lord Skidelsky
Baroness Wheatcroft

Examination of Witnesses

Witnesses: **Mr Russell Collins**, Chairman, Financial Services Practitioner Panel, **Mr Guy Matthews**, Chairman, FSA Smaller Businesses Practitioner Panel, **Mr Adam Phillips**, Chairman, Financial Services Consumer Panel, and **Sir Anthony Holland**, Complaints Commissioner, examined.

Q438 Chairman: Good morning, gentlemen. Welcome to the meeting of the Joint Committee of both Houses scrutinising the draft Financial Services Bill. I particularly welcome our witnesses this morning. We are very grateful to you all for attending. Would you be kind enough to introduce yourselves, starting from my left?

Mr Collins: My name is Russell Collins. I am the current Chairman of the Financial Services Practitioner Panel.

Association of British Credit Unions Limited (ABCUL); Association of Financial Mutuals; Building Societies Association; Association of Independent Financial Advisers; Institute of Financial Planning; International Regulatory Strategy Group; Financial Servi
Mr Matthews: I am Guy Matthews. I am the Chairman of the Smaller Businesses Practitioner Panel.

Mr Phillips: I am Adam Phillips. I chair the Financial Services Consumer Panel.

Sir Anthony Holland: Tony Holland. I am the Complaints Commissioner.

Q439 Lord Skidelsky: Concerns have been expressed about the financial stability objective of the FPC and alternatives have been suggested. Barclays has suggested that the objective should be to maintain a sustainable supply of credit and HSBC has suggested a stable and sustainable supply of finance to the economy, as possible more specific alternatives. Do you think it would be helpful to have a more specific statement of objectives for the FPC? What are your views on the suggestions provided by Barclays and HSBC?

Two things follow from that. First of all, leaving aside the question of how you define an adequate and sustainable supply of credit, can one do that in any way that makes sense? Secondly and particularly to Guy Matthews, do you think there is already an adequate supply of credit to small businesses? Do you think the objectives of the FPC would improve that situation? This has been one of the perennial complaints: that small businesses are starved of credit.

Mr Matthews: You make an extremely good point. As you stated, the credit supply to smaller businesses has been a problem with the economic backdrop. The overall requirement of the FPC to focus on financial stability is an understood concept but very difficult to measure. One of the aspects of that is proportionate regulation. The view is to have an overriding aspect on financial stability, but it needs to be proportionate in how it is overlaid and the impacts on smaller businesses and consumers. So it is a much wider remit that is required. Going back, financial stability is a difficult concept to measure. It is an understood concept, but maybe you should start to bring in having regard to diversity or competitiveness and other aspects, and that would be something we would consider.

Q440 Lord Skidelsky: Would it be helpful or not?

Mr Matthews: It is a difficult basis. Financial stability is the focus, but if you have other regards to competitiveness and other aspects then those things would help the overall Bill.

Q441 Lord Skidelsky: In general, what would the witnesses think about making the objective a bit more specific, which is to include an adequate supply of credit as one of the remits?

Mr Phillips: One of the existing difficulties is that the FSA only regulates deposit taking. Unsecured lending to companies and consumers is regulated through the Office of Fair Trading. If credit regulation comes to the FCA, it would be a very good idea to have a somewhat broader objective, but at the moment it would not be something that they could necessarily do very much about.

The reason I make this point is because we have about £1 trillion of unsecured lending to consumers, which is a very important aspect in driving the economy—the way

that consumers spend their money. In my view that should be under regulation. That is best done through conduct, through the FCA, rather than by prudential measures. In unsecured lending the interest rates are already very high. It is the ability of firms to extend credit to their customers and the length of the repayment terms which affects the affordability of the credit.

Mr Collins: From the Practitioner Panel point of view, when we discussed this we preferred one overriding objective of financial stability, which resonates well with the people on our panel. We do a survey every two years of the regulated firms. In the last survey, which was published earlier this year, 84% of the firms supported strong regulation for the benefit of the industry as a whole. The financial stability objective brings that together. We also think that the reference to not doing things that would adversely affect the growth of the economy probably does capture these issues.

Having said that, we are concerned that work does need to be done to define "financial stability" as far as we can; otherwise we will find ourselves arguing about that definition. If measures such as the supply of credit or others can be introduced as indicators, yes, we would support that but we think it is broadly covered by the overall terms at the moment.

Mr Phillips: I would, however, like to add to what Russell has said. From our perspective we think that the focus on the capacity of the financial sector to contribute to the growth of the UK economy is too narrow a focus. This is such a powerful group that they should look at the impact of their actions on the growth of the UK economy, not just the financial sector. We feel they should have to take that into account.

Q442 Baroness Wheatcroft: I am interested in the make-up of the FPC, which is going to have huge input into the new system. Are you confident that the balance is right between executive and non-executive on the FPC? Do you have views on that?

Mr Collins: No, we are not confident at the moment. We have quite strong views that the balance should be shifted more towards independent members. We would like to see as wide a variety as possible of relevant expertise from parts of industry in that group. We are moving into somewhat uncertain territory with macro-prudential and new tools. We want to see the experience and expertise of people who can work out how that is likely to pan out in the industry, available to the FPC. We would strongly support that.

Q443 Baroness Wheatcroft: Mr Matthews and other members, do you agree with that?

Mr Matthews: Certainly, again, our panel has endorsed the basis that the current power, with the Bank of England's overall position within this regulatory system, is overpowering. There should be checks and balances and a wider and more informed membership taking account of all aspects - consumers and smaller businesses. That is certainly something that we would support.

Q444 Baroness Wheatcroft: That would be, presumably, a majority of non-executive members?

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Mr Matthews: Correct.

Mr Phillips: We would have the same view, which is a majority of non-Bank members of the FPC. We question whether there need be quite so many people from the Bank on the FPC as currently proposed.

Q445 Baroness Wheatcroft: Because they have input anyhow.

Mr Phillips: Yes, absolutely. We also think that there needs to be diversity on this group, because if it is simply cast as a group of economists working on the stability of the economy there is a possibility for its decisions to bear very heavily on small sectors of the population. This really is an issue where people with a wider perspective need to be engaged in the discussions. We have no doubt that at a time of crisis they would vote together, but most of the time we hope it will be a benign environment where their decisions could have a major impact on the future development of the UK.

Q446 Baroness Wheatcroft: That is interesting; thank you. Sir Anthony, this is probably not something that concerns you?

Sir Anthony Holland: No. I don't think I can help on this particular issue. I am concerned more with complaints.

Q447 Baroness Wheatcroft: But you are perhaps on the next question, which really leads on. I am interested in the PRA, which is going to have a duty to engage with the outside world but not with the Practitioner Panel. I would like to hear your views on that. Some of your submissions have made clear that you are not entirely happy about that.

Mr Collins: If I could start, we believe that there should be a requirement for a statutory panel for the PRA. We would envisage that it would have common membership with the FCA Panel. There are a number of advantages to that. There is the straightforward one that it provides a regular means for engagement. The members of all the panels, but particularly the Practitioner Panel, come from the senior ranks of all parts of industry. We don't look at one sector: we look across the whole industry. We have also historically looked at conduct and prudential regulation. There are some significant benefits to improve the co-ordination between the FCA and the PRA that could be gained by having a group of practitioners who look at this.

By way of an example, we all have concerns about the way the regulator is willing to interface with Europe and internationally. One of the jobs of a panel like this is to remind the regulators early in the process, early in the development of initiatives, what the impact would be as it applies to other international regulations. We are quite strongly in favour of this.

We are not suggesting at the moment that this is in any way a panel to whom the PRA would be accountable. We see it as an engagement, a consultation. In other words, it is broadly a continuation of the current role of the panel.

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Q448 Baroness Wheatcroft: I confess I didn't really understand the Bank's reasoning for not continuing it.

Mr Collins: They made two points. They said it is a form of accountability with which they don't agree. Currently we are an advisory body. We send our thoughts to the Board of the FSA and they consider them. If we felt that they were really not taking us seriously and not listening, we would put it in our annual report and we would make a public statement to that effect. That is broadly what this equivalent Committee designed when the Financial Services and Markets Act influenced the input of the current panel. We see that as an advisory body. They make a reference to previous self-regulatory organisations. I think that is ancient history. The panel we are talking about here came into being when the Financial Services and Markets Act came in. I am afraid I don't fully understand their arguments either.

Mr Matthews: There is not much more to add to Russell's comments. Certainly our view is that the smaller businesses within the PRA will still represent the majority of the firms—the smaller credit unions, mutuals and small deposit takers. This co-ordination and the cost and burden are across the twin peaks. We question the basis of twin peaks and the weaknesses that are created. As to the complexity that we are now talking about—the underlaps and overlaps of the regulatory system—the panel would help in this co-ordination across the two panels and see how it works in practice.

Mr Phillips: If I could add to that, there is a perception—at least that is the way it appears to come from the Bank—that the consumer interest is really only represented at the FCA and it is not relevant to the PRA. In our current single regulatory structure we have been having serious discussions with the FSA about the mortgage market review and the balance between conduct and prudential regulation in order to deliver the best market. In their recent guidance which they put out on forbearance, we had a long discussion with the prudential side—the shadow PRA in effect—about what they were proposing to do and how we could make that work in the best possible way, both for them and for consumers. The inability of us to make those representations to the PRA would be a significant weakening of the quality of the input into their decisions.

Q449 Baroness Wheatcroft: There is nothing to say that they would not listen to representations, or indeed seek them. This just does away with the formal structure, is that right?

Mr Phillips: In the current structure, the panels get access to the agendas of the board and the major executive committees, so we can be aware of the issues that are being discussed and make our input at an appropriate time, before the decision is taken. We would not necessarily have that access if we were waiting for the PRA to contact us.

Q450 Baroness Wheatcroft: That seems a step in the wrong direction, with respect. Sir Anthony, do you think these proposals would actually lead to more potential complaints?

Sir Anthony Holland: I am sure they will. The present arrangements as proposed will be rather difficult to implement in practice. It reminds me very much, having had some experience of the railway industry in consideration to complaints, of the situation that arises between Railtrack as was—now it is Network Rail—and the train operating companies. There are complaints, and people know what has happened. The end result is that the

consumer suffers. What is going to happen here is that, first of all, there is this enormous overlap by a number of bodies, each doing different things. If you have a complaint, for example, against the FCA, they may use as a partial explanation the policy of the PRA, who would have a different Complaints Commissioner, not truly independent. As you may remember, the last Joint Committee in this very room 13 years ago insisted that there should be an independent complaints system. You will not have that in the context of the PRA. You will have it in the context of the FCA, but if the FCA use, as part of their cover for what they did or did not do, a policy of the PRA, who in turn may blame the FPC, I can see there being problems.

In addition you have the implications of what is called section 348, and the issue of confidentiality. As it happens at the moment, the FSA can say to a complainant, "Well, we can't tell you what we did when you made a complaint about a particular activity." However, I can actually see what they did. I can examine in great detail what they did. I can then report to the complainant, in not such great detail, but having said that I have seen it, exactly what happened. However, in the current arrangements as proposed the PRA could use as against the FCA the section 348 principle. The FCA might be quite happy to tell me what happened and I could see that, but the PRA may use a curtain and say, "We are not prepared to tell the Complaints Commissioner via the FCA what happened because of the section 348 implications."

This confidentiality issue is quite important if you want a truly independent complaints system. That brings me back to my particular point, which I said in my evidence to this Committee. The separation of a complaints system between the PRA and the FCA will lead to less transparency, not more. It will create more problems for the FCA and it will also mean that you cannot truly say that the system is a stand-alone independent one, which you can say it is at the moment.

Q451 Baroness Wheatcroft: Can you see any advantages in it?

Sir Anthony Holland: In what is proposed?

Baroness Wheatcroft: Yes.

Sir Anthony Holland: No, I can't actually. I can see from the Bank of England's perspective that it is much better of course to have this curtain and this protection, but from the consumer's point of view and indeed from the industry's point of view—and remember this original idea of a Complaints Commissioner stemmed from the industry's need to feel that if these vast powers are being given there needs to be some protection for the industry—they will not feel particularly protected either. I do not think the current arrangements as proposed in the draft Bill represent a fair deal either for the consumer or indeed for the industry.

Q452 Baroness Wheatcroft: And potentially it represents more cost?

Sir Anthony Holland: It is bound to involve more cost, because you have my system which runs fairly modestly and has been at the same level in budgetary terms of about half a million for the last 10 years, or since I have been there, for the last seven years, whereas you are

going to have another system for the PRA. Indeed, the interrelationship between the PRA and the FCA in dealing with a particular complaint that covers both areas or both activities will in turn lead to greater costs, both in terms of the bodies themselves and in the fact that you have to duplicate what I am doing.

Baroness Wheatcroft: Thank you; that is very helpful.

Q453 Mr Brown: We have touched on some of these issues. My questions are directed at Sir Anthony. You were kind enough to send us a written submission in response to our original call for evidence. You sent us this diagram, which makes your point very well. What is the remedy?

Sir Anthony Holland: People say, "He would say that, wouldn't he?" but that doesn't apply because I finish my particular role in about 18 months time so it won't impact upon me. My own view is that you ought to have it combined in one operation. I cannot see any advantage in separating it except, of course, that the Bank of England would much prefer not to have someone like me digging around in their activities, because they operate in a particular way. I cannot see anything but a simple benefit of having one body to do it.

Q454 Mr Brown: It is probably important to all the other citizens involved in this. Could you say something to us about transparency versus commercial confidentiality?

Sir Anthony Holland: Yes. To be perfectly honest, I always find the FSA very helpful in telling me what I want. When I first went there, whatever had gone before had not been entirely successful, if I can put it like that. I said to the FSA that as far as I could see any complaint system has to operate on the basis that the person doing the investigation is there to help the person complained about improve their performance. That is the object of the exercise, both in terms of its response to the industry and indeed consumer. That has worked very well. I have always gone to the board. I have told them where I think things were going wrong or going right. Certainly in my view there has been a rapid improvement over, initially the first three years and since then over the last seven years. I have been there seven years.

If you have a system whereby both parties appreciate that what you are trying to do is to improve the performance of both the body of the FCA and the PRA, it will work very well. But if you have a defensive attitude, which can creep in very easily—"We have got it our way and we don't want to change that"—that is a problem for the consumer. This is where section 348 comes in on this question of transparency. If you are going to give to the FCA a consumer-championship role, although that is not the word used in the proposed legislation, you have to be able to show them that in fact with transparency they are performing their role in that context. The only way you can do that is to have one independent Commissioner, in my view, who is able to get at everything that went on but then you have to rely upon him to use his discretion in what he discloses to the complainant.

Q455 Mr Brown: As you know, this is a pre-legislative scrutiny exercise and we can make recommendations. Should we be seeking to recommend amending the Bill to reflect the points that you are making to us?

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Sir Anthony Holland: In a word, yes.

Q456 Mr Brown: What do you think about consumer protection more generally in the current structure?

Sir Anthony Holland: You have of course the FOS which deals with the issue of consumer protection.

Q457 Mr Brown: Is it strong enough? Will it work?

Sir Anthony Holland: It is strong, in the sense that it covers up to £150K, or will do, and it does not operate a system which is what the law provides. It is on a "fair and reasonable" basis when it comes to a decision now. There is more to consumer protection than just providing a remedy for a particular mis-selling operation. You have to have regard to the products themselves. The issue is, do you start to regulate the products before they are sold, as happens on the continent? That is quite a tricky area, because you are inhibiting freedom of choice and so on. There is a balance to be struck, but what is currently proposed does need improvement.

Q458 Mr Brown: We have heard different views on that point. Do any of the other people giving evidence want to say anything to us on that?

Mr Phillips: From the Consumer Panel's perspective, I have already made the point that there are areas that the PRA will be dealing with—specifically mortgages and insurance—where an input of the consumer interest, shall we say, will be helpful to the quality of the decisions. Certainly the FSA have found it useful. It is not clear in the current structure that there will be any need to take account of that. It will depend very much on the people who are involved asking for advice.

One of the advantages of all three panels is that we get quite closely involved in the early stages of the development of regulation. We have the ability, because we are reasonably expert in our areas, to bring alternative perspectives to the same problem. Very much like this Committee is doing, there is a pre-discussion about whether the approach is a good approach and whether other approaches might be tried. It would be a pity if that is not written across into the new structure so that there is the possibility for this external input to operate.

One of the PRA's objectives should be to take account of the impact of its actions on consumers. There will be issues particularly relating to activities regarding mortgages but also to life assurance, that are really important.

Q459 Chairman: Do other witnesses have views on that issue of whether the PRA should have regard to the impact of policies on consumers?

Mr Collins: From the Practitioner Panel we have our own request, which is that it should have regard to the international competitiveness of the UK financial services industry. That just reflects our perspective. On one specific issue we can see that the PRA will be involved

in consumer protection, which is around the insurance and policyholder area. We think that would be an area where they need to have regard to that.

Mr Matthews: The fact is that certainly the widening of that objective is helpful: looking at competitiveness and looking at the consumer. If you have a slightly wider objective, that would be helpful.

Q460 Chairman: Though quite often it has been put to us that an emphasis on consumer protection has an adverse effect on competitiveness of the industry. Would that be a view you share?

Mr Phillips: If you couch it in the terms of consumer protection that is not an unreasonable view. It implies a level of regulatory intervention which is not what we are looking for. What we are looking for is a positive impact, as Sir Anthony was talking about, for both the industry and the consumer. It is the case that if you are concentrating on prudential regulation, to make a strong and stable industry, you may not take as much account of what that does to the consumer in times of stress, such as we are seeing now, as might be seen to be appropriate if you took a wider perspective. It is the ability to pay regard to the impact of your actions which is important, as we have seen with the FSA and the industry with forbearance in the mortgage market at the present time where repossessions are much, much lower than they were 15 years ago.

Sir Anthony Holland: Can I just add one further relevant point? Don't forget that the bodies concerned, both the FCA and the PRA, will have legal immunity for anything to do with negligence, mistakes, lack of care, etcetera. Having been given that, in my view the sine qua non following on from that is that you must have a really independent system. It is this lack of transparency that worries me. Indeed the Burns Committee, sitting here in the same room 13 years ago, said that you have to have that. With legal immunity you must also have some independent complaints system which stands, is transparent and is seen to be consumer friendly.

Mr Collins: From the Practitioner Panel's point of view, we would support the idea of one complaints system across the PRA and the FCA. We do like the idea of a straightforward financial stability objective for the PRA, but we also support the idea that they should have regard to the wider considerations.

Q461 Lord Newby: This is a question initially to Sir Anthony about complaints and compensation. At the moment when complaints are upheld there is no right to compensation; it is done on an ex gratia basis by the FSA. What are your views about the way that system works? Do you think that the Bill should contain any provisions around that issue?

Sir Anthony Holland: It is a Pandora's box that I really don't want to open up, as you probably saw in the evidence I submitted last time when this debate was had in the House of Commons. The difficulty is that if you allow the bodies concerned to be exposed to claims for liability and damages, in the normal way that the civil law operates, that is being funded by the industry, and therefore indirectly and in turn by the consumer. You can get substantial amounts of damages awarded. What has happened has been a fudge really over

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the past 13 or 14 years. The Law Commission in Paper 187 looked at this in great detail and published a vast tome about what you do about damages against administrative bodies when the citizen needs to have redress against those bodies. They came down in the end to a similar kind of fudge—that if you have direct and clear liability then there are serious issues about the volume of damages that can be awarded as well as a ghastly thing called causation. What actually caused the loss? Was it the initial act of negligence or did something happen in between when the person suffered the final loss which actually prevents the body being held responsible for that loss?

Once you go down that road it is a lawyer's paradise. I am no longer practising, so I can say this. The lawyers love it. It is a real opportunity to pile in there and make things really complicated. I don't think you can have that. You have to have something like we've got now, which is compensatory awards—and the word "compensatory" has never been defined by the courts—which are ex gratia. First of all, the definition of how you calculate the damage is not in accordance with the common law calculation. Secondly, it may depend upon the interpretation placed upon it by Strasbourg under the Human Rights Act. Then it is ex gratia, because it depends upon whether the body concerned—the FSA now, but it will be the FCA—wants to pay up. All the awards I have made have always been honoured by the FSA. There are times I could have made quite substantial awards. I don't take evidence on oath, so it is not easy to establish whether there was a break in the chain of causation which prevented me from coming to a final decision about the correctness of making a large award. The current fudge is about as good as you are going to get.

Q462 Lord Newby: Have there been many complaints about the current system? When you have not made an award, for example, have there been many cases where people have felt really aggrieved and that there should have been greater redress?

Sir Anthony Holland: Yes, they do feel sometimes that I am not being very generous but by and large their main complaint, which we come back to time and time again, is that it is not transparent enough. The FSA has used section 348. I have seen everything. I tell them I have seen everything. I try to get them to rely upon my goodwill and integrity that I have seen everything and I have come to the view that the FSA did do the right thing. They usually complain that I would say that, wouldn't I? But the complaint about the level of damages is not as frequent as it might have been. It may be because I explain fairly early on in the negotiations and the correspondence that my powers are limited. That seems to be understood by them. They may not agree with it, of course, and certainly the debate that took place in the House of Commons last time round was a bit disingenuous as to what was going to happen because it never did actually happen as was portrayed.

Mr Phillips: Since Sir Anthony has raised the section 348 constraints that are imposed on the FSA, they bear very hard in terms of forcing the regulator to be non-transparent. I have received several complaints during my term from consumers. Although we don't take complaints from individual consumers they do still complain to us about their assurance from the Complaints Commissioner that the FSA has done a reasonable job, but with no evidence about what the follow-up has been by the FSA. For example, they may believe there has been mis-selling and the FSA will not tell them what action they have taken other than for them personally. The Complaints Commissioner cannot tell them either. All he can do is say, "I think the action of the FSA was appropriate." We believe that section 348 should be modified to allow the FSA, in pursuit of its regulatory purpose, to release

information which would help achieve that purpose. This is a particular area where an easement would be very useful.

Q463 Chairman: Could you give us your views on whether the Bill should create a presumption in favour of the early publication of disciplinary action? For instance, in the case where the FCA or PRA have issued a warning notice in relation to a proposed disciplinary action should there be a presumption that this will be publicised?

Mr Phillips: Perhaps I should go first, because I am sure the practitioners will have a slightly different view from my own. The term “warning notice” is slightly misleading. What in fact happens is that if the FSA decides that a company has, in their view, broken the rules they report this to the Regulatory Decisions Committee which decides on breaches that are contested, which is many of them. The RDC, then institutes a review to report on whether there has been a breach of the rules. That report goes to the Regulatory Decisions Committee, and if they decide that it seems to be fairly conclusive that there is likely to have been a breach they issue a warning notice. At this point the company, the organisation or individual is able to make its own representations to the committee.

From that point it can take nine to 18 months before a decision notice is issued. At that stage the outcome will become public. During this period of time, which can be a year-and-a-half, no one knows what is happening. We think, given there is a review that decides that there is a case to answer, the publication of a warning notice is very similar to a committal in a criminal process. It is also not dissimilar to what happens with the Securities and Exchange Commission in the United States. Warnings should be published except in exceptional circumstances where there may be good reason not to do so.

Mr Collins: From the practitioners’ point of view we do have some reservations about this, as I think you would expect. The fact of the matter is that, if there were publication of early warning notices with the name of the firm involved, then there would be publicity and concerns around the firm’s reputation before the firm had had a full chance to defend itself and any guilt had been proved. We would draw attention to the fact that quite a significant proportion of the final notices are different from the original notices, so in quite a number of cases firms would have suffered reputational damage and then subsequently found to have been acting correctly. In some cases consumers might take action on the basis of the early warning notice that a product was not appropriate and then subsequently find that it was safe. I am personally not a lawyer and I do not know if it is practical, but our suggestion in this regard is to not publish the name of the firm. The FSA and the new regulators should find a way to make public their concerns in a way that would not damage the reputation of an individual firm. We can see that as a perfectly valid regulatory tool. As Adam says, there is sometimes a long period to wait for the final outcome.

Mr Phillips: If I might come back on that, this happened with four mortgage advisers a couple of years ago. It was announced that four advisers had been mis-selling mortgages. It then took nearly nine months before anybody knew who they were. It cast a blight on the industry, because clearly there was some problem, but nobody knew who the people were. Perhaps it might give the industry some comfort if there was the ability to have a completely independent review before the warning notice was issued, so that the process could be examined to make sure that it was reasonable.

Q464 Lord Skidelsky: Is there any way of speeding up the process and therefore reducing the period of uncertainty? Why does it take up to 18 months?

Mr Phillips: Lawyers.

Sir Anthony Holland: I can perhaps help on this. It will take that sort of time if there is a lot of money involved, a lot of possible mis-selling, if PI insurance is involved and so on. That is what takes the time. I can give you my view about this question of publicity. It is a really tricky area. It is a very fine line, and there is a very fine judgment to be made. This is a civil matter, not a criminal matter, for a start. That means that you cannot precisely compare it to a committal proceeding. Secondly, it is a regulatory matter which determines people's livelihoods and people's jobs and so on. Publishing it before you have reached finality in relation to what actually happened does run the risk—and everyone has to accept that—that in the interests of consumer protection (a) there may be no guilt and (b) that people's jobs and/or security may be affected. It is a very fine line to draw. It is not very helpful to tell you that, but from a legal perspective it is, probably on balance, a decision that most lawyers would say "Don't publish until you have reached some kind of finality." That is purely a personal opinion.

Q465 Lord Maples: Following up this point, we had some witnesses about two weeks ago who were consumer representatives of one sort or another. They made two points to us. One was that the FSA allowed the payment protection insurance mis-selling, or whatever one wants to call it, to run for months without either banning it or publicising what was going on, and in that process lots of people were mis-sold this insurance. Secondly, one of them said that another FSA—the Food Standards Agency—regularly bans products and publicises what it has banned. It does not ruin people's reputations; they are taken off the shelves and stopped. But the FSA does not seem to want to do that. You all seem slightly reluctant to let it do so. Might there not be cases where it would be appropriate for the FSA, or its successor body, to say, "We are not going to allow people to sell that"?

Mr Phillips: Absolutely. We would very much like to see them being able to do that. The industry fights tooth and claw where the FSA tries to do that. We have seen with payment protection insurance that they went to judicial review over whether the concept of treating their customers fairly was being reasonably defined by the FSA, even though the FSA had consulted on the fact and had published the results of its consultation. That caused part of this delay.

As Sir Anthony has pointed out, the Financial Services and Markets Act constrains the FSA in ways that the Food Standards Agency is not constrained. When the payment protection super-complaint came from the Citizens Advice Bureau in 2005 it went to the OFT; it did not go to the FSA. The OFT starts off by asking the FSA to answer the complaint. There was then a discussion about who had the power to do a competitive investigation because this looked like a market failure, and that was the OFT and the Competition Commission which introduced further delays. We believed at the time that the FSA should have stepped in, using the principle of treating customers fairly which in fact resolved a lot of this in the end, and it would have sorted things out two or three years earlier.

What would help in the new Bill is to make it very clear about the competitive responsibilities of the FCA. We would like them to have concurrent powers similar to other regulators, which would give them the lead on competition regulation in such a situation where a super-complaint comes in. Of course the Competition Commission would be there, but a financial services market can be quite competitive without necessarily delivering good value to the customer, as the Vickers Independent Commission on Banking pointed out. The ability to use the tools which the FCA will have in order to encourage effective competition means that we think they should be given concurrent powers and they should be the lead regulator in this area.

Sir Anthony Holland: Can I try and cut through an issue here which may be confusing everybody? You have the product and then you have how it is sold. If one is talking about forewarning difficulties about the product—whether it is PPI, pensions or whatever—that is one issue. As much advance warning as you can give there from the consumer's point of view, the better. How that product is sold is an individual responsibility of the particular person engaged in selling that product. That is a separate issue. I suspect all of us probably agree that when you have a product that looks as though it is going to be causing consumer loss and damage, then it is very important that there should be a rapid response. But how it is being sold, which in turn may make it a dangerous product when it would normally be a safe product, is where you have this very fine line to draw. I don't know if that helps or not.

Q466 Lord Maples: Isn't the issue likely to be that the product of itself—it isn't like the Food Standards Agency, I agree with you, where it might poison you—may be very suitable for some people and totally unsuitable for others? The two issues do necessarily become entangled, it seems to me.

Sir Anthony Holland: They can become entangled. PPI is a beautiful example. I could think of very few occasions, speaking personally, when I can envisage PPI being a good deal for anybody, because of the conditions imposed. If you changed the conditions, of course, then suddenly it might become a reasonable product. It is entangled. You have the product; the conditions you impose with it; how far they relate to the person to whom it is being sold; and then, was the sale suitable for that particular individual? Those four aspects can cause enormous confusion.

Q467 Chairman: We have a different view from this end of the table.

Mr Matthews: The question was really the presumption of an early warning notice. As you can see, it is finely balanced as to whether you actually announce this. There are a lot of aspects. In relation to the appropriate decision and when to use it, of course early warning notices have their appropriate time and place to be used. It depends sometimes on the complexity of the issue. There is also the undermining of the confidence of the financial system and consumer behaviour. Making an announcement which for a consumer may be ill-informed may result in detriment to consumers. There are all these aspects. We talk on product intervention. That is one of the powers that is being proposed for the new regulator, so there are those aspects. Certainly for the smaller businesses, there must be enough checks and balances so publication is used in the most appropriate circumstances and there is not a presumption that it will be used.

Mr Phillips: I would just like to say again though that one of the issues here is confidence in the regulatory system. The fact that the police are taking action to arrest criminals, that they are discouraging people from speeding too fast on the roads and are seen to do that is important in building confidence that if you break the rules you will be caught. If you look at the Food Standards Agency, we had a real problem and a crisis of confidence in the quality of British food at the time of BSE. The Food Standards Agency stepped in and they have restored that confidence.

We have a crisis of confidence in financial services regulation and we have to think about whether being more transparent would help that process.

Mr Collins: From the Practitioner Panel point of view, we completely agree that it is the interaction of product itself and its sale—how the product is sold and indeed to which consumers—that matters. You cannot look at any one axis, so I completely agree with the interaction.

We also completely agree that if there is wrongdoing in the industry then early identification and enforcement of that is for the benefit of the industry as a whole. On the specific point we are talking about here, the concern we have is that there are sufficient safeguards for the firm to know that due process has been gone through and they have had enough ability to make an appeal against the initial contact from the FSA so that there can be as much assurance as we can get that that firm won't suffer unnecessary reputational damage. From our point of view, the safeguards in the process are really important. Our preference would be that, wherever possible, the name of the firm is not published until the final notice is issued. Statistics indicate that approximately 30% of the final notices do not bear a great deal of resemblance to the initial notice. That is the balance we have to take here.

Q468 Mr Ruffley: On that point, I have a question for Sir Anthony, just so I am clear. Would you recommend that before early warning notices were sent out there was an independent panel that a firm could go to, to say, "Look, on the face of it this early warning notice is ridiculous and there are no grounds for it," in the light of Russell's statistics, which do seem a bit worrying, showing that final decisions would throw into doubt the need for an early warning notice in the first place in a high proportion of cases?

Sir Anthony Holland: Probably on balance they would. It is this eternal triangle of the consumer, the industry and fair play. On balance that would provide some modicum of comfort if you are going to publish these things at an early stage. After all, it is an important industry. There has to be protection for the industry in the way they operate on a daily basis. On the other hand, the consumer is also entitled to be protected. That would provide some safeguard if you are going to publish early.

Q469 Mr Ruffley: Why has not such a system been in place already? The logic of the position, which is where I am coming from, is that there should be some independent panel before these early warning notices are issued. That is not just a good idea because this Bill has been put before us. It seems to me a good idea in principle. Why do you think this has not happened before?

Mr Collins: My personal view, and it is the Panel's view, is that the firms have always placed a lot of reliance on the system that Adam outlined right at the outset of this discussion: that there is a process internally at the FSA for an independent review of the case. When that was introduced it gave the firms the critical assurance that was needed that the evidence base would be looked at coldly by the FSA. While I am generally in favour of independence, it would create quite a cumbersome process to have to have a fully independent review from scratch of all the facts related to a case. It is a balance. I can see the benefit of that, but we have placed reliance so far on the internal process within the regulatory body.

Q470 Mr Ruffley: Finally, Sir Anthony, how might such a process be set up at the early warning stage, where there can be an appeal or a challenge? Do you think it is desirable to put it in the Bill?

Sir Anthony Holland: It would be cumbersome. The Regulatory Decisions Committee was meant to be that kind of safeguard initially, but of course it has developed its own jurisprudence in the way it has processed itself. You can now get hearings and lawyers present and so on. Originally it was intended to be the kind of safeguard we are talking about. What you would be building on is a safeguard on a safeguard. That is what would make it cumbersome. It could be done. You could have an individual or two who are experienced in this particular work who could look at the preliminary papers and say, "This is something that could be published without prejudice to anybody" or "This is frankly a very dubious way forward or one where there are arguments on both sides so I don't think there should be publication."

Q471 Mr Ruffley: How do you think the Bill should be amended?

Sir Anthony Holland: I did not come prepared to have a view about this. My own view is that I would amend it so as to provide that when you have the process involving the RDC there is the opportunity before publication, if the person concerned who is to be the victim of the publication wants to refer it to a third party, for them to have it done at their option. It does slow things down; one has to accept that. You could build in a time limit of, say, six weeks so there is a very limited space of time. It would not be popular with what I call the people who are operating the system, but it would provide a safeguard if you want to have publication. Does that help?

Mr Ruffley: It does, yes.

Q472 Baroness Wheatcroft: What you are saying is really interesting. I wonder whether there is a risk that there will be a willingness to publish early warning notices and to name names only of smaller practitioners. I cannot see the point in the suggestion that Mr Collins came up with of saying "four anonymous firms are subject to potential disciplinary action". Naming big names—for instance, that a big bank has been guilty of potentially mis-selling mortgages—would place the financial stability objective at risk. Is that potentially a problem?

Mr Phillips: We have always accepted that there will be situations where certain kinds of warnings could not be published. That would be part of the review process. There are

almost no cases that have come for enforcement which really have a systemic impact, as far as I am aware.

Q473 Baroness Wheatcroft: It is quite clear that there should be.

Mr Phillips: It is always possible that that could happen, but essentially the cases that go through enforcement tend to be about rule breaches and by their very nature they can be quite significant. The most significant one we have come across of course is PPI, which does have a huge cost implication. It has been broken down through enforcement into a number of different individual cases, but the real issue has been dealt with at the regulatory level, and I would anticipate that that would happen in the future.

Sir Anthony Holland: That is a very real problem. When I get complaints from small firms or consumers, that is one thing; but when I get a complaint about a major body, of course then I get what are called the "magic circle" firms involved. I will have long 100-page submissions as to why I should or should not be doing something. While that may test my mental acumen about dealing with it—and that is something I accept—they bring a different dimension to the whole thing. They are in there because it is big money and a lot is involved.

There was one particular area where I was involved fairly early on with one of the magic circle firms, where they really did want to stop something happening. I do have the power to do a preliminary investigation even though the FSA are continuing their investigations. I can do that if there are exceptional circumstances. You will then get a submission of perhaps 30 pages on what are exceptional circumstances as to why I should intervene. It doesn't sabotage it, but effectively it makes it very difficult for the FSA to continue to investigate. So far, in all those cases I have declined to find that there have been exceptional circumstances, but no doubt the day will arrive when someone, and if not me then my successor, will decide that in fact they can intervene. That is when the problems would start.

Q474 Baroness Wheatcroft: When you refer to the "magic circle", you mean the big banks or the big financial institutions that are using the big law firms?

Sir Anthony Holland: It will be one of the big banks, yes. The big organisations will use a magic circle firm, who will then throw teams of lawyers at it. Ultimately it is only myself and an investigator who have to field the issues.

Q475 Baroness Wheatcroft: Clearly the smaller firms just don't have that firepower?

Mr Matthews: First, they don't have the firepower, but also, picking up Russell's point on the number of times an early warning notice occurs, that could be the death of the company. If later on it comes out that it was not appropriate, you will have firms going out of business based on that.

Mr Collins: We do have one example which is a larger firm, which was Gartmore. I know we were operating a different system but that firm's reputation was affected by something that was done in an earlier process. Subsequently, of course, things developed commercially for them.

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Baroness Wheatcroft: That is very interesting; thank you.

Q476 Mr Laws: Following on a bit from those questions and looking at the issue of the FCA's objectives, including strategic objectives, there have been quite a few bodies, including the ICB but also consumer organisations, that have been critical about the way in which those objectives have been framed, not least the objective to protect and enhance confidence. Do any of you share those concerns and would any of you like to suggest any restatement of the objectives?

Mr Collins: I can be quite brief. The Practitioner Panel is quite comfortable with the FCA's overall objective. I will repeat my comment that we would prefer to see international competitiveness there as a consideration. What we are more concerned about is that they have to operate that objective on a definition of "consumers" which is so broad, from the smallest retail consumer to the largest wholesale and professional consumer, that it would mean that they are trying to apply a single objective to such a wide range of situations where, frankly, a different approach is needed. It has been one of the strengths of our system here that the regulators have taken into account the fact that even if a professional and a very large wholesale firm is a consumer they come at it with a different set of information and knowledge. Our main concern would be around potentially narrowing the definition and making it clear which consumers they are really talking about. That would be our preference. The Bill does provide for a different approach by the FCA on the different types of consumer. It does allow it, but it is not really as strong as we would like to see. We think they could easily drift into treating all consumers as small retail consumers. On the objective we are broadly comfortable.

Mr Phillips: We think the overall objective, which is confidence, is not a particularly helpful objective. In our original submission this time last year to the Treasury we suggested that fair and transparent markets should be the objective. Now we would say, having thought about it for another 12 months, that fair, efficient and transparent markets would be a clearer description of what we think the FCA should be trying to deliver.

Q477 Mr Laws: Do you think this is about issues of real substance in terms of the way the FCA does it job, or is it just about getting the technical definition right?

Mr Phillips: First of all, the overall objective sets the tone for the discussion. To say that markets should be fair, efficient and transparent are good things to guide the discussion. When it comes on to the subsidiary objectives which are more specific we don't think that either access to markets or competition have really been effectively dealt with. There is an objective which says that the FCA should have the objective of delivering efficiency and choice. We would like to add "efficiency, access, choice and competition". We think access is important because competition does not necessarily lead to access to financial services. It depends on the cost of provision, and yet many financial services are essential to operating in a modern economy. As with Sir John Vickers, we would like to see the word "competition" in there. This idea of effective competition is really quite important to deliver value to the consumer.

Could I come back on Russell's point about the definition of "consumer"? I mentioned this earlier on. Currently FSMA does have quite a broad definition of consumer.

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We have had a number of representations from SME organisations about their concerns about provision of credit to small businesses. At the moment we have no levers to pull because FSMA does not influence that market, but we would be very interested in getting engaged should credit come to the FCA. Also, consumers have an interest in how their pensions and savings are handled in the wholesale markets. There is no doubt that there are problems in the wholesale market relating to the size and power of the consumer. We would support the broad definition.

Q478 Mr Laws: Do any of the other witnesses want to add anything to those comments?

Sir Anthony Holland: There is an impossible tension between "consumer champion", to use a terminology that has been used by other people, and regulating a financial services industry. You have to accept that that tension exists. Whenever I do a response to a complaint, which I do quite frequently, I always try and explain that there is this problem. You are trying to ride two bicycles at the same time, which can produce a very uncomfortable result for the body doing it and make it almost incomprehensible to the person complaining about the manner in which it is being done. Either way, you have a problem, but this is how the system works. You have to have responsibility for consumer protection inbuilt into what you are doing, at the same time regulating the industry, giving it fair access and making it competitive. Those are all very conflicting objectives and you just have to get the wording right and make it workable from the point of view of a Complaints Commissioner.

Q479 Mr Laws: In relation to the FCA's consumer protection powers, there seem to be some very different views between some of the consumer groups that think that what is in the Bill on consumer protection is really pretty feeble, and some of the other bodies, including financial services companies like Barclays, that have said the pre-approval regime could have a potentially chilling effect on product innovation. What are your views on that issue of whether this is an improvement in consumer protection? A question for you, Sir Anthony: is this likely to lead to additional complaints compared with the existing system?

Chairman: Brief answers would be appreciated.

Sir Anthony Holland: Yes, there will inevitably be additional complaints. That is my answer.

Q480 Mr Laws: Because?

Sir Anthony Holland: Because the consumer will be led to believe as a result of these changes that in fact consumerism has a greater part to play in the way this legislation operates. Indeed, it will have a greater part to play, as we all concede by the consultation paper we have been reading. There is inevitably going to be an increase in complaints, plus the fact that you have this overlap which in turn will make the thing very complex to operate and will make it less transparent to the consumer.

Mr Phillips: Written into the Financial Services and Markets Act and carried across into this draft Bill is the concept that consumers should take responsibility for their actions. Looking from the consumer perspective, and I can understand some of the points that were made in

the earlier hearing, there is an issue about whether the industry actually delivers a reasonable product to consumers in a way that they can effectively engage with. We would like to see written into the new Bill a duty of care for customers being imposed on the industry as a principle.

The FSA has tried to go as far as it can with the principle of treating customers fairly and has found it very difficult to make it stick. We think that an expectation that the actors in the industry should treat their customers in a way which is fair and reasonable—a duty of care—would be a good expectation. If we copied the proposals in the Dodd-Frank Act in the United States, which gives the SEC rule-making powers to deliver that duty of care, that would make it quite clear that the principle would be delivered through rules which would be subject to the normal controls of cost-effectiveness and proportionality, but would move the debate in a direction where the industry would be trying to provide to the customer something which the customer can engage with.

If I could just take a little bit more time to give two examples. We currently have products which are called absolute return funds where you can lose significant amounts of your capital, which is not what the name implies. The ABI has done work which suggests that what they define as a cautiously managed product most people would regard as quite a safe investment. When told it contains a 70% equity content, two-thirds of them say that they think that is a risky product. If a duty of care was imposed on the industry, the way that products are named, for example, would become an issue for discussion, because this is clearly something which a consumer may be misled by. I would just like to put forward this idea.

Mr Collins: The naming of products is an issue. It can be dealt with under the current legislation and, if that is carried across, that can be dealt with by the regulators. On the question of a duty of care, we the practitioners want to retain this consumer responsibility comment in the Bill. We think it is important to the way business is done in this country that people have that responsibility. There are lots of duties of care in the Act that firms have to follow. If we are going to extend it in any way, clearly it requires consideration of quite complex legal duties. If you already have a number of duties of care which are imposed through the Act, and then another one is introduced, you have to—

Q481 Mr Laws: It sounds quite mild, Mr Collins.

Mr Collins: I have heard it expressed as a fiduciary duty. I have to say that that does bring in quite a lot of ramifications for firms and what they have to know about the person and the responsibility they take when ultimately, and we have to be clear, they are selling a product to the person. They are not just providing trust services; they are actually selling a product. When you are selling a product, it depends how far Adam intends that to go. It is a legal question but exactly what duty of care are we imposing when we already have lots of responsibilities on firms in the Act? It is not something we want to rule out of court now because we have not really had time to consider it.

Mr Matthews: With the regulations as they are currently drafted, if we go to the naming of products, many of the products require pre-approval currently from the FSA so that naming can easily be brought into the process and is part of the process. If it needs improving that should be easy. In terms of fiduciary responsibility, again it is a question of balance. Firms

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have a duty of care to a number of relevant parties. That balance between consumer and its own financial well-being and viability is potentially a conflict.

Chairman: Thank you very much indeed, Sir Anthony, Mr Phillips, Mr Matthews and Mr Collins. We are very grateful to you for your evidence today. It will be very helpful to the Committee in its deliberations.

Examination of Witnesses

Witnesses: **Mr Mark Lyonette**, Chief Executive, Association of British Credit Unions Limited, **Mr Martin Shaw**, Chief Executive, Association of Financial Mutuals, **Mr Jeremy Palmer**, Head of Financial Policy, Building Societies Association, **Mr Steve Gay**, Director General, Association of Independent Financial Advisers, and **Mr Nick Cann**, Chief Executive, Institute of Financial Planning, examined.

Q482 Chairman: Gentlemen, welcome. We are very grateful to you for appearing before the Committee. We are conscious that there are a lot of you. Please don't feel obliged, all of you, to answer every question but only if it is either specifically to you or you have something different to say from what others have said. It would be helpful to the Committee if you would begin by introducing yourselves, starting on my left.

Mr Gay: I am Steve Gay. I am the Director General of the Association of Independent Financial Advisers.

Mr Cann: Nick Cann, Chief Executive of the Institute of Financial Planning.

Mr Palmer: Jeremy Palmer, Head of Financial Policy at the Building Societies Association, standing in for our Director General who is abroad.

Mr Shaw: Martin Shaw, Chief Executive of the Association of Financial Mutuals.

Mr Lyonette: Mark Lyonette, Chief Executive of ABCUL, the Association of British Credit Unions.

Q483 Chairman: Thank you very much. Could I ask you in particular whether you think that the draft Bill makes sufficient allowance for the particular nature of your businesses, many of them smaller and certainly different from the banks and the large institutions on which attention has focused? Do you think the Bill will be okay, and will the proportionality principle enshrined in it be sufficient, or do you think something different is needed?

Mr Gay: Constant regulatory change places a heavy burden on small firms. It deters investment in the sector. In some cases it can threaten the existence of small firms as we have seen with the Retail Distribution Review. We are concerned about the overall burden of cost on small firms, the layers of cost for different regulatory entities, whether it be the FCA, the Financial Ombudsman Service, the Compensation Scheme—now the Money Advice Service—and whether or not that aggregate burden is being looked at in the whole

in terms of whether or not it reduces access to services and therefore creates detriment to the consumer. We would like the FCA to be required to quantify how incremental cost damages consumer access. As far as the proportionality principle is concerned, it really only works if it works visibly.

Mr Cann: We would share the subject of cost being a real issue. As yet there is no sign of how any regulatory dividend might be shown through in terms of this change. It is still more of the same rather than more of an improvement. On the other part, I am concerned about consumer engagement which seems to have been missed. There is talk about competition and protection but no real engagement, which we see is a big issue as an outcome of the current regulatory regime.

Mr Palmer: We see the proportionality principle as very helpful and broadly sufficient. The wording we saw in the Bill we thought was quite careful. In the end, it will also be a matter of culture and not just legislation as to how it works out in practice. We found helpful indications of a proportionate approach in the PRA's launch document, where they talked about concentrating on systemic risks, but as the other witnesses have mentioned we also remain very concerned about the overall cost burden.

Mr Shaw: We are very pleased that the latest Bill takes account of the Coalition agreement's commitment to a more diverse marketplace for financial services. We believe that was very critical for the new regulators to have that sewn into the way that they operate given that, over the last 20 years or so, the environment for the mutual sector in particular has been incredibly hostile. There is a lot of coverage of the demutualisation of building societies, but with mutual insurance as well the same has applied since around the mid-1990s when the mutual insurance sector represented over 50% of the whole insurance sector. We now have a position where it has fallen to 5%. That in itself is a reflection of legislation and regulation which has made it increasingly difficult for mutuals to prosper.

We therefore see that the Bill takes account of the need for the new regulators to take account of diversity. That is incredibly welcome but in itself it will not be enough to stop a new trend to demutualisation and in mutual insurance in particular given some of the policies that we see in place within the FSA at the moment. We remain very concerned that while the Bill goes to some extent to help to address some of the issues around diversity, it does not go the whole way.

In addition, in relation to proportionality we also see there that the Bill assumes that proportionality will be inherent in the way that the regulators operate. Interestingly, most of the dialogue there relates to the proportionality in the functions of the regulator; in other words, that it spends its money cost effectively and focuses on large organisations. It does not really consider proportionality in relation to the impact on the industry itself. There we remain concerned that small firms face an increasingly hostile and expensive environment in which to operate.

Mr Lyonette: Along with my colleagues here we have three main concerns, as you will see in our response overall: proportionality, diversity within the industry, not just in terms of the Government's model and I know there is a commitment in terms of looking at it from mutuals but diversity in terms of customer base, membership base, who the industry is managing to serve and cost. Of course for our sector, which is a small sector but there would still be 1.4 million people using credit unions by April when Northern Ireland credit

unions are under the new regime, we have no ability to pass on that cost to the consumer. If regulatory costs rise and we have a maximum interest rate on our lending, which we are the only folks in the UK that do, then we have very limited ways in which we can manage that growing regulatory cost. Cost is absolutely key to us. It will not just be in the law but of course in the implementation of the regulation. The devil is in the detail.

Q484 Mr Brown: My questions are aimed primarily at those of you whose members are going to be subject to dual regulation, i.e. by both the PRA and the FCA. What are your views on the arrangements for dual regulation as they are set out in the proposals in front of us? Could they be improved? Are they too burdensome? What would you want to say to us about them on the subject?

Mr Shaw: There are lots of examples of countries across the world where dual-regulation does work. There are by necessity some complications around the edges in terms of what represents prudential regulation and what is conduct regulation. Certainly in some jurisdictions it is sometimes quite difficult to see that the conduct regulator has sufficient powers to be able to discharge its responsibilities fully. I don't think that is the case with the PRA and the FCA. The concern we have is to the degree of overlap between the two regulators where both of them are trying to do the same job in different ways, and therefore where the cost burden on firms increases as a result.

Q485 Mr Brown: Is that the view of all of you?

Mr Palmer: We would certainly broadly share that view. We saw some useful improvements in the White Paper and in the Bill itself. We welcome the statutory duty to co-ordinate, which seems very sensible, and we welcome a common authorisation gateway. Beyond that we can see again whether it works is down to culture as well as legislation. We think it is very important that the successor bodies should co-operate and not empire-build or fight turf wars.

There is promised a draft of a memorandum of understanding between the two bodies, which we understand was to be published before the Bill is introduced but we are not aware that it has appeared yet. It is difficult to have a concluded view until we have seen that.

Q486 Mr Brown: What are your views of the PRA's veto over the FCA?

Mr Palmer: We are content with that.

Mr Shaw: Likewise, particularly in the most recent version of the Bill, the veto is built around issues of "with profits" in particular. That is one of those product areas which matters a great deal to mutual insurers and where there have been historic difficulties in terms of the regulation of those products. The veto itself provides a much greater opportunity for stability within the whole financial system.

Q487 Mr Brown: Do you have views on a single point of contact proposal?

Mr Lyonette: Perhaps for ourselves. Remember that for many credit unions you are talking about one or two people who are dealing with these two organisations. We are still a healthily growing sector but you are talking about just doubling the institutions and having potentially two different people to talk about and work out whose responsibility it is. Martin was talking about the overlap. It is really burdensome. We are not necessarily convinced by the Government's arguments that this should not be something that is captured in legislation and it should just be left to operation because it seems elsewhere that quite a bit of detail has been captured in the legislation. It does not seem to me unduly burdensome to suggest that you don't want to put out of business all the small deposit takers.

Q488 Mr Brown: Is that a universal view? Do any of you have dissenting views?

Mr Palmer: I would agree with Mark. We think things could go further in making clear that there should be single points, particularly to help smaller firms.

Mr Cann: A single point is preferable, to come with the same objective rather than having cumbersome duplication meetings with slightly different agendas.

Q489 Mr Brown: You think it would have a better chance of working if we were clearer about it in the legislation?

Mr Cann: I think so, and also the fact that you have this ombudsman and compensation scheme coming in the same remit. It makes sense to have a co-ordinated conversation rather than negotiation and discussions with three completely independent regimes.

Q490 Chairman: Would the same apply to the idea of a single rule book for dual-regulated firms?

Mr Palmer: Yes. In our evidence and in what we said to the Government, we have advocated as far as possible—and we understand there will be difficulties—keeping a single regulatory handbook because firms have got used to it and it is another upheaval which, if it can be avoided, would be good.

Q491 Mr Laws: Do any of you believe that the definition of consumer in the Bill needs to be qualified in some way?

Mr Palmer: We think it is possibly too wide. We looked at it and it is quite difficult to understand. It has four sub-clauses and it took five or 10 minutes to work out what it was actually saying. This point was touched on by witnesses from your previous panel. It appears that it does cover users up to the largest firm. Our view is that consumers are individuals and small businesses but not large businesses. Maybe that is too simple but that is what we think.

Q492 Mr Laws: So you want some sort of refinement that would make clear which bits of the Bill should deal with different classes of consumer, if you like?

Mr Palmer: It is confusing to use the term "consumer" if it is capable of meaning large businesses as well.

Q493 Mr Laws: Can I ask Steve a question? I think that your organisation supports the concept of having some sort of longstop in the Bill that would restrict people's ability to go back and make claims after a certain period of time. What is the argument for that from your perspective, and how would you convince the consumer groups that this is not going to be something of a conspiracy against legitimate complaints?

Mr Gay: Yes; I understand the concern around that. We are very keen that there should be a longstop available for financial advisers. We think it is in the consumer interest that there should be so, because we want to see a vibrant and well-capitalised advisory community. At the moment it is very difficult for them to attract investment if they cannot quantify the risk to any potential investor. At the moment we have a sector that is populated to a large extent by small firms that are unable to attract that capital because they have an unlimited risk into the future.

Q494 Mr Laws: What type of time cut-off are you suggesting?

Mr Gay: I think 15 years would be appropriate.

Q495 Mr Laws: What type of complaints are you getting at the moment to your members that typically go beyond 15 years?

Mr Gay: The complaints tend to be for longer-term products, as you might expect.

Q496 Mr Laws: But are they more mortgages or pensions?

Mr Gay: Primarily they tend to be pensions, but of the number of complaints that are received by the Financial Ombudsman Service, the proportion of them that come from independent financial advisers is remarkably low. It is less than 2%. Of course, with consumer redress schemes now they are already subject to legal requirements and therefore have that longstop in place. It does not seem to us that it is too much of an extension.

Q497 Mr Laws: Do you have any idea of the number of complaints that this would impact? Are we talking about quite a trivial number of complaints that frankly get nowhere anyway, or is there really much evidence of a significant number that go anyway?

Mr Gay: I don't have the numbers but I could revert to you with details.

Q498 Mr Laws: I can ask through the Chairman. That would be very useful, because it would be helpful to understand a bit more about the numbers, and also what types of complaint and whether this is really a side issue or not.

Mr Gay: We are not talking about very large amounts.

Association of British Credit Unions Limited (ABCUL); Association of Financial Mutuals; Building Societies Association; Association of Independent Financial Advisers; Institute of Financial Planning; International Regulatory Strategy Group; Financial Servi

Mr Cann: Looking at that, we would be supportive of a longstop. The retail advisory sector is going through a huge change of cost and having to improve and demonstrate having met new standards and adhering to that. A lot of the problems historically through all of the various mis-selling or issues that have risen to the top have been around short-term selling as against the ability to be able to provide ongoing service and advice. You get to a stage where after 15 years very few things would still exist that would be any systemic issues that have not already been picked up or developed. It would only be the odd type of occasion where people are unhappy, having not looked at something for some while, and it being brought to the attention of any new adviser. There needs to be some recognition built in of the changes that small, medium and some large firms are changing to adhere to the new standards and, having proved that they are adhering to those new standards, that that can then be improved on an ongoing basis. That term might be reduced then over a period against maintaining the status quo or improving it still further because that does start to give confidence to the sector. There is some proof and evidence that firms have made changes to what might have historically happened.

Q499 Mr Laws: Thank you. Any information you have on that we would very much appreciate. I don't know whether any of you heard the last evidence session. We had some discussion about the product intervention powers in the Bill. Many people might feel that these are quite sensible powers that will prevent some fairly dangerous products getting out there in the future, or perhaps being sold to people whose level of financial literacy is quite low and who don't really understand entirely the risk that they are taking. Are any of you sympathetic to that or is your general view that this is going to stifle innovation?

Mr Cann: Product innovation worries me on two levels. On the one hand it sounds very attractive. On the other hand we have seen people looking to short-circuit opportunities to create sales opportunities for businesses. It has to be looked at very carefully. If you look at the environment where we are, as a result of the Retail Distribution Review there is going to be far less access for people to be able to take advice. Therefore, they are currently going to be far more reliant upon the internet and friend recommendations, and not being able to either afford or engage an adviser to be able to take sensible decisions. Therefore, the risk of innovation and other ways of presenting products will stack up some problems for the future.

Mr Lyonette: We are broadly very happy with it. Credit unions tend to offer simple, straightforward products. We don't employ departments to add complex and difficult to understand features. Provided it works well in practice for the industry as a whole, we are broadly happy with that.

Q500 Mr Laws: Are there any products that spring to mind that would not have gone out into the marketplace or have been significantly amended if this power had been there for the last decade?

Mr Shaw: It is quite difficult, of course, because the benefit of hindsight is great in terms of identifying products that have gone wrong. I full well remember 20-odd years ago the regulators endorsing the concept of mortgage endowments, only at a later point to understand that they were not by any means suitable for all consumers. That is part of the challenge of getting product intervention right. You need people within the regulators who

have the relevant skills and experience to be able to understand what products are designed to do, but also to understand some of the problems that can emerge at a point in the future where circumstances unknown today might emerge.

Q501 Mr Laws: With something like the shared appreciation mortgages, because the point you make is obviously a very good one, do you think, if this type of product intervention had existed when they were originated, that would have led to any different approach or failure to validate or approve them?

Mr Shaw: I would certainly like to think that an earlier engagement from the regulators in the design of products which have features which are uncommon or unlikely to be understood fully by consumers would have prevented those products either from being developed or else would have put some kind of structures around the way that they were marketed and distributed.

Q502 Mr Laws: But do you think in that particular case, which is a good example, because it has gone wrong for lots of consumers, but arguably you could say it might have gone right for them, and some of them might have understood the risk they were taking very well, it would have led to much of a difference with that product?

Mr Palmer: On the specific point, Mr Laws, it is possible that this is a good example of something that could have application for some consumers but may be unsuitable for many, but that does not lead you to ban the entire product. It comes back to the point that was touched on in the earlier panel session. You have products and the selling, and is it the product itself or is it how and to whom it was sold?

Q503 Mr Laws: Could there have been any useful intervention in that particular product, as a general example, at the beginning that would have allowed the people that were qualified to take a punt on it to do so while protecting others?

Mr Palmer: Possibly.

Q504 Mr Laws: How?

Mr Palmer: Maybe if you have product intervention rather than banning you have some way of being clear which products are not suitable for less sophisticated or vulnerable consumers in the most general sense. Otherwise you just rely entirely on the selling process to make the decision.

Q505 Mr Laws: It's a tough call, though, to decide that you are financially literate and the person next door to you isn't.

Mr Palmer: Exactly.

Q506 Mr Laws: You might not be very charmed when you speak to the company and are told that you are graded as a financial moron, basically.

Mr Palmer: But it might be worse to ban the product entirely.

Mr Cann: A lot of products are designed with today's market in mind without any real thought for the next few years. There is talk today about 30-year fixed mortgages. That sounds great at today's interest rates, but who knows what is going to happen over the next 30 years for that to be a decision that people might or might not want to take either from the person who has got to supply that, maybe the bank, or the consumer in terms of what might happen to interest rates. Endowment mortgages were the same at the time. In terms of the economic conditions they were an excellent product, but nobody reviewed that over the first five or 10 years as the economic conditions changed completely and product innovation started to take those products in different areas for the sales function to continue far better.

There can be more co-ordination at the start potentially of a product, but there has to be something in to review some of these that are designed for a longer term on changing market conditions. We need to come from a situation of selling rather than provision of long-term advice, and as that is changing we need to change with it.

Mr Gay: I do think there is a more general point behind this that should be made as well. It is not entirely clear how these powers in reality would be exercised. If a product is going to be banned on a temporary basis, it would appear that it could be done without there being a cost-benefit analysis or without there being thorough consultation. We think there needs to be greater clarity about how it would work in practice. We have talked here about the difficulty in making some of these decisions. We would need to be confident that the FCA would have the right skills and experience to be able to do that.

Q507 Baroness Wheatcroft: We have been talking about fairly nitty-gritty issues. I would like, if I may, to take you back to something rather larger, the Financial Policy Committee, which is at the centre of this new legislation. Do you feel that the FPC has the right objectives as currently constructed, or would you like to see them taking them rather wider to take in more of an objective on the competition front? Perhaps we could start with you, Mr Shaw.

Mr Shaw: We would like to see the FPC have much better regard to competitive forces within the financial services industry. We would like to see it take account of diversity in particular, both in terms of the size of organisations and the business models which they explore. We believe that the FPC will be ideally placed to be able to measure diversity over time and that that in effect would both act as a signal to the regulators and also help support the Government's commitment to diversity.

Q508 Baroness Wheatcroft: Thank you. Mr Lyonette?

Mr Lyonette: We have not made any particular comments on the FPC at all.

Q509 Baroness Wheatcroft: So as far as you are concerned financial stability is available?

Mr Lyonette: Yes; it really fits into the general tenor of our remarks. So long as it does not have a detrimental impact and we don't see fewer and fewer firms paid more and more for their regulation, which is what we have seen for 10 years. We have said that proportionality, cost and diversity are key.

Q510 Baroness Wheatcroft: I have that. Mr Palmer?

Mr Palmer: We have said that we support the formulation in the Bill which qualifies the financial stability remit by reference to UK economic growth and the contribution of the financial sector. I would agree with what Martin said about diversity as well.

Q511 Baroness Wheatcroft: There was also a suggestion that perhaps one of its objectives should be to ensure a ready supply of credit. It has not always been the case, and particularly for small firms that is not the case. It is not necessarily from building societies, but do you think that there should be an obligation on the FPC to ensure that there is a ready supply of credit?

Mr Palmer: We are content with the present formulation. We have not advocated the sort of credit supply objective.

Mr Cann: I say much the same. My broader concern is more about consumer engagement generally rather than competition and other restrictions.

Mr Gay: Likewise, I would endorse what has been said there. The broader requirement to ensure that consumers are represented in the discussion is very important.

Q512 Baroness Wheatcroft: Your concerns really lay elsewhere in this Bill?

Mr Gay: Yes.

Mr Shaw: In terms of financial stability, for a long time the received wisdom was that financial stability was best achieved by encouraging the growth of "big is beautiful" organisations and "banks are best". The last few years have proven that that is not the case and financial stability is more likely to be achieved where there is a diverse marketplace for financial services.

Q513 Baroness Wheatcroft: Of course, the Government are really embracing the concept of mutuality now with new enthusiasm.

Mr Shaw: Absolutely; and that in itself is very much part of the way in which a diverse marketplace will help to ensure that the marketplace is stable but also that consumers have access to good products no matter what their financial circumstances.

Q514 Lord Skidelsky: I would just take up that last point that in your view financial stability can be achieved by increased or greater diversity. There has not been financial stability for the last three years, ever since 2007-08. Do you think anything in this Bill would have made it more likely that financial stability would have been achieved over that period?

Mr Shaw: Yes, because the formulation of the new regulators should ensure that there is much better early warning of adverse trends; that organisations are more accountable for the way in which they operate and therefore that the regulators have both the knowledge and the power to intervene earlier if they see those adverse trends emerging.

Q515 Lord Skidelsky: But that has nothing to do with diversity or competition, has it?

Mr Shaw: It does in as far as if you take the premise that the shareholder model itself inflicts greater risk and less likelihood that organisations will wholly focus on the best interests of their consumers, then at a micro level it forces you to consider that stability is supported by a diverse range of product providers.

Q516 Lord Skidelsky: So you would have no interest in laying on the duty of the regulator to ensure an adequate supply of credit or take into account the interest of economic growth, for example?

Mr Shaw: Within individual regulatory bodies you have to focus them on the issues which they can reasonably take responsibility for. With the system itself the Bank of England and the FPC are clearly looking at those macro issues in a much greater level of detail than you would necessarily want the day-to-day supervisory teams to be focused on.

Q517 Lord Skidelsky: But at your level you think that is a level above that which is of concern to your organisation?

Mr Shaw: Yes.

Q518 Lord Skidelsky: And therefore you have nothing really to say on those macro issues?

Mr Cann: The proof will be in the outcome. If you look at the troubles when they occurred, part of the reason was there was not enough challenge of those large institutions and what they were doing strategically. There was a belief that what they were doing was okay. Under this new regulation the proof will be in how that new organisation challenges those regimes in the future. Having set that aside, the reality will be what happens in practice.

Q519 Chairman: I have one final question. The Government are emphasising the move towards more judgment-led regulation rather than box-ticking. Will this affect you and your organisations? Do you favour it or do you think it will make life more unpredictable for you than having clearer rules and less judgment?

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Mr Palmer: Perhaps I can go first on that one. There will still be in the new regulatory regime a very large number of rules, many of them deriving from European legislation. In Europe the culture tends to be more rules based. Within that framework we would support a judgment-driven rather than a box-ticking approach. We are aware that won't always be comfortable for all firms but we think it is the right way to go.

Q520 Chairman: Does anyone else wish to comment?

Mr Gay: I would agree with that. In broad terms movement towards a judgment-based approach would be welcome although, again, there would need to be appropriate skills and experience within the FCA to make that work effectively otherwise we could get some unintended consequences. There would also need to be an appropriate mechanism of appeal that is suitable for small firms and cost effective for them.

Mr Lyonette: That would broadly support our points. We have only been in the regulated sector for 10 years. We found the move in the FSA towards principles-based regulation and away from rules-based was quite challenging for small firms. Even to start from a principle of treating customers fairly, while intrinsically it is part of our ethos, in a firm with a few employees and work out what it means is quite burdensome: more so than treating customers fairly. For small-scale firms rules are quite helpful. Bearing in mind what Jeremy said there about there still being the existence of rule books and we would hope within it our own rule book survives, then judgment per se does not appear to be a problem. It is all about the resources firms will have to operate in that way, as much as the issue of complying itself. It is more about the resources needed to show that you are complying.

Mr Shaw: Jeremy made a very good point about the impact of European regulators. Of course one of the things that we will all have to come to terms with is the fact that most rules will be developed in Europe in the future rather than within the regulators here. That inevitably means that you don't want regulators repeating the rules that are made elsewhere, and therefore judgment-based regulation is a very natural place to get to.

Q521 Chairman: Do you think it will be compatible with Europe? Mr Palmer was saying that was a much more rule-based and box-ticking approach. Will it be possible to combine a judgment basis with rules emanating from Europe?

Mr Shaw: A lot of that, of course, is based on how well the judgments are maintained and how well they are consistent with the rules which we would be expecting both the regulators and regulated firms to understand and to work with. Given that the rule books will be at least as dense as they are now from a European perspective, then those judgments must be seen in the light of how those rules emerge over time.

Chairman: Thank you all very much for your evidence today. It has been very helpful and will be valuable to the Committee as it prepares its report. I am very grateful to you.

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Examination of Witnesses

Witnesses: **André Villeneuve**, Chairman, International Regulatory Strategy Group (City of London), examined.

Q522 Chairman: Mr Villeneuve, welcome. Thank you very much indeed for agreeing to appear before the Joint Committee. We are grateful to you and for your submission. Could you begin by giving us your views on the consistency of regulation across the EU and internationally, whether you have any concerns about Basel III and how it is implemented within and outside the EU?

André Villeneuve: "Consistency" is not a word I would use at the moment. We are moving towards a lot of inconsistency. Would you mind if I just explained for one minute the constituency I represent because it is quite important you understand this?

Chairman: Yes, of course.

André Villeneuve: My body, which is the International Regulatory Strategy Group, is not a specific trade association. It looks across the whole spectrum of things that are happening in financial services, particularly in the wholesale area, and tries to draw out macro issues of concern right across the sector from banks to insurance companies to fund managers, etcetera. We also have legal and accounting firms on it and we work very closely with the Treasury. We have the FSA on it. If you want technical input on Basel III, I am not the person to give it to you. I will try in my comments just to focus on the macro issues that come out in the group. We undertook quite a detailed study ahead of this meeting to make sure that we properly captured the views of the group, although there is no such word as a "unanimous" view when you are talking about the City of London.

Coming back to the question you asked, it is quite clear that different countries are on different railroad lines. You have the US with Dodd-Frank, which is absolutely focused on the US, with the added twist that the US is very generous about exporting its rules to the rest of the world where it can. You have the EU which is focused on a single rule book, and you have us who have signed up to a single rule book but, as we heard from the previous panels and no doubt in lots of previous sessions, we have introduced an element of judgment in how the supervision is done. There is an inherent potential contradiction between having a single rule book and exercising a lot of judgment at a national level as to how you apply it. That contradiction is quite apparent to the EU authorities that we talk to, who are quite concerned about it.

Q523 Chairman: So the EU itself is concerned?

André Villeneuve: Yes.

Q524 Mr Brown: One of the rules in this place is that you should never ask a question to which you do not know the answer. I genuinely do not know the answer to this question, so I hope that you can help us. We understand that the European Union regime will set out a

minimum set of regulatory requirements to which everybody will be required to adhere within the European Union. Is there also a maximum level? To give an example, if the European regime requires everyone to hold reserves of, say, 7% of their total volume and the United Kingdom regime decides to make that 10%, is there a requirement that they go and ask permission from the European Union authorities or is that something they would be able to do for themselves?

André Villeneuve: There is a cultural difference between the two. The European authorities are looking to have a single rule book which applies everywhere. For instance, on the Basel III issue which you raise regarding capital requirements, they would basically like a maximum.

Q525 Mr Brown: As well as a minimum?

André Villeneuve: Yes.

Q526 Mr Brown: So it would be the same for each country?

André Villeneuve: Yes; so everybody has the same rule. If you operate in a single market, in theory that is desirable. If you are the biggest wholesale centre in financial services in the single market one might think that you would want to have a single rule book because that would facilitate your ability to operate.

The UK has asked, because of the special nature of financial services in this country, its size in proportion to GDP and all the other issues as you know, to be able to make its own judgment on what the maximum should be and increase it. They have effectively allowed in their discussions for wiggle room in order to introduce Vickers and other issues surrounding that. This is causing a lot of tension. The tension is exacerbated by the fact that the UK seems to be leading the charge on being the first with everything. They will take a rule and then they will apply super-equivalence. This causes problems not only with the EU, who are trying to create a single rule book with the same rules for everybody, but it potentially causes problems internationally. Bear in mind that most of the constituency on my committee are international banks, fund managers and all the rest of it. They are very concerned about international consistency and they don’t like it that Dodd-Frank is going in one direction and the EU is going in another direction on certain issues. Certainly having the UK on top of that going in its own direction complicates it.

Q527 Mr Brown: I am still not quite clear what the actual answer to the question is, though. Is it possible for the European Union to say, “Our minimum requirement is also our maximum requirement; you may not move below it”—that, of course, I understand—“but you may not move above it either”?

André Villeneuve: Just a minute. You have Basel III, where you can effectively put on whatever criteria you want over and above the minimum. Then you have CRD IV, which is the European implementation of Basel III. CRD IV is single rule book. Basel III gives you more flexibility. The answer to your question is actually not clear at the moment, which is probably why you were asking it. I am not able to answer this question.

Q528 Mr Brown: At least you understand why I don't know the answer.

André Villeneuve: But I do not think anybody can answer it because this remains to be tested. In theory CRD IV is a qualified majority voting issue. If you have qualified majority voting for maximum capital as part of CRD IV, then the UK has an issue. Is it going to apply Basel III; is it going to apply CRD IV; how is it going to deal with the QMV problem?

Q529 Mr Brown: We would be obliged to, wouldn't we?

André Villeneuve: It remains to be seen. Yes, I think we would be. I am sorry that I cannot be clearer than that, but that is where we are at the moment.

Q530 Chairman: It seems obvious that you have a minimum to prevent people getting unfair advantage by having less than the minimum level of capital which is thought to be required for stability, but it is not obvious to me why countries should not, as they have been up to now, be entitled to impose their own minimum above the minimum set by Basel III or by the European Union. What is the advantage to anybody preventing any individual country making its banks even safer still?

André Villeneuve: I have two answers to that. First of all, if you just take a single thing like capital requirement then maybe you can say, "Well, given the special position of the UK we should take into account the fact that they need to do this". But of course it is not just capital requirement where the UK is taking the lead; it is on liquidity ratios and all sorts of other issues where, if you aggregate them all, it would take us quite far away from the principle of a single rule book

The second part is, of course, if you are an international bank and you have to meet international requirements in lots of different countries, having different standards in every country in which you operate complicates the issue.

Q531 Chairman: Yes, I can see it might be a disadvantage to British industry if Britain imposed more onerous obligations, but I cannot see why anyone else in Europe should be worried about that.

André Villeneuve: As I say, international banks are just worried about different standards. Your point about British industry is quite interesting. I saw it manifested last week when I was in the US. What we are seeing now in the US are French banks—and I just cite them because it is a clear example—reducing their dollar assets and therefore not participating in the sort of credit deals that French banks would normally have participated in. I mean plain vanilla stuff like bridging loans for big mergers. They are just pulling out. The implication of them just pulling out is that it has to be worked through. If individual countries are going to see their banks looking at their domestic agenda much more than any international agenda, this has implications also for large firms in the UK and their ability to raise credit. We have not worked through the implications of that yet but certainly this is a trend which is beginning to develop. I don't think it will only be French banks that will be doing this as a result of the Euro zone crisis.

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Q532 Lord Skidelsky: If that trend continues will it lead to a less international banking system and a banking system which pays more attention to their domestic requirements than expanding their international business?

André Villeneuve: In theory one would say that it might well do that. It does then raise the issue of what benefit the financial wholesale market is for the UK. We are about to do some work on that, just so that you know, because we need to nail down now what the benefits are of having a wholesale financial centre in terms of credit raising for UK companies. We are not sure what the answer is. We think it is positive, but we need to demonstrate that.

Q533 Lord Newby: Coming on to the way in which we interact with the European supervisory bodies, we have a twin peaks system and they have a triple peaks system. How much of a problem do you think that difference in structure is?

André Villeneuve: There are lots of twin peaks in Europe. One of the previous speakers was talking about that. I am less concerned about having an exactly matching regulatory structure than I am about how we interact with it. First of all, an absolutely critical element of this is that we are well represented on three European bodies even if they don't exactly match our whole layout; that we have worked out carefully between the three bodies that we have an integrated approach to each issue that comes up at a European supervisory body. The mechanisms need to be in place to make sure that that happens.

Secondly, we need competent and authoritative people who contribute to these debates. Thirdly, a point raised earlier by the Chairman is that if you are too keen to go down the super-equivalents route on supervision you then tend to make your negotiating position more difficult with the other members of the European supervisory authorities, who on the whole would not want this to happen.

Q534 Lord Newby: Do you think there is more scope for putting in the Bill provisions to ensure that we do exercise our influence as effectively as possible, or do you think that is just a basic organisational thing that will drop out?

André Villeneuve: I would welcome it. If you hardwire something fairly solid into the Bill it really does reinforce the need to have an integrated UK approach. The reason my group was created, by the way, was because the industry did not have a sufficiently integrated approach on key issues.

Q535 Lord Newby: Given that you have the bodies here, do you think it would be sensible to have a European secretariat in the Bank of England or located in one of the three bodies that drew together both the expertise and the approach that we were adopting to make sure there was a controlling mind and that things did not slip between the gaps?

André Villeneuve: That would be a very interesting contribution to the issue. One of the things exacerbating the UK's position at the moment is the huge turnover at the FSA as a result of these moves. I am not saying that the moves are wrong, but it is just a practical fact that we have a huge turnover. We are losing people who have got placed on the European supervisory authorities. We have a further problem as a country that we are under-represented on the European supervisory authority secretariats. That is not for any

nefarious reason on the part of their secretariats but just because we did not have the people in place. It seems to me and my members that we do not have an adequate plan to make sure that the UK is well represented at the right levels of all these groups.

Q536 Lord Newby: Isn't the problem there, though, that the financial services firms themselves are very resistant to seeing any of their staff who are any good going off either to the FSA or to the European supervisory bodies? There is a brake almost on getting the best people. A number of our witnesses have discussed this. If that is the case, do you think that there might be scope for some kind of almost mandatory system under which significant firms are expected to second good people, both domestically and internationally?

André Villeneuve: I would imagine that at the senior levels of these firms they can certainly see the logic of what you are suggesting. Whether it needs to be mandated or not, I don't know. I am not a banker but if I were a Chairman or a CEO of a British bank and I was concerned about UK engagement with the European supervisory authorities, I would also expect myself to be able to contribute something to resolving this. A really serious discussion at very high level between the appropriate Minister and the CEOs or Chairmen of the banks would probably produce the right result. You see a lot of this transfer in the US and it is encouraged. People who come out of public service back into the private sector often benefit from a career perspective.

Lord Skidelsky: It is called "the revolving door" sometimes.

Q537 Lord Newby: I have talked about the EU bodies, and there are issues about how we exercise our influence there. Do you think there are any problems or challenges about exercising influence on other bodies; on the Basel procedure or on G20?

André Villeneuve: As far as I know, we are as influential as we should be at the Basel procedure. There are issues internationally, particularly with the US, but that is not necessarily of our making. The US is very focused on their domestic agendas. There are some regulatory authorities in the US who are trying hard to get some sort of international co-ordination on some of these issues, but they have their own political battles to fight back home which are not helping them, frankly. It is an issue.

Our position vis-à-vis the US would be better if we were seen to be more part of the EU than just some offshore place that sits uncomfortably between the US and the EU. That is a personal view.

Q538 Lord Maples: Following up on this, I would like your views on where this input should come from within the British Government. It is being suggested that the Bank of England needs to beef up its capacity to lobby and make representations within Europe. On the other hand, the Treasury has for years had representatives in Brussels well plugged in. They have had a huge amount of input into resolutions, directives, regulations and one thing and another. Where do you think this is best to come from? Should the Treasury retain overall responsibility for it—the Financial Conduct Authority and people will have issues that they may well want to raise direct or through a forum—or should we in future see this coming through the Bank of England? As you said, they are well plugged into the whole Basel

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procedures but I am not sure they are well plugged into the Commission's activities on regulation, whereas the Treasury is perhaps the other way round.

André Villeneuve: At a technical level the regulators need to speak to each other. At a macro level, which is what I think you are talking about if I may use that term loosely, the Treasury has to play a key role. I would be more attuned to seeing a key Treasury role because they tend to listen to the industry more than the Bank of England does. The Bank of England is concerned about stability. It is perfectly reasonable that a regulator should be concerned about stability given everything that is happened, but they are not particularly concerned about balancing stability and facilitating growth. They are not like the Fed. They do not have that, as far as I know, as part of their remit. Therefore they are not necessarily sympathetic to listening to the consequences of the judgments they are making on European rules, for instance.

The Treasury, in our experience, is at least more open although the processes could be substantially improved. Probably the major macro concern about this new set-up is how we get a balance between delivering financial services stability and facilitating growth, particularly as we have moved away from looking at the economic impact of what is being proposed to making judgments. The danger with judgments is that first of all they are very heavily dependent on who is making the judgments and the quality of the people who are making those judgments. Bear in mind what I said earlier about staff turnover at the FSA. Secondly, it is less transparent. Rule making tends to be more transparent, so we tend to have more input into the rule-making bodies in Brussels than we do in how the rules are interpreted and applied here.

That was a very long-winded answer, but we would be more comfortable working with the Treasury and the Treasury taking a lead on this; and the Treasury having to balance not just regulation but also economic growth, credit flow and all that sort of thing than just relying on the Bank of England, particularly in its current philosophical mode.

Q539 Lord Skidelsky: On the financial stability requirement a couple of banks, Barclays and HSBC, have suggested that the objective should be to maintain a sustainable supply of credit and have regard to economic growth, and that that should be the FPC's mandate rather than financial stability. Your remarks seem to support that.

André Villeneuve: Both those banks are members of my Committee and they would be part of the critical mass. The answer is yes, and I will add one thing to that. It is an illusion to think that it is only medium and small-sized companies who are affected by credit flow. That may be the case now. Large companies have much better access to capital markets than they did in the past, but if you go and talk to some of the continental European CEOs they are very concerned at the trickle effect of limited credit at medium and small-sized companies trickling up to have an impact on large companies as well.

By the way, the story I was telling you about a French bank applied to a very large company, a Dow 30 company. No French bank credit and nothing to do with their balance sheet.

Q540 Lord Skidelsky: Do you think the Treasury is more committed to economic growth than the Bank of England?

André Villeneuve: I would like to think so.

Lord Maples: I hope so.

Q541 Baroness Wheatcroft: I would like to ask you about the twin peaks structure, Mr Villeneuve. You said that in the context of the international negotiations it did not worry you terribly much, but are you concerned about those organisations that are going to be regulated by two separate regulators: the FCA and the PRA?

André Villeneuve: Yes. If I used the words "did not worry me too much", that does not entirely reflect what I should say. I don't think there is much we can do. We've got what we've got so we have to work with it. The answer to your question is yes. There have been a lot of suggestions as to having a co-ordination committee. I do not know how that is coming along. I sit on the board of an insurance company, by the way, in this country. We have heard very clearly from the FCA that they were going to do all their interviewing and investigations completely separately from the PRA, which means effectively that you have two lots of people coming in. It may not always be for the same things but often there is an overlap in these products.

Q542 Baroness Wheatcroft: That is time-consuming and expensive.

André Villeneuve: Exactly, and probably not very efficient as a regulatory tool.

Q543 Baroness Wheatcroft: It is interesting that they are telling you that at this stage because there is supposed to be a memorandum of understanding being written.

André Villeneuve: I think they are moving towards trying to get a more rational view, but this was expressed to us very recently.

Q544 Baroness Wheatcroft: If you were to be offering thoughts as to how this dual structure should work, could you be more specific? You would want single interviewing, for instance?

André Villeneuve: You would want single interviewing. It is already clear that PRA takes precedence over FCA if it concerns financial stability, although again how do you interpret what affects financial stability?

Q545 Baroness Wheatcroft: A single rule book?

André Villeneuve: Yes. I have run an electronic brokerage company in a country where we had two completely different regulators at war with each other, which is the US. It is very uncomfortable for the people in the middle. I am sure that that won't happen because you have the Bank of England over and above that, and they would bang heads together, but you

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can understand why some people might be sensitive if they have lived through having two different regulators trying to do the same thing.

Q546 Baroness Wheatcroft: You can. Do you think a single rule book may be the answer?

André Villeneuve: A single rule book helps. Assuming that we are not going to change the structure now, the real answer has to be to go along the lines you were proposing which is to make sure they work very closely together; that one person is in charge of individual firms; and then that person will make the call. It reminds me that the City of London at the moment is a complete bombsite in terms of navigating through it. The reason is that there are 27 different utility companies who have 27 opportunities to drill up the roads when they more or less feel like it. The analogy with what we are proposing—although it is not 27; it is two or arguably three—is a good one.

Q547 Baroness Wheatcroft: With the potential for things to fall down the holes they are all digging?

André Villeneuve: Yes. There is also the question of falling through the gaps. The potential for things falling between the gaps was exactly what happened in the US, as we heard, between the CFTC and the SEC. I hope that enough lessons have been learnt from that that this is not likely to happen in quite that form under the structure that is being proposed now because that has been quite well studied. But the fact is that, if we have two people pulling in different directions, that is not good so you need very tight co-ordination and you need one person to be clearly in charge.

Q548 Baroness Wheatcroft: Is there evidence of who is being consulted as this crucial MoU is being drafted?

André Villeneuve: Quite a lot of individual financial services companies and trade association have been consulted. That is my sense.

Q549 Mr Brown: I want to ask about the accountability and the contestability of the arrangements that we have under consideration and what your view is on that. As I understand it, we are putting an enormous amount of power and responsibility into the hands of the Bank of the England and I suppose ultimately the Governor. Yet the structure for accountability to Parliament is still as it is now, through Ministers. There is the Chancellor of the Exchequer and Treasury Minister at Question Time in the normal way and to the Treasury Select Committee. If there are any new responsibilities and accountabilities under these arrangements they are lodged in the Court of the Bank of England. Do you think that is the correct structure? If people wish to contest these arrangements there is not really a forum for debating it or sounding warning notes. Should there be such a thing and should it be located in Parliament or somewhere else?

André Villeneuve: I think you are right to be concerned about it. I was roundly condemned yesterday for calling it "the Court"; apparently it is "Court". I stand corrected. I am sorry

Association of British Credit Unions Limited (ABCUL); Association of Financial Mutuals; Building Societies Association; Association of Independent Financial Advisers; Institute of Financial Planning; International Regulatory Strategy Group; Financial Servi
that Lord McFall is not here, because I appeared in front of his former Committee [the Treasury Select Committee] a few months ago, and even then it was quite clear that the Bank of England Governor was going to be a uniquely powerful individual. The issue came up, which you have no doubt heard from others, that if you have a governor of a central bank, independent under Maastricht rules, who is also responsible for supervision, are you quite sure that you can hold him ultimately accountable for failure in supervision without damaging his role as an independent central banker? This came up about three years ago during a financial crisis in the Netherlands. They had a similar issue where there was a supervisory problem and the Governor of the Dutch Central Bank refused to be fired, on the grounds that he was an independent central banker.

If you have that structure, then the governance and accountability thing becomes doubly important and you need to make sure that it is structured in a way that if there is a failure in supervision and you want ultimately to get rid of the Governor of the Bank of England—I am sure no such situation would happen—you could do it without damaging sterling, the UK's standing with an independent central bank, and all the rest of it. The way we have structured it, we have given unique powers, so it is very important not only that his actions have proper oversight but also that you can separate his role as independent central banker looking after the interests of sterling and everything else from his role as head of supervision.

Q550 Mr Brown: I understand the point you are making. We have not done that in the proposals that we currently have under consideration. I don't want to put words into your mouth, but I take from what you are saying that we should at least consider the point.

André Villeneuve: I think you need to consider what would happen if a failure of supervision—unlikely, but you need to consider it—would ultimately lead to you wanting to get rid of the Governor of the Bank of England, and how you would be able to separate his two roles.

Q551 Mr Brown: I was thinking of a situation a long way back from that, where there might be a tension between the Chancellor and the Governor. If they had, for perfectly valid reasons, different emphases on a matter of public policy, it is not clear to me how that gets resolved. On a different point, if the public representatives at large want to sound a warning note, where is the forum for doing that?

André Villeneuve: The answer is, I don't know. It needs to be clarified much more. This is a very important point that you raise. The objectives of the Treasury, particularly if there is a major downturn in the economy here, could be very different from the objectives of somebody who is concerned primarily with financial stability.

Q552 Mr Brown: It is not clear to me how that gets resolved.

André Villeneuve: No, it is not clear to me either. You are very wise to raise it.

Q553 Lord Maples: We are starting to get into these areas of governance. There is one area which particularly interests people which is the Court of the Bank of England, which has been largely decorative in our lifetime and probably longer than that. It seems to me it is going to need to be strengthened into more like a board of directors, perhaps even with a chairman who is not the Governor. I know it has a senior governor at the moment but somebody who plays that role of senior non-executive director. I would like your thoughts on that, given that under these new arrangements the Governor is such a powerful figure.

Secondly, this problem that the Governor might have if there is a failure in regulation feeding over into doubts about monetary policy, would it be better if the Governor were not the Chairman of the Prudential Regulatory Authority, as he is designated to be. He could be Chair of the FPC and the Monetary Policy Committee but let his deputies or maybe even independent members of the Court chair the other two Committees?

André Villeneuve: On the latter point, I would say yes, because it would distance himself a bit and therefore you could preserve the thing, but ultimately he is responsible. We cannot get away from that from this structure. To your earlier question, it would be good if he were not the Chairman, but if he is the Chairman there has to be a very strong lead director.

Q554 Lord Maples: Chairman of the Court?

André Villeneuve: Of the Court, yes.

Q555 Lord Maples: Or of the Bank?

André Villeneuve: Sorry, yes. A very strong lead director with a very strong remit, to be able to overrule, basically if there is an issue. The third element is the degree of participation of non-executives in all this. That is very important. I was talking earlier about the voice of industry, and by "industry" I don't just mean financial services but industry in general. The availability of credit needs to have a very strong voice at that governance level. It needs to be done in a way that they cannot be trampled over by an overly-opinionated central bank governor. I am not of course referring to the current one, but were ever such a thing to happen.

Lord Maples: We have known them in the past.

Q556 Chairman: Thank you very much indeed. You mentioned that you were doing a report on the wholesale market in London.

André Villeneuve: Yes.

Chairman: That itself might be of interest to the Committee, but it also raises a question which perhaps you could answer as a last one. Concern has been expressed to us that there is regulatory creep moving from the protection of consumers to involvement in the wholesale markets where the participants are probably not in need of protection other than through the courts. Is that a concern of yours? Do you see it? Do you think the Bill will aggravate it or alleviate this regulatory creep?

André Villeneuve: I don't think it will affect it one way or the other. There is creep. We spend a lot of time with the European supervisory authorities when they are designing rules, trying to explain the difference between wholesale markets and consumer markets. A lot of time MiFID is brought up and all sorts of issues regarding that.

On your first point, we would be delighted to share the work. This work, by the way, is designed to be helpful to the Treasury. We have just decided this week so we have not had a proper discussion with the Treasury yet. It is designed to help the Treasury define what it is they want as a wholesale market in the UK. There is a lot of confusion amongst our members. They hear on the one hand certain regulators saying, "We want the financial services industry cut down to size; 4% of GDP" and all the rest of it. On the other hand, "We are open for business; please come in, please open branches".

We are trying to do this debate in a helpful way, to say, "Look, the sort of wholesale industry you really need here probably looks like this." If that were broadly accepted we would then seek to work with the Treasury to find a way of creating a framework in which it can thrive. That is what we are intending to do.

Q557 Chairman: That sounds very interesting. If it is produced in the timeframe of the operation of this Committee we would very much like to see it.

André Villeneuve: I am happy to share it with you.

Chairman: Thank you very much indeed for your evidence today. It has been very useful.

Association of British Insurers (ABI) – written evidence

1. The ABI is the voice of insurance, representing the general insurance, investment and long-term savings industry. It was formed in 1985 to represent the whole of the industry and today has over 300 members, accounting for some 90% of premiums in the UK. The ABI's role is to:

    - Be the voice of the UK insurance industry, leading debate and speaking up for insurers.
    - Represent the UK insurance industry to government, regulators and policy makers in the UK, EU and internationally, driving effective public policy and regulation.
    - Advocate high standards of customer service within the industry and provide useful information to the public about insurance.
    - Promote the benefits of insurance to the government, regulators, policy makers and the public.

2. The ABI welcomes the opportunity to respond to the Joint Committee's call for evidence.

3. Any queries or requests for additional information should be sent to the Parliamentary Affairs Manager.

Overall Comments

4. The ABI welcomes many of the Government's proposals in the draft Financial Services Bill but we do have some substantial concerns about how the system will operate.

    - Close **co-ordination** between the PRA and FCA will be necessary to ensure that the new regulatory structure operates in an efficient and effective manner. It is vital that the PRA and FCA do not duplicate each others' activities. It is particularly important for dual regulated firms that there is effective co-ordination in order to ensure a consistent and proportionate approach to regulation.
    - Overall **accountability** arrangements need to be better defined to make clear who is ultimately responsible for decision-making within the system and to ensure clarity and transparency of responsibility between and within the different institutions within the system.
    - The proposed **timetable** is very ambitious. The financial sector is at the same time facing other substantial regulatory developments, for example RDR and Solvency II. Both firms and the regulatory authorities are stretched responding to these developments and have limited capacity to absorb further changes. The current timetable does not appear to make provision for any transitional arrangements – firms will require time to make changes to documentation and review and implement changes arising from the new rulebooks.

- The **European Supervisory Authorities** (ESAs) are becoming the main source of detailed regulatory requirements for UK financial services firms for both prudential and conduct issues. In order to retain their influence the UK authorities will have to do more to guide the process of setting EU rules. 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 skill. This needs to be taken into account in selecting UK representatives on the ESAs and more generally in the recruitment of staff to the UK regulatory bodies and the setting of work priorities and allocation of resources.

Bank of England and the Financial Policy Committee

5. We agree with the decision of the Government to set up a Financial Policy Committee (FPC) to oversee the Bank of England's financial stability remit and are content with most of the proposals in the Bill concerning the FPC. However, we continue to have concerns in a number of areas:

- The current proposals give the **Bank of England** wide powers over economic as well as regulatory and monetary policy. The Government must ensure that it retains overall control of economic management and has powers to ensure that the Bank of England complies with its priorities.

- The FPC needs to ensure that it draws on a wide variety of **experience** (including from the insurance sector) and we are concerned that as presently constituted the FPC is overly weighted towards Bank of England insiders.

Prudential Regulatory Authority

6. We welcome the setting up of the PRA and in particular the recognition by the Government that insurers need to be considered separately and be subject to sector specific regulation.

- The proposed **general objective** clearly sets a micro-prudential remit for the PRA (which we believe is the correct focus) whereas the PRA seems to be required to meet this objective by focusing on financial stability issues (a macro-prudential objective). We believe that the focus of the PRA should be on its micro-prudential remit of ensuring the prudential soundness of individual institutions while macro-prudential policy is a matter for the FPC.

- We agree with the focus of the **insurance objective** being on policyholder protection. However, we are unclear about the implications of extending the objective to cover those who 'may become policyholders'. While both the firm and the regulators have a clear responsibility for ensuring adequate protection of policyholders it is not clear that any such duty extends to the as yet undefined category of those who may become policyholders or what the regulatory implications of ensuring adequate protection for this class of person would entail.

- We remain unclear about how the proposed **judgement-led** approach will operate alongside UK regulatory requirements which will have to comply with relevant EU directives (such as CRD and Solvency II) which contain many detailed, technical rules.

There is a danger in any judgement-led approach that this could give rise to inconsistent, and possibly arbitrary, decisions by supervisors in respect of individual firms. In the worst case it could lead to what would amount to retrospective changes to rules and to supervisors second-guessing management decisions. It is, therefore, essential that the PRA maintain sufficient checks and balances to prevent such outcomes. This must include robust arrangements to enable firms to challenge PRA decisions.

- The requirements for the PRA to **consult** are much improved since the initial consultations but remain less secure than those for the FCA. Many of the requirements to consult are to be developed by PRA rather than being set out in legislation.

Financial Conduct Authority (consumer)

7. The ABI welcomes the opportunity for a fresh start in conduct regulation. We need a regulatory framework that commands consumer and industry confidence and allows a competitive market to deliver positive outcomes for consumers.

- We are broadly content with the FCA's proposed **objectives** and the statutory duty to promote competition. However, there should be a specific requirement on the FCA to increase access to financial products. This will ensure that FCA places due weight on the value of consumers accessing products that meet their needs, and does not act as a barrier to more saving and a resilient society.

- More clarity is needed from Government and the FSA about the FCA's enhanced role in influencing the **products** that are available in the market. Regulators should not be involved in designing or approving financial products. Instead, the focus should be on effective, proactive and consistent supervision and enforcement of the existing requirements on firms to treat customers fairly, including when developing products.

- We are very concerned by the proposal that FCA could publish a warning notice indicating that it has commenced an **enforcement** action. This could cause lasting reputational damage to the firm (and indeed the regulator) before the facts have been fully determined, and before the case has been proven.

- We support the **Financial Ombudsman Service** (FOS) in its important role as an independent and free service for resolving individual disputes. However, the respective responsibilities of the FCA, FOS and the courts should be set out in statute. For example, novel points of law should be referred to the courts and broader regulatory matters determined by the FCA. In addition, new measures are needed to ensure that the FOS is properly transparent and accountable.
- We have reservations about the proposed new requirement on the FOS to **publish reports of their determinations** (unless the ombudsman concerned considers it 'inappropriate' to do so). This is a significant change in policy, particularly combined with recently enhanced FSA rules/guidance requiring firms to take account of ombudsman decisions. There is a danger that the stock of ombudsmen determinations will unintentionally be interpreted by firms and consumers as a second rulebook. It may also deter firms from appealing an adjudicator's decision to an ombudsman, even if they regard the adjudicator's decision to be a poor one. We believe open debate and consultation is needed about the implications of this new power, led by the FCA when it

is established. In the meantime, we suggest the FOS should have the statutory option (rather than statutory obligation) to publish determinations, and this should be balanced by safeguards for a firm to challenge publication which it considers would be inappropriate.

- We should be wary of a 'compensation culture' being fuelled by the rapid expansion of **Claims Management Companies** (CMCs). CMCs are involved in nearly half of all cases that go to FOS, even though the FOS has pointed out that they do not deliver better outcomes for consumers, and they take a considerable proportion of redress payments. The current regulatory framework for CMCs (low key and under-resourced Ministry of Justice regulation) is inadequate so the Government should consider inclusion of CMCs within the regulatory scope of the FCA.

Financial Conduct Authority (markets)

8. We agree that responsibility for markets regulation should be within the FCA but have some concerns with the Government's proposals:

- The approach of the FCA with its strong consumer focus creates a considerable risk that **wholesale market conduct** will be viewed through a retail lens. The output from the FCA Approach to Regulation document concedes that there may be differences between the retail and wholesale markets, but envisages greater emphasis in future on wholesale conduct, both for its knock-on effect on retail markets and for its systemic impact. More thinking is needed on this including the way in which UK approaches will interface at European level with a MiFID regime which is currently subject to review.

- As investors we are concerned that responsibility for **regulation of clearing and settlement** will rest wholly with the Bank of England. It is well-understood that the Bank should be closely interested in the effective and safe operation of systemically important infrastructure. However this is ancillary architecture that supports the operation of markets and needs a close working relationship to be established with the FCA as markets regulator. 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.

The annex sets out our responses to the specific questions raised by the Committee.

ANNEX
Questions for Consultation

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1. *Is the separation of prudential and conduct regulation into a "twin peaks" system the right approach?*

   There is no ideal regulatory structure and we believe that the Government's proposed 'twin peaks' model with separate prudential and conduct regulators, which has already been adopted in a number of countries, is an acceptable model which can be effective. We believe that the focus of debate should be on ensuring that the proposed structure is implemented in a way that delivers effective and proportionate regulation.

2. *What lessons can be learnt from the approach of other countries to regulation of the financial sector?*

   As noted in our response to question 1 above we do not believe that there is an ideal regulatory structure and would note that problems during the financial crisis arose in many countries with differing systems.

3. *Is it appropriate to make such major changes to the regulatory system by way of amending legislation, rather than starting afresh?*

   We believe that the use of amending legislation is the only practical way of approaching this issue. As it is the Government's proposals are extremely complex and the timetable for implementation is very challenging and starting from scratch would add considerably to the complexity and time required.

   Large parts of the existing regulatory regime have worked well and continue to be fit for purpose. In practice, therefore, starting afresh would largely require the re-enactment of existing legislation. This could divert Parliamentary attention from more important issues and, to the extent that changes were made to the existing requirements, could impose additional costs and burdens on the industry.

4. *Are the accountability and governance arrangements for the Bank of England, FPC, PRA and FCA satisfactory?*

   Overall accountability arrangements need to be better defined to make clear who is ultimately responsible for decision-making within the system and to ensure clarity and transparency of responsibility between and within the different institutions within the system.

   In particular we would stress the importance of the FPC's composition and the risk of undue control by the Bank of England executive. We believe that the FPC needs to

have the qualities of independence expected also of the board of a public company (i.e. that it is independent of management and connected individuals).

We are generally content with the proposed arrangements for the governance and accountability of the PRA and FCA and we particularly welcome the provision for the National Audit Office (NAO) to launch value for money investigations.

We do, however, have serious concerns about the erosion of 'due process', in various parts of the Bill. In a more interventionist and judgement-based regulatory environment, the ability to challenge the regulator's decisions should be strengthened not weakened. For example, we are surprised by the proposal that the Upper Tribunal should no longer be able express an opinion about the appropriate cause of regulatory action in the event that it does not uphold the FCA's original regulatory decision. We are also concerned by the planned suspension of requirements to consult and conduct a CBA when the FCA makes use of its product intervention powers, and the proposals around early warning notices (see Q17).

We think there is a clear risk that fees will increase under dual-regulation. It is therefore important that there is greater transparency to help ensure additional overheads or any rises in regulatory fees are proportionate and represent value for money for customers who, ultimately, finance regulatory costs. We believe that there also needs to be a stronger commitment by the regulatory authorities over future cost control – there has been a marked increase in regulatory fees for insurance firms over recent years.

5. *Are the FPC's objectives the right ones? Is the concept of financial stability adequately understood for the FPC to be able to perform against its objectives?*

   We believe that the FPC's objectives are correct. However, as set out in the Bill these remain very high-level and dependent on the Court of the Bank of England determining a financial stability strategy. The Court should consult widely in drawing up its strategy in order to ensure that this is fully understood and as widely accepted as possible.

   The concept of financial stability appears to be adequately understood in so far as it pertains to the risks posed by the banking system and this has been the subject of further intensive discussion in forums such as the Basel Committee and the Financial Stability Board since the financial crisis.

   However, much less work has been undertaken to consider the potential financial stability implications of insurance. To a large extent this is due to the recognition that the banking and insurance business models are very different and that conventional insurance business presents little risk to the financial system (indeed the actions of insurers in financial crises can act as a stabilizing factor). However, we understand that the FPC will, quite rightly, include insurance within its remit. Therefore, there will be a need for the FPC to consider the financial stability implications of problems that might arise in the insurance sector. The FPC needs to give separate consideration to insurers and should ensure that it has access to relevant expertise in its membership in order to undertake this work.
6. *Should the FPC be limited in the actions it can take which might affect the growth of the financial sector?*

We believe that the FPC's central objective relating to financial stability needs to be supplemented with secondary factors. This is necessary to ensure that the FPC properly takes account of the impact of its decisions both in the wider economy and in relation to the regulated entities that might be affected by macro-prudential judgements.

The factors identified in paragraph 2.28 of the Treasury's consultation '*A new approach to financial regulation: judgement, focus and stability*' (July 2010) appear to be the appropriate ones to be taken into account. In particular (and given the lack of political oversight over the work of the FPC) there is a need to take account of the possible societal impacts of FPC decisions which may, for example, reduce the amount of credit available to some groups of citizens. It may well be appropriate for the FPC to take such actions but it should be under an obligation to consider the wider implications of its policy decisions.

We are not convinced that the requirement (in draft section 9C(4) of the Bank of England Act 1998 as proposed by the Financial Services Bill) for the FPC to ensure that its actions do not have a significant adverse impact on the financial sector provides the necessary level of checks and balances.

7. *How will the interaction between macro-prudential and monetary policies be handled by the FPC and the MPC?*

   We believe that there should be close co-ordination between FPC and MPC given that macro-prudential policies can be used to damp down the types of financial exuberance and despair that have a genuine influence on monetary conditions and inflation but for which interest rate policy may not be the best tool. Co-operation between the MPC and FPC will, therefore, expand the policy options available.

8. *Has the right balance been struck between the powers of the FPC and the powers of the Treasury?*

   The current proposals give the Bank of England, through the FPC, wide powers over macro-prudential policy – decisions taken by the FPC could have significant impacts on the real economy. The Government must ensure that it retains overall control of economic management and has powers to ensure that the Bank of England complies with its priorities. We are not convinced that the requirement (in draft section 9C(4)) for the FPC to ensure that its actions do not have a significant adverse impact on the financial sector provides adequate checks and balances.

9. *Can Parliament take an informed decision about the proposals for the FPC without details of the macro-prudential tools at its disposal?*

   It would considerably aid debate about how the FPC will operate if information about the proposed range of potential macro-prudential tools was available for the pre-legislative scrutiny phase rather, than as currently proposed, only for the introduction of the Bill. We do not believe that a fully informed debate can take place until details of the proposed macro-prudential tools are available.

However, it is clear that most of the thinking in relation to the work of the FPC and the macro-prudential tools that it might adopt has been focused on the banking sector. We agree that this is the correct focus given the much greater risks to financial stability posed by banks compared to insurers. However, we understand that the FPC will, quite rightly, include insurance within its remit. Therefore, there will be a need for the FPC to consider the need for macro-prudential tools to tackle problems that might arise in the insurance sector. As the Treasury and FSA have acknowledged, insurers operate different business models from banks and so it will not be appropriate for macro-prudential tools designed for banks to be applied to insurers. The FPC, therefore, needs to give separate consideration to insurers and should ensure that it has access to relevant expertise in order to undertake this work.

10. Does the draft Bill adequately deal with the risks posed by the shadow banking system?

The shadow banking system gives rise to very different risks from those posed by more mainstream banks. We believe that the provisions in the Bill which enable the FPC to recommend extensions to the regulatory perimeter provide appropriate safeguards – this will enable particular institutions or activities to be made subject to regulation where the risks could impact on overall financial stability.

11. Are the PRA's objectives clear and appropriate?

We are grateful for the recognition in the draft Bill of the need for the PRA to have a specific objective for insurers. We also welcome the proposal in draft section 2H that the PRA must give guidance on how it intends to advance its objectives and will provide specific guidance on each sector. However, we believe that further thought needs to be given to the proposed objectives of the PRA:

- We agree with the general objective as set out in draft section 2B(2). However, it is not clear to us that this is consistent with subsection (3). The general objective clearly sets a micro-prudential remit for the PRA (which we believe is the correct focus) whereas subsection (3) seems to require the PRA to meet this objective by focusing on financial stability issues (a macro-prudential objective). We believe that the focus of the PRA should be on its micro-prudential remit of ensuring the prudential soundness of individual institutions while macro-prudential policy is a matter for the FPC.

- We agree with the focus of the insurance objective (in draft section 2C(2)) being on policyholder protection. However, we are unclear about the implications of extending the objective to cover those who ‘may become policyholders’. While both the firm and the regulators have a clear responsibility for ensuring adequate protection of policyholders it is not clear that any such duty extends to, the undefined, category of those who may become policyholders or what the regulatory implications of ensuring adequate protection for this class of person would entail.

- We agree that provision along the lines of draft section 3F (with-profits policies) is needed and that it is correct for the PRA to be responsible for matters related to PRE. We will, however, consider further the drafting of the section to be sure that it is appropriate and adequate, particularly in relation to the definition of 'surplus.

The ABI considers that the regulatory principles should include a requirement on the PRA (and the FCA) to take account of the competitiveness of the UK financial services industry in setting its rules. The FSA is subject to a similar requirement. The UK financial services industry is a world leader and this provides substantial benefits to the wider UK economy through creating many skilled jobs, its impact on the balance of payments and on tax receipts. An effective regulatory environment is a competitive advantage for UK firms but it is essential that regulation does not damage the UK's attraction as a centre for financial services or add burdensome costs for UK wholesale and retail consumers.

12. Are there any risks in the Government's proposed 'judgement-based' regulation?

We remain unclear about how the proposed judgement-led approach will operate alongside UK regulatory requirements which will have to comply with relevant EU directives (such as CRD and Solvency II) which contain many detailed, technical rules. The UK regulatory regime sits within the EU level regulatory regime, and EU level rules and decisions take precedence over rules and decisions generated domestically. The UK regime needs to be transparently situated in its EU context if regulated companies are to avoid double jeopardy. To avoid regulatory uncertainty and supervisory confusion for regulated companies, it is essential that judgement-led decisions are communicated transparently in their EU context, and cleared prior to promulgation with the necessary EU authorities where this is necessary.

There is a danger in any judgement-led approach that this could give rise to inconsistent, and possibly arbitrary, decisions by supervisors in respect of individual firms. In the worst case it could lead to what would amount to retrospective changes to rules and to supervisors second-guessing management decisions. It is, therefore, essential that the PRA and FCA maintain sufficient checks and balances to prevent such outcomes. This must include robust arrangements to enable firms to challenge PRA and FCA decisions. As outlined in response to Q4, we are therefore concerned about a number of erosions to due process in the Bill, including the restrictions on the scope of Upper Tribunal decisions and the suspension of consultation and CBA requirements when products are banned on a temporary basis.

A judgement-based approach will also rely on the PRA and FCA having suitably qualified and experienced staff. It is, therefore, essential that both regulators ensure that it recruits and retains suitable staff.

13. Is the Government's proposed approach to 'orderly' firm failure satisfactory?

The PRA documents on insurance and banking supervision set out a proposed 'Proactive Intervention Framework' which shows the steps that would be taken by the PRA where a firm enters stressed conditions leading ultimately to the process that would ensure the

orderly failure of a firm. We believe that the proposed approach is satisfactory. In the case of insurers it appears consistent with the proposed Solvency II 'ladder of intervention'.

We agree that it is necessary for both firms and regulators to plan for stressed conditions and possible failure. However, such planning should be proportionate and tailored to the specific needs of each sector. We are concerned that almost all the thinking about recovery and resolution plans ('living wills'), whether in the UK or at EU and international level, has been focused on banks. The very different nature of insurers means that solutions which may be appropriate in a banking context will not be relevant to insurers. In particular we would note that where an insurer fails its liabilities will fall due over an extended period which allows time for regulatory intervention and enables insolvent insurers to be resolved under ordinary insolvency laws. For these reasons we do not believe that insurers need to be subject to the equivalent of the SRR process that applies to banks.

14. *Given that the PRA and the FCA will inherit FSA staff does the draft Bill do enough to ensure a new regulatory culture and a more proactive approach to regulation? Will these two new bodies have staff with the appropriate skill and expertise?*

This is a reasonable question to ask and it is important that the regulatory authorities have staff with the appropriate skills and expertise. We believe that the draft Bill provides the necessary framework to enable the proposed new regulatory culture to operate. However, whether there is a successful transition will depend on the work of the senior management and other staff of the regulatory authorities. The FSA is currently in the process of reorganising itself in order to meet the requirements of the new system. This 'internal twin peaks' model will operate until the new legislation comes into force and will provide an opportunity for both the authorities and external commentators to consider the extent to which the necessary changes have been introduced and successfully implemented.

We have a particular concern that to retain their influence in the EU the UK authorities will have to do more to guide the process of setting EU rules. 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 skill. This needs to be taken into account in selecting UK representatives on the ESAs and more generally in the recruitment of staff to the UK regulatory bodies and the setting of work priorities and allocation of resources.

We also believe that the recent crises have shown the need for the authorities to have in place senior staff that are experienced in dealing with crises and have the skill and judgement needed to make decision under pressure in stressed situations.

15. *Are the FCA's primary objectives appropriate? Is significant emphasis given to the promotion of competition?*

The ABI considers that the proposed strategic and operational objectives are a sensible balance. However, the FCA should be explicitly required to facilitate consumer 'access'

to financial services. The FSA often points out that it is not statutorily required to put weight on the potential benefits from more consumers having access to financial products that meet their basic financial needs. If the Government wants to ensure that the FCA does not act as a barrier to additional saving and a resilient society, we suggest a reference to access should be added to the efficiency/choice objective.

The ABI welcomes a greater regulatory focus on effective competition given its importance in delivering good outcomes for consumers. However, we agree that pursuit of competition should not be the exclusive objective of the FCA, given the other important considerations such as consumer protection and market integrity.

As stated in our response to question 11 above, we believe the FCA should be subject to a regulatory principle requiring it to take account of the competitiveness of the UK industry.

16. Are the responsibilities of the FCA towards the regulation of markets appropriate?

We agree that responsibility for markets regulation should be within the FCA but are concerned that the approach of the FCA with its strong consumer focus creates a considerable risk that wholesale market conduct will be viewed through a retail lens. The output from the FCA Approach to Regulation document concedes that there may be differences between the retail and wholesale markets, but envisages greater emphasis in future on wholesale conduct, both for its knock-on effect on retail markets and for its systemic impact. More thinking is needed on this including the way in which UK approaches will interface at European level with a MiFID regime which is currently subject to review.

17. Does the draft Bill strike the right balance between the responsibilities of consumers and firms? Are the FCA's new powers in the area of consumer protection appropriate?

We think the draft Bill does strike an appropriate balance between the responsibilities of consumers and firms. We welcome, for example, the inclusion of a general principle that consumers should take responsibility for their decisions. Insurers recognise that they have a responsibility to provide an appropriate degree of protection to consumers, particularly in retail markets where there is a risk of market failure.

However, we have some concerns both about the FCA's specific new powers in the area of consumer protection and the overall direction of conduct regulation. We need a regulatory framework that commands consumer and industry confidence and allows a competitive market to deliver positive outcomes for consumers. So we support a more proactive approach to regulation but this should be risk-based, focusing on retail markets where there is evidence of consumer detriment and market failure. We see little need to add to the FSA's extensive rulebook and instead suggest the FCA should focus on effective, proactive and consistent supervision and enforcement of the existing requirements on firms to treat customers fairly.

We are concerned about the proposed additional product intervention powers proposed in the draft Bill and, in particular, the right to make temporary product

intervention rules without consultation and cost-benefit analysis (CBA). Although we are somewhat reassured that the FCA will be required to publish a statement of policy on the use of this power, we are not persuaded that the suspension of basic regulatory safeguards is justified.

We also strongly oppose early publication of disciplinary action against firms. There is a risk it will cause lasting reputational damage to firms before the facts have been fully determined, and before the case has been proven. At the very least, we propose there should be stronger statutory safeguards on the use of the power, such as requirements on FCA to consider the impact of the disclosure upon the firm, and to publicise discontinuation of the enforcement action.

The FCA should be encouraged to work with the Money Advice Service to build consumer confidence about financial products so that consumers become more confident in taking responsibility for their financial decisions.

18. *Are the prudential regulatory responsibilities of the FCA towards FCA-only regulated firms given sufficient emphasis and detail?*

By definition those firms which are prudentially regulated by the FCA are not taking significant risks onto their balance sheets and, therefore, prudential regulation is of less importance in these cases. It is appropriate that the detailed requirements for prudential regulatory requirements should be a matter for rules made by the FCA rather than for the Bill.

The FCA will need to take steps to ensure that it is able to offer an appropriate career path for its prudential regulators given that the PRA will offer an attractive alternative.

19. *Will the new regulatory arrangements reduce the risk and cost of dealing with miss-selling of financial products?*

There are a number of factors which should reduce the risk and cost of dealing with future instances of widespread miss-selling of financial products. This includes the work of the insurance industry and others to proactively address risks of consumer detriment and to embed treating customers fairly principles (e.g. improving the governance and consumer focus of product design processes). In addition, the Financial Services Act 2010 enhanced the powers of the FSA (and in future the FCA) to establish consumer redress schemes. If there are future instances of miss-selling on the scale of PPI, we agree with the Government that it would be more effective for the regulator to take the lead in resolving the matter rather than the Financial Ombudsman Service (FOS).

Finally, the Government's stated commitment to the FCA taking earlier and more proactive action than the FSA could reduce the risks and costs of miss-selling, provided that these interventions are well targeted and consistent. This is primarily an issue of the quality of supervision rather than about increasing the considerable quantity of rules and powers. However, there is a risk that additional burdensome regulations, or inappropriately zealous supervision in pursuit of a 'zero-failure' regime, could reduce the

capacity of the industry to invest in UK markets and limit consumer choice and access to core financial products.

20. *Are the proposals for co-ordination between the PRA and FCA clear and adequate? What would be the advantages and disadvantages of having a Single Point of Contact and/or a joint rule book for dual-regulated firms?*

Close co-ordination between the PRA and FCA will be necessary to ensure that the new regulatory structure operates in an efficient and effective manner. It is vital that the PRA and FCA do not duplicate each others' activities. It is particularly important for dual regulated firms that there is effective co-ordination in order to ensure a consistent and proportionate approach to regulation. We, therefore, welcome the proposed statutory duty of co-operation.

The proposed MoU between the PRA and FCA will clearly be a vital tool for ensuring that co-operation works in practice – we believe that the Government should ensure that a draft of the MoU is available for public discussion during the pre-legislative scrutiny phase, rather than being delayed until the time the Bill is introduced, in order to inform debate at this important stage of the process.

We are generally content with draft section 3D setting out the duty to co-operate. However, we are concerned that the exemptions in section 3D(2) could, if interpreted widely, significantly limit the requirement to co-operate. We would propose that additional guidance should be given making clear the extent to which these exemptions might be used to disapply the duty to co-operate in particular circumstances.

The list of issues to be covered in the MoU in draft section 3E(2) seems comprehensive but more detailed comments are not possible until the draft MoU becomes available. However, whether the arrangements work in practice will be dependent on the working relationships between the parties rather than on the legal requirements. It will, therefore, be important for the FSA and Bank of England to ensure that close working relationships between the units that will become the PRA and FCA are built up and maintained during the period of 'internal twin peaks' which is currently being introduced and will last until the revised legislation comes into force. These close working relationships will need to be formed at all levels of the respective organisations. We will look to the FSA and the Bank of England to keep the industry informed of its progress in developing the 'shadow' PRA and FCA and to consult where appropriate.

In relation to the proposed legislation on the MoU we have the following comments:

- Draft section 3E(4) to 3E(7) requires that the MoU is regularly reviewed and published. We welcome these requirements. However, there is no requirement for the PRA and FCA to consult on changes – we believe that the authorities should be required to consult. How the authorities work together will impact directly on regulated firms and it is important that they are able to comment on proposed changes which may impact on them.
- Draft section 3E(8)(b) allows technical or operational issues relating to co-operation between the authorities to be left out of the MoU. We are concerned that this will

allow issues which have a direct and material impact on firms to be omitted and we believe that any agreements covering such issues should be made public.

From the point of view of dual-regulated firms a single point of contact and a single rulebook would provide greater clarity in their dealings with the regulators and would help to ensure that overlaps and inconsistencies were avoided. However, requiring such an arrangement on a legal basis would not be in keeping with the underlying intention of the proposed reforms. However, it would make sense for the PRA and FCA to undertake joint working wherever possible to minimise the burden on firms. It is also essential that where both the PRA and FCA have an interest in a particular section of the rule book that any rules and subsequent changes are made jointly in order to ensure that differences do not arise between the requirements of the two regulators.

21. *How do the proposals in the draft Bill fit within the new European regulatory regime? What freedoms and constraints will the UK have to operate within that regime?*

The proposed UK architecture does not fit well with the EU structures. The ESAs are based on a sectoral approach (banking, insurance, securities) rather than the functional (prudential and conduct) approach being pursued by the UK Government. This will mean that there will be an onus on the UK authorities to ensure proper co-ordination to ensure that UK interests are fully represented on the ESAs by the appropriate authority. We also believe that in order to retain their influence the UK authorities will have to do more to guide the process of setting EU rules. 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 skill. This needs to be taken into account in selecting UK representatives on the ESAs and more generally in the recruitment of staff to the UK regulatory bodies and the setting of work priorities and allocation of resources.

In terms of the impact this will have on the freedom of the UK authorities we noted in our response to question 12 that it is not clear to us how a judgement based approach will be compatible with the fact that EU level rules and decisions take precedence over rules and decisions generated domestically. The creation of the European Supervisory Authorities (ESAs) means that to an increasing extent there will be common supervisory requirements across the EU and so less discretion for national supervisors. This situation has been acknowledged on a number of occasions by senior FSA staff.

We are concerned that some of the powers proposed for the new bodies may go beyond what is permissible under EU law. For example, it is by no means clear that all of the intrusive product regulation powers proposed for the FCA are permitted under the terms of MiFID or the Life and Non-life Framework Directives. Equally, it is not clear that the proposed PRA powers over branches of foreign domiciled providers of financial services are compatible with the usual split of responsibilities between home and host regulators in EU legislation. We get the impression that compatibility with EU law was a rather late consideration when the Government was formulating its proposal, and that it has been grafted on after the main ideas were fixed. Clearly it is essential for legal certainty that the Government goes back and checks that all the proposed powers are indeed compatible with EU legislation.

22. *Does the draft Bill contain any proposals or omissions, not covered by the questions above, which cause concern?*

    An important issue meriting scrutiny by the Joint Committee is the role and governance of the Financial Ombudsman Service (FOS) and its place within the broader regulatory framework.

    The ABI supports the important work of FOS in providing an independent and accessible alternative dispute resolution body. However, as the Government has identified, there is a need to make the respective roles of the regulator and the ombudsman service clear and distinct. We agree with the Government that the FOS should be able to focus on processing individual complaints on a case-by-case basis rather than having to deal with mass issues. More broadly, we suggest that it is not the role of individual ombudsmen to privately make final decisions on precedent setting cases, which could have wider implications for potentially thousands of similar cases. The small minority of cases that fit into this category ought to be referred to the FCA, or to the courts if a legal test case is needed. The legislation should set out a clear process for decision-making on cases requiring regulatory or legal clarification. This might include giving trade associations and other stakeholders the right to refer such cases to the appropriate body. Whilst FOS state that its decisions do not set precedent, our members sometimes find that FSA supervisors do treat them as such and indeed the FSA has recently strengthened the requirements on firms to take account of ombudsman decisions.

    We believe the legislation and FCA rules should set out a clear process for decision-making on cases requiring regulatory or legal clarification, perhaps building on the recently established FOS, FSA and OFT Co-ordination Committee. This might include giving trade associations and other stakeholders the right to refer such cases to the appropriate body. The legislation should also require FOS to take account of the relevant regulation at the relevant time when making determinations.

    We also believe the accountability of FOS needs to be strengthened, given its importance to the industry and consumes. We therefore welcome some of the specific legislative changes included in the draft Bill, such as requiring FOS to publish an annual plan and making it subject to NAO audit. In addition, we suggest FCA should conduct regular reviews of its overall operations, policies and procedures. This would not, and should not, compromise the operational independence of ombudsmen when adjudicating on individual cases.

    We also suggest that the ombudsman service should be required to exercise its functions in a manner which is consistent with the FCA's strategic and operational objectives and the regulatory principles. The Legal Services Ombudsman is subject to a similar high-level requirement to operate within the regulatory framework for legal services, and we consider this to be a reasonable discipline on FOS. The FOS should also be required to consult with stakeholders before it issues guidance (or 'technical notes') about its procedures and its approach to handling common categories of cases.

    Finally, we have reservations about the proposed new requirement on the FOS to publish reports of their determinations (unless the ombudsman concerned considers it 'inappropriate' to do so). This is a significant change in policy, particularly combined with

recently enhanced FSA rules/guidance requiring firms to take account of ombudsmen decisions. There is a danger that the stock of ombudsmen determinations will unintentionally be interpreted by firms and consumers as a second rulebook. It may also deter firms from appealing an adjudicator's decision to an ombudsman, even if they regard the adjudicator's decision to be a poor one. We believe open debate and consultation is needed about the implications of this new power, led by the FCA when it is established. In the meantime, we suggest the FOS should have the statutory option (rather than statutory obligation) to publish determinations. This should be balanced by safeguards for firms to challenge publication which they consider to be inappropriate.

Finally, we have proposed to Government that responsibility for regulation of CMCs should be transferred from the Ministry of Justice to the FCA, given the large number of CMCs that get involved in financial services complaints. Stronger regulation is needed to address consumer detriment associated with some CMCs, including high fees for poor service, misleading communications, unsolicited advertising and fraudulent activity.

September 2011

Association of British Insurers (ABI) – oral evidence (QQ 558-642)

Tuesday 25 October 2011

Evidence heard in Public Questions 558 - 642

Members present:

Mr Peter Lilley (Chair)
Mr Nicholas Brown
Baroness Drake
Mr David Laws
Lord McFall of Alcluith
David Mowat
Lord Newby
Mr David Ruffley
Lord Skidelsky
Baroness Wheatcroft

Examination of Witnesses

Witnesses: **Ms Maggie Craig**, Director of Conduct Regulation, and **Hugh Savill**, Director of Prudential Regulation and Taxation, Association of British Insurers, examined.

Chairman: I welcome our two witnesses before the Committee today. Thank you both for agreeing to come and answer our questions and also for submitting your evidence beforehand in writing. We are very grateful to you. I would like to ask Lord Newby to start the questioning.

Q558 Lord Newby: The first area of questioning relates to where you find yourself as an industry under the new proposed regime, which is very much under the prudential regulatory body rather than the conduct of business body. Do you think that that is an appropriate place to be, given the risks to financial stability posed by your sector compared to the banks?

Ms Craig: There are a couple of things I would like to say by way of introduction. I am Maggie Craig. I lead on conduct regulation for the ABI. My colleague Hugh Savill leads on prudential regulation. You may find that, if it is a conduct regulation piece, I might be more inclined to answer and Hugh will answer on prudential regulation, but we will try to supplement where possible. I will let Hugh speak on prudential regulation to your point in a

minute, Lord Newby, but we would say that our members will have a lot to do with the financial conduct regulator, whether it is in terms of the financial conduct regulator's work on product, customers or whatever. Many of our members will in fact be dual-regulated, so not just regulated by the PRA. Perhaps, Hugh, you would like to pick up the other point.

Hugh Savill: There was initially a question about where we belonged. The whole framework was set up with banking in mind. Did we belong in the Financial Conduct Authority or Prudential Regulation? We took the view that we preferred to be in the Prudential Regulation Authority because that was, in effect, the senior body and that is where the major decisions were going to get taken. We are content with where we are.

Q559 Chairman: You are content, but do you think that the insurance industry represents any systemic risks in the same way that banking clearly does, because they borrow short, lend long, and are therefore intrinsically unstable?

Hugh Savill: Thank you, Chairman. No, we don't. Insurers take in the premiums and set aside reserves to pay claims, sometimes over a long period of time. There is nothing like the same liquidity issues as there are with banks. Also, we are also not connected to each other by the payments system as the banks are, so there are nothing like the systemic issues that you will find in banking. We would expect the Financial Policy Committee, for instance, to spend most of its time considering banking issues. If an insurance issue turns up, it is important that there is somebody there on that Committee, or indeed at the top of the PRA, who understands insurance issues.

Q560 Lord Newby: Do you think there needs to be greater safeguards to ensure that your interests at the FPC level are properly represented? If so, do you think that should be on the face of the Bill?

Hugh Savill: We would prefer to have it rather clearer that there should be somebody with insurance expertise on the Committee. Yes, if that were on the face of the Bill, we would not object.

Q561 Mr Brown: I have a supplementary question to that. To what extent as an industry do you make use of novel financial products in the shadow banking system, particularly in the United States?

Hugh Savill: Not very much, is the answer.

Q562 Mr Brown: But you would know; you would have a handle on how much the people you represent make use of these products.

Hugh Savill: I am not certain to what you are referring. We did not buy very many of these CDOs that caused all the trouble. They did not fit with our mandates. We do make use of derivatives, for instance, to help asset liability matching.

Q563 Chairman: The presumption is that the Government included insurance within the purview of this Bill and the structure of regulators they have set up because of the AIG events in New York. Was the British insurance industry involved in doing the sort of things that AIG was doing?

Hugh Savill: No, Chairman. AIG was brought down by a really quite small investment banking business that was in London. That caused the huge losses that brought down many insurance companies around the world which were in fact being run perfectly all right. AIG shows that there was a failure of group supervision. A supervisor has to have a handle on the business of a group right across the globe; otherwise there is a risk that some business, maybe not a part of its main business, will bring the whole lot down.

Q564 Chairman: Would British-based insurance companies have investment banking subsidiaries?

Hugh Savill: No.

Q565 Lord Newby: Does that not then argue that you are in the wrong place? If the prudential risk was faced by an AIG-type event, and you don't do the kind of business that could lead to an AIG-type event, surely the vast bulk of the regulation has to do with conduct of business.

Hugh Savill: No; you still need prudential regulation of any insurance company. You have to make sure that the best estimate of the liabilities is properly calculated; that the insurer has held the capital against that; and that the assets in that capital are the right kind of assets. It still needs to be done. As I said, our assessment was that we preferred to be part of what we perceived as the senior body, the PRA, rather than in the FCA.

Q566 Baroness Wheatcroft: Do you think you should be within this structure at all? The Bank originally, it would appear, was quite opposed to the idea of the insurance industry coming under its auspices at all. Do you think that, ideally, there should be a separate regulatory authority for the insurance industry?

Hugh Savill: That would make four or perhaps five regulators. The more regulators you have, the more difficult it is for them to talk to each other and co-ordinate. One of our major concerns about this set-up is that, with the best will in the world, it will be difficult for these institutions to talk to each other. So, no, we did not want a separate regulator.

Q567 Baroness Wheatcroft: But you would hope that the expertise needed to regulate your industry will be there.

Hugh Savill: Indeed, and we take comfort from the fact that some of the insurance supervisors and regulators in the FSA, who have done a rather good job over the past 10 years and have not really received credit for it, are moving across to the PRA.

Q568 Mr Laws: I want to look at the product intervention powers in the Bill. To start off with, is there a need, in your view, for stronger product intervention powers in order to protect consumers from potentially harmful financial products?

Ms Craig: We need to be particularly careful about how any product intervention powers are deployed. If you were to start from a premise that a complex product is necessarily a bad thing, that would not be a good premise from which to work. There is a need in the market for some products that are more complex and some that are simpler. There is also something around not assuming that a product is necessarily bad because it is not suitable for one segment of the market. Our position would be that we would hope that product intervention was only used in particularly extreme cases, it was not something that was regularly deployed, and that there would be an intelligent dialogue between the regulator and the member firm or firms involved as to exactly what was going on.

Q569 Mr Laws: There is an issue about how it is implemented and delivered in a sensible way. My starter question was: do you agree or disagree with the need for greater product intervention powers? Regardless of how they are framed, are they needed?

Ms Craig: I am not sure we are entirely convinced that they are, given that one of the things we would suggest is that it would be better to use the tools that are already at the regulator's disposal and they don't necessarily have to get into product intervention. There is a lot of work that could quite usefully be done on product governance processes aligned to treating customers fairly. If you, as a regulator, are working through and working with a firm on how they are developing their products, and that is done in line with treating customers fairly, that product development should be done appropriately and, therefore, it would be unlikely to need a product intervention.

Q570 Mr Laws: Are you particularly worried about some of the powers to intervene to block the launch of a new product that might be seen to be dangerous to particular classes of consumers?

Ms Craig: It could be. We have already had feedback from some member firms that in some cases they have chosen to launch a particular product or a particular investment line out of another jurisdiction—for example, out of Dublin—because it takes too long to get the process through that is done by the regulators. There is a concern here around the competitiveness of the industry.

Coming back to Hugh's point, there is a concern that, if the regulator is going to become involved in regulating or intervening in products, do they have the type of people employed in the regulator who properly understand the market and what customers need?

Q571 Mr Laws: Do you think there is any greater role that the sector as a whole could play in self-regulation in order to deal with some of the legitimate concerns about this without requiring the regulator to do something that it might also find quite difficult, which is to make all these decisions itself before a product has even been launched? Is that something that has been explored?

Ms Craig: That is something that is certainly well worth exploring. In fact the Treasury announced last week the steering group they are setting up to look at what has loosely been called simplified products or simple products. The Treasury have been very clear that they want that to be an industry and consumer group-led initiative rather than a Government-led initiative. That group was only announced last week. We don't yet know what format that will take, but it is something that we have been actively talking to the Treasury about and are very keen to support. We ran an event on simple products last week. Some of the speakers were talking about whether it would be possible to have some form of kite mark or quality mark against certain products. That is something the industry is interested in taking forward. It would need work with the regulator, because it is all very well to talk about a safe or a simple product, but at the moment—and increasingly so, it would seem—our product regulation system is based on pointing people toward the best product. There can sometimes be a tension between getting the absolute best outcome in every single individual case versus getting an outcome where a product is safe. You then get into definitions of what is safe and what is simple. The short answer to your question is that there is mileage in exploring that, and the industry would be willing and indeed very happy to be engaged.

Q572 Mr Laws: I want to ask you one other question before my colleagues follow up in this area. In your view, who should do the product intervention regulation for auto-enrol pensions where the business is selling the pension to the employer and then auto-enrolling the employees? Who should look after the interests of the consumer, i.e. the employee, in that situation, where the employer is essentially taking the decision?

Ms Craig: The employer is essentially taking the decision and the Pensions Regulator will regulate the employer in terms of the employer's compliance with the employer duty. That is that piece, if you like. There is a certain level of comfort in the sense that in an auto-enrol situation people will have an employer contribution and tax relief, so there is a bit of a buffer there that makes it probably the right decision for the vast majority of people. One of the things we have been pressing the Financial Services Authority on is to have a form of simplified advice which would enable a consumer who cannot afford or does not want, or in those circumstances probably does not afford or want, full financial advice to get some form of financial advice that would help them with the question, "Is auto-enrolment right for me?"

Q573 Mr Laws: If the pension product is crummy, and the employer does not really care because he may be contributing to it, but it is going to be somebody else's problem in 30 years' time, which body is particularly looking out for the consumer in that situation?

Ms Craig: It will depend, I suppose, on what sort of product. If the product—and I hope it would not be crummy—is offered by, say, an ABI member firm who is regulated currently by the FSA, and then the FCA, then that product provider has a responsibility to offer a good product to the market, and the consumer is enrolled into that. So there is a protection there, in the same way as consumers are currently enrolled into group personal pensions. If the product is a trust-based scheme, then the Pensions Regulator has a responsibility, and if it is NEST we are in a slightly different space altogether. It is going to be very important that people have that explained to them, because they are going to be auto-enrolled into a situation and a product that they may well never have met before and simply do not understand. They may assume that because their employer is the facilitator that the employer has taken that responsibility on themselves. Does that help?

Mr Laws: Yes; thank you.

Q574 Chairman: Why did these precautions not work in the case of payment protection insurance?

Ms Craig: Well, there were a number of problems with payment protection insurance around not just the product—it was very largely a distribution problem. The product was sold inappropriately; there is no denying that.

Q575 Chairman: It had about a 90% profit level, so it was clearly bogus. You weren't getting anything for 90% of your money.

Ms Craig: Payment protection insurance was a problem, and it is one of those ones we absolutely need to learn lessons from. There is no denying that. That is part of the reason that people have thought more about product intervention now. Until recently, the Financial Services Authority's focus on regulation has been very largely on the distribution and the sale and that process, which in itself is changing, but now they do feel there is a need to look more at product intervention.

Q576 David Mowat: Is your point on that that the product was fine but it was just mis-sold?

Ms Craig: I would not say the product was fine, but I think there were significant problems in the way it was sold. The product could be a perfectly good product.

Q577 David Mowat: If the product was okay and the issue, as you have said, was that it was mis-sold, that would imply that product intervention would not have helped, because the product was okay in the first place.

Ms Craig: The main cause of the PPI problem was a distribution issue.

Q578 David Mowat: By distribution do you mean selling?

Ms Craig: Selling, yes.

Q579 Chairman: You mean it might have been good for someone but they didn't find the person who it was good for, to put it brutally.

Ms Craig: Yes.

Q580 Chairman: That is not a terribly convincing thing to say, is it—that it was a distribution problem? It was wrong for almost everybody that bought it. That is not distribution to my mind. Yet it went on for years, so there must be something wrong with a

system that did not find it. You say we have to learn the lessons. That is what we want this Bill to do. What are those lessons?

Ms Craig: One of the lessons is around the way the regulator has said that it will intervene further upstream. Another of the lessons is that there needs to be an increased focus on the governance of product design within firms.

Q581 Chairman: But presumably it is all in the fine print. The question then is whether the regulators read the fine print. Can they relate them to the circumstances of likely purchasers? That is difficult, presumably. I had never heard of any criticisms of PPI—and when I was at the DSS there were other mis-selling issues—that related terribly much to the fine print. The real symptom was that they were hugely profitable. I am all in favour of profit normally, but if that is a symptom of mis-selling, should we be looking at that? In other words, should we be saying, "What are the costs to the purchaser for the insurance or the savings product he is getting?" If the costs are disproportionate, then there is something wrong.

Ms Craig: I am not quite sure what question you want me to answer.

Q582 Chairman: Should we be looking at the cost ratios in these products rather than either the fine print or the distribution mechanism?

Ms Craig: I am not sure about that one. Hugh, do you have a view on that one particularly?

Q583 Chairman: It is built into the stakeholders that the maximum cost should be 1%.

Hugh Savill: It is one of the things that the FCA has said they want to look at. In a case where there is obviously a very profitable commission structure, that may be one of the tell-tale signs that there will be problems in the future. We would not disagree with that.

Ms Craig: Indeed, that is one of the areas where the Retail Distribution Review, moving away from commission as a remuneration-method, will be very important. We know that there is convincing research that commission can introduce product bias. Going forward, that is one way in which that will be addressed.

Q584 Baroness Wheatcroft: The FSA had an overwhelming objective for its regulatees of treating customers fairly. Are you really telling us that that served no purpose, the only way these unwholesome products might get stopped being sold is if the regulator intervened early and the industry itself is not going to be moved by treating customers fairly as a concept?

Ms Craig: No; I think the industry is working hard on treating customers fairly and will continue to do so. I don't think that framework disappears at all. Treating customers fairly applies not just to product design but across the board. It can apply in terms of the communication and the service that you give to customers. As a concept, it is something that the industry has taken on board and is increasingly taking on board. I don't think it is as narrow as just one piece.

Q585 Baroness Wheatcroft: I am sorry that we are harping on about PPI, but it was not a small problem and it affected a lot of people. As the Chairman said, it is very hard to see that anything other than a small minority of the products that were sold would have benefited the purchasers. The balance was simply against the interests of the purchasers. I am struggling here. How does that fit into treating customers fairly?

Ms Craig: PPI was a problem. I would not attempt to suggest that that was an example of people being treated fairly. I would not attempt to suggest that. The industry, however you want to describe that, and however you want to describe the industry, got it wrong with PPI. I do not think there is any point in shirking that. But it is important that we do not lose sight of the fact that the industry does sell a lot of good products in a lot of good circumstances. I am suggesting that we need to be very careful that a response designed in one situation is not applied across the board in an inappropriate way.

Q586 Baroness Wheatcroft: But, if, with this Bill, we are striving to find a mechanism that would ensure that customers are treated fairly in all circumstances, is there anything that is not in it at the moment that we ought to be looking for?

Ms Craig: It is not so much what is not in the Bill; it is what will be needed as the conduct authority works through. There will be a number of things around working intelligently and sensibly with the Prudential Regulatory Authority so that it is joined up. There is a lot of talk in the Bill and other places about a judgment-led approach. It will be very important that the regulator, if it is going to use a judgment-led approach, is clear within which framework that judgment is going to be exercised so that firms understand and there is a dialogue going on there. There is otherwise a danger that judgments become inconsistent because they are very personal things.

If I might be permitted to say a little more, we need to be careful that a judgment-led approach is properly joined up with a much more detailed technical approach coming out of Europe. We have those two things to join up. The other thing that slightly concerns me is that some of the rhetoric around the Conduct Authority is very much in terms of a regulator being required to avoid negative outcomes for customers. Clearly, a regulator has a duty to do that, but it might be helpful if there was a mindset that also said that the regulator should be seeking to enhance or encourage positive outcomes and not just working to avoid the negative.

Q587 Baroness Drake: I want to close down an outstanding issue from your exchange with Mr Laws. Most of the discussion there was at the point that the employer makes a choice on the pension, but of course, one of the big consumer issues is that, after they leave the employer, the individual defaults into insurance-based products. There seems to be a regulatory gap there, because it would not be the responsibility of the TPR. That is going to be quite a risk around consumer protection. Would product intervention powers not be a way of giving protection there, because there is no employer to articulate protection for the employee who has left.

Ms Craig: Sorry, when you say default into an insurance product, at what point?

Q588 Baroness Drake: If an employer takes a contract-based provision on the grounds that, "If you leave my company, you leave my scheme," and there is a default arrangement with Standard Life or Legal & General, which puts the employee into another personal pension or some other arrangement, that individual is then left with lots of small pots depending on the number of times they change employment. There is a regulatory gap there, because you would not look to the TPR. It is outside their remit.

Q589 Chairman: What is the TPR?

Ms Craig: The Pensions Regulator. It is something we are very alive to. There are two issues here. There are a number of ways in which people can build up small pots. Some of the small pots may be built up in different insured contract-based schemes. Some of them may be built up in employer trust-based schemes. It is something we are working on at the moment to try to develop an initiative, where we could have people transfer their money from pot A to pot B, particularly where it is a small amount and you don't want it left building up lots of small pots.

There would probably have to be some sort of regulatory intervention there, on the face of it, to see whether people could be automatically transferred. If I leave employer one and I have a small amount of money and I go to employer two, could that be automatically transferred? However, you would need to be careful that there was some form of safeguard in that automatic transfer. In principle, absolutely, we need to get small pots sorted out. We do need to be clear who is protecting the person there, particularly if they are moving from a Financial Services Authority environment to a TPR environment. It could certainly be done.

Q590 Baroness Drake: On a general level, if one listens to the consumer groups, they feel that the Bill fails to seize the opportunity to strengthen consumer protection. The ABI is concerned about the product intervention rules and how they would be deployed. How would you prefer the Bill to address the issue of strengthening consumer protection?

Ms Craig: As I said before, we are looking at an environment where the regulator has an intelligent relationship with product providers, where product intervention may be part of the armoury but is deployed only in very particular circumstances. There is this recognition that we need to have people in the regulator who properly understand what goes on in the industry and also properly understand what consumers need. One of the most positive things is that I believe the FCA is going to have some sort of market analysis or consumer analysis team. The idea that the regulator also gets closer to consumers and asks consumers directly what they want and gets a much better involvement with consumers will help.

Q591 David Mowat: I want to ask one final follow-up question on product intervention. I was reflecting on your answer that PPI was a mis-selling thing and not a bad product. In essence, every product is going to be a good product for somebody. Therefore, under that definition that you gave, there is no such thing as a bad product, because any idea would be good for somebody.

Chairman: Not necessarily.

David Mowat: The issue is the combination of the two together, isn't it?

Ms Craig: Yes; it is about a combination. There are some products that are inappropriate for some people and perfectly appropriate for other people. That is one of the things that makes the simple products initiative so interesting. There will always be people who do want very complex products for self-investment or something quite sophisticated, but those would be completely inappropriate for a mass-market customer. A simple product might be a better product. You are right that it is very difficult to pin down that a product would always be the wrong choice in all circumstances, or even that a particular product would be the best choice in all circumstances.

Q592 Mr Brown: Is there not a danger that auto-enrolment could be the next mis-selling scandal? What safeguards would you point to, either in the legislation that we have under consideration or in the way in which your member companies are operating, that would prevent this from being so?

Ms Craig: There are a number of points there. We have been strong supporters of auto-enrolment and we remain so. One of the greatest safeguards in auto-enrolment will be if there is this basic citizenship pension. That will take out a lot of the issues around whether or not auto-enrolment is the right choice for people. It will be around whether or not at the end, when they retire, the benefit of auto-enrolment is effectively means-tested away. If we get out of that and we have a basic level citizenship pension or universal pension—whatever you want to call it—that is a big plus.

The other thing is that, if you compare, and a lot of people do, auto-enrolment to stakeholder, for example, the two big differences are that stakeholder did not require auto-enrolment. Stakeholder did not require an employer contribution, so there is money going in from elsewhere which adds to the pot. NEST will be a trust-based arrangement and there is, therefore a trustee structure which looks to protect its members. That is what trust structures are for. In the private sector environment, the typical employer contribution into, for example, a group personal pension run by an ABI member firm is of the order of 6% or 7% typically, which is roughly twice the level of employer contribution going into NEST. There is, if you like, a bigger employer contribution going in. There will, of course, be the products that are sold, as in contract-based products, which are subject to full scrutiny and regulation by the Financial Conduct Authority. There are a number of pieces in place there.

Q593 Mr Brown: Can you still not see scope for this going wrong?

Ms Craig: There may be some people for whom it might not be the best choice, but for the vast majority of people it probably will be the best choice. There are other things, not just in terms of level of contribution, if you look at the care that NEST has taken in structuring its default funds, so that people—

Q594 Chairman: I am very bad on acronyms. We have been talking about NESTs for some while.

Ms Craig: I do apologise. It is the National Employment Savings Trust. It is the Government default scheme, effectively. If you look at the care they have taken to structure the default investment that people will be going into, that is yet another safeguard.

Mr Brown: Chairman, can I move us on to dual regulation or do you want to come to that later?

Chairman: We can probably skip dual regulation at this stage and move on to Baroness Wheatcroft, if you don't mind.

Q595 Baroness Wheatcroft: I would like to explore a narrow part of the new structure, which is the PRA's responsibility for with-profits. That is something that has caused some comment. I would be interested to hear whether you think it is going to be something that the PRA is well placed to guard on behalf of investors, and in particular this concept that it has to be conscious of the reasonable expectations of with-profits policyholders. How do you see that working?

Hugh Savill: With-profits is a joint venture between the policyholder and the company. It raises both conduct and prudential issues. We think it is right that the PRA should take the lead in regulating its products and there is an important role for the FCA in advising the PRA on how that goes forward, because the two are completely joined at the hip. You cannot take a prudential decision without it having conduct effects or take a conduct decision without it having prudential effects. They both belong together.

Q596 Baroness Wheatcroft: Do you think there should be a requirement for the FCA to advise the PRA, and for the PRA to take note of that advice, written into the legislation, or are you confident it could work without?

Hugh Savill: It should work without. It is always safer if it is written in. On the other hand, you end up with a Bill, if you are not careful, with all sorts of duties written in that fur up the process. Ideally, it should be so obvious that they would work together.

Q597 Baroness Wheatcroft: It does not appear to have been totally obvious to the Governor of the Bank of England. I think he described it as a mess.

Hugh Savill: No; he said it was a nebulous concept. I think reasonable expectations are no more nebulous than this judgment-led approach that he has promoted. It says that the policyholder should be at the heart of how this is taken forward and regulated, and I think that is right.

Q598 Baroness Wheatcroft: But you are relatively sanguine with this arrangement.

Hugh Savill: Yes.

Q599 Baroness Wheatcroft: I will ask you about another concept and see whether you are equally sanguine about it. It is that the PRA insurance objective extends to protecting those who may become policyholders. Again, that is a somewhat nebulous concept, is it not?

Hugh Savill: Yes; I agree. That is why we would prefer to have it out. If this was a conduct regulator, I could understand because a lot of conduct regulation is, in effect, before

somebody becomes a policyholder. It is advice. In the context of prudential regulation it is very difficult to see what it adds. As a result we would prefer it out.

Q600 Chairman: Other than that it is odd, can you envisage specific problems arising if it is included?

Hugh Savill: No. This is basic caution: if you don't know what something is, why include it in a piece of law?

Q601 Baroness Wheatcroft: It is hard to see how you safeguard the interests of those who at the moment don't exist.

Hugh Savill: Particularly in a prudential context, I agree.

Q602 Mr Ruffley: To a large extent we might have covered some of this, but are there any specific drafting proposals that you will be offering up as an organisation about the requirement for the FPC to specifically have regard to insurance issues?

Hugh Savill: As I said earlier, if asked, yes, we would like it said on the face of the Bill that there should be somebody on the FPC who has specific insurance expertise.

Q603 Mr Ruffley: Would that be all the drafting amendments you have? Are there other parts of the FPC structure, apart from just one person? There is a comment about the personnel. You would like one member to have an insurance background. Is there anything else?

Hugh Savill: No, I don't think so. The objectives seem the right ones to us. Financial stability is extremely important and this is a Committee that will fill a gap that was evidently there before.

Q604 Mr Ruffley: Ms Craig, do you have anything to add to that?

Ms Craig: No.

Q605 Lord Skidelsky: In the ABI response, you support the financial stability objective, but you say that less financial risk is represented by the insurance industry because "conventional insurance business presents little risk to the financial system". What is the difference between conventional insurance business and non-conventional insurance business?

Hugh Savill: The examples that have been given are, for instance, the derivatives business that AIG was running in London, which was certainly not conventional insurance and which I would argue was investment banking. One can also point to the financial guarantee business that the so-called monoliners had in guaranteeing structure of products. That was also not

conventional insurance business and was arguably about credit guarantee and closer to banking.

Q606 Lord Skidelsky: To what extent was the kind of business which AIG was doing not only non-conventional insurance but not insurance at all in the way most people have understood it, in so far as the risks against which they were insuring could not be properly known or identified?

Hugh Savill: I agree; this was not at all insurance business. This was an investment banking business. They had taken on a huge credit risk.

Q607 Lord Skidelsky: To what extent will the macro-prudential tools which it is proposed to apply make it easier to identify risks faced by that kind of insurance—in other words, capital ratios, leverage limits and things of that kind—to make the institutions which are seeking insurance more robust?

Hugh Savill: To that kind of banking business, yes, they apply quite well. To conventional insurance business, they are pretty useless.

Q608 Lord Skidelsky: So you would not be in favour of institutions that offer the kind of insurance that AIG was offering.

Hugh Savill: Most of the AIG insurance was fine, ran very effectively across the globe and did not fall down. I am very much in favour of that kind of insurance. The mistake was having a subsidiary of AIG which was not properly ring-fenced from the rest of its insurance business and was allowed to go unsupervised and run risks for the whole large business.

Q609 Baroness Wheatcroft: If an AIG equivalent was operating under this legislation as currently drafted, would there be anything to prevent it getting involved in the sort of unconventional derivatives business/pseudo-banking that AIG was doing?

Hugh Savill: Not on the face of this Bill. You have to look at the group supervision elements of something like Solvency II or the consolidated supervision provisions of the CRD to see where that ought to come in.

Q610 Baroness Wheatcroft: Are you confident that, given those various restrictions, there is sufficient to avoid a situation such as the AIG one?

Hugh Savill: It needs to be done at an international level. The problem with AIG is that it was basically regulated by a Thrift regulator in New York. This investment banking business in London was regulated by La Commission Bancaire in France. It is absolutely crucial in a globalised world that the regulators also act in a globalised manner.

Q611 Baroness Wheatcroft: Is the structure there at the moment that would ensure that happened?

Hugh Savill: No, not at the moment.

Q612 Mr Brown: Who would the regulator be?

Hugh Savill: Traditionally, it is the home regulator that takes responsibility.

Q613 Mr Brown: Would it be regulated as a bank or as an insurance business?

Hugh Savill: AIG was an insurer, basically, but it was regulated by a Thrift regulator. One has to ask why that happened because it probably should not have done. At the moment the way the international regulators talk to each other is through so-called colleges. Any large multinational business will have a college which is run by the home regulator of that business and on which all the host regulators of the various subsidiaries round the world sit. At present these are informal on an international basis. They do happen and the regulators talk to each other a lot. It is essential that that kind of arrangement continues.

Q614 Mr Brown: But under the proposed European Union structure and the structure that we have under consideration in the Bill in front of us, who would be the regulators at European level and at United Kingdom level? What would be the forum for them talking to each other?

Hugh Savill: Of an AIG-type body?

Q615 Mr Brown: Yes; in other words, the non-conventional insurance operation.

Hugh Savill: It is difficult, because the EU structure is set up sectorally with banking insurance securities, whereas the UK has adopted the twin peaks approach of conduct and prudential regulation. They don't have to be the same. You can put together and co-operate any kind of structures. It will be more difficult for the UK regulators and supervisors to make sure that they have all spoken to each other correctly and to co-ordinate their business in the European regulators just because of this mismatch of structures.

Q616 Mr Brown: And there will be a quarrel over definitions, presumably.

Hugh Savill: I do hope not.

Mr Brown: It seems possible to me.

Q617 Baroness Drake: Does that mean there should be, in regulatory terms, a requirement to have structural separation between conventional and non-conventional activity in insurance companies, a bit like retail and wholesale banking, so that one cannot call on the other?

Hugh Savill: Yes, I would have thought so. If you have a large derivatives business, an obvious solution to that not being able to bring down the rest of the insurance business is that you set a ring fence between them and safeguard the insurance capital.

Q618 Baroness Wheatcroft: Would that not be for the PRA to insist upon?

Hugh Savill: Yes, assuming it was in the same country.

Q619 Lord Skidelsky: What do you think should be done about these products if it is impossible to get internationally consistent regulation? You said international regulation is an absolute requirement for regulation of these types of products. Suppose that is impossible. What would you do about the products?

Hugh Savill: I don't think it is impossible at all.

Q620 Lord Skidelsky: Do you think it is easy?

Hugh Savill: It is not easy. What should be done about those products? These were credit risk products. There is nothing intrinsically wrong with the products. What was wrong was the massing of risk in one place.

Q621 David Mowat: You talked a moment ago about the sectoral approach in Europe versus the twin peaks approach that we are contemplating. You also said that any organisation structure can be made to work with any other organisation structure, which is true, although a principle of organisation design is that you try and go for clear accountabilities and simplicity. Do you think we have failed on that in terms of this Bill?

Hugh Savill: No, I don't think so. There is always concern that in a moment of crisis you don't know exactly who is in charge, as experience in the last crisis shows. If we look at this Bill, there are occasions when it could be clearer exactly who is in charge. The point that most worries us is whether in practice, two years down the road when these organisations are up and running, the middle ranking people in those organisations really will pick up the telephone to each other. That is a matter of human behaviour.

Q622 David Mowat: That is an interesting phrase that you used—that in a moment of crisis the risk is that you won't know who is in charge. You could argue that is the be-all and end-all of a regulation system. You must know who is in charge at the moment of crisis. At a moment of non-crisis it does not matter quite so much.

Hugh Savill: I will accept that. I would argue that it is the build-up to the crisis, when people didn't know, which often causes that.

Q623 David Mowat: If I can clarify it, on the sectoral thing you understand that a twin peaks system can be made to work with a sectoral system and we have just got to get on with it.

Hugh Savill: Yes, absolutely.

Q624 David Mowat: In terms of the insurance industry at ESA level, you are going to be represented by the PRA rather than the FCA.

Hugh Savill: Yes.

Q625 David Mowat: Does that give you any issues? Are you content with that?

Hugh Savill: Yes, we are content with that. We are also particularly pleased that Hector Sants himself is taking the management board seat on EIOPA. That is a real signal to us that the PRA takes insurance seriously. We are content with that. It will be a matter that, on the working groups, the UK bodies co-ordinate and talk with each other and also that those sitting on the management board, where the really big decisions are taken, can convince the others that they have the authority and can speak on behalf of the different organisations in the UK system.

Q626 David Mowat: One of you said earlier that there is a potential mismatch between the technical approach of Europe and the judgment-based approach of the UK. Would you elaborate on that and perhaps give an example of how something might go wrong because of that?

Hugh Savill: Certainly. At the most basic level, European law supersedes British law. Our regulators have to do what European law says. That limits the sphere in which that judgment can operate. There is nothing wrong, in principle, with the judgment-led approach. It just has to know in which field it can work and in which field it can't work. It has to know its own limits.

I can give an example. There are specific rules in Solvency II, which is the forthcoming European insurance regulation, about how you set capital requirements for insurers. You can imagine circumstances in which the FPC might take a look at an insurance situation and say, "We are concerned about the capital requirements of insurers; this should be raised." That would have to be done in accordance with Solvency II, otherwise we will get a regulatory clash and the regulated will not know which way to turn.

Q627 David Mowat: I have a final question on your submission. You talk about the need for a higher level of negotiating and influencing skills and political awareness to ensure that the industry is represented fully at the European level. The fact you have raised it like that might imply that you are not sure that has always been the case in the past.

Hugh Savill: Yes. We are talking about an attitude of mind. In the past, FSA staff have been really good technically. Perhaps, because they were really good technically, they were not so quick to pick up the nuances of what some of the other regulators were after or wanted. If you are working in a world where a decision is made by several people, yes, it matters that, technically, you are right. The expertise matters. It also matters that you listen carefully to the others who are going to be taking part in the decision. Ideally, the first stage, if you recognise a problem as a British regulator, would be to pick up the telephone to some of the major regulatory figures on the continent and say, "I have this problem; what do you reckon about it?"

Q628 David Mowat: It is what, in a wider sense, you could call influencing skills.

Hugh Savill: Yes.

Q629 David Mowat: Is there anything more this Bill can do in respect of that, or do we just have to manage that?

Hugh Savill: That is a people issue.

Q630 Chairman: Could I follow up on that point? You place great emphasis, because it is ultimately governed by European law, on us having the optimum, maximum input into the defining of European regulations and clearly we should deploy people who are technically competent and brilliant negotiators in the most effective way. Suppose we did all those things. Are you confident that our views and our interests would prevail, given that it is majority voting at the end of the day?

Hugh Savill: Not necessarily.

Q631 Chairman: Would you like it if we had a sort of Luxembourg compromise arrangement where, given that we are predominant in this industry, no agreement would be reached until the country with the predominant interest was in accord with the consensus?

Hugh Savill: I can only look at the regulatory landscape that surrounds me as it is. I look at the European Supervisory Authorities as they have been created, and these have very strong regulatory powers. They also have very strong mediation powers over the activities of our regulators as supervisors. That is the world that we, as the regulated, have to live in and that is the world in which I have to try and influence and persuade our regulators to work.

Q632 Lord Skidelsky: Could you bear to return for one moment to the non-conventional insurer?

Hugh Savill: Certainly.

Q633 Lord Skidelsky: The other thing that brought AIG down was that it held a number of sub-prime mortgages in its pension product business. Would you agree that any large insurer would need to be holistically regulated?

Hugh Savill: Entirely.

Q634 Lord Skidelsky: Could you expand on that for one moment? What would that type of regulation entail?

Hugh Savill: This goes back to the group supervision arrangements about which I was talking. First, within each insurance subsidiary, you need to take a look not just at the liabilities of the company, which is what people traditionally think of as insurance—the claims

they might have to pay out—but you also have to look at the assets they hold. Over the last couple of years the asset side of insurers has caused more trouble than the liabilities side. That is one aspect of "holistic" within the subsidiary. One then needs to take an holistic view right across the entity, if you like, to make sure that risks in subsidiary B are properly balanced by any capital that might be in the home company. On both levels it needs to be an holistic approach.

Q635 Chairman: I bring you back to the subject of judgment-led regulation. I can understand your concerns about it. Perhaps you can help me because I don't even understand what it means. Does it mean that the regulator will exercise its judgment as to whether the capital ratio should be 7% or 8% for this company? Does it mean that the regulator will exercise its judgment as to whether a rule should be applied or not applied? What does it mean?

Hugh Savill: To be honest, Chairman, I don't know.

Chairman: I am glad I'm not alone.

Q636 Mr Ruffley: May I follow up on that? The evidence we have taken so far, whether from Barclays, Legal & General, the ABI itself or the City of London Corporation, seems to converge in coming to this conclusion. I am just reading out from the City of London's view. They warned that a judgment-based approach is a move away from consultation and is likely to be detrimental to UK-based firms. Then they say that they are concerned that the judgment-based approach may conflict with the move to a single rule book and supervisory convergence at the level of the European supervisory authorities. It seems the argument is that this leads to much more uncertainty, as in the draft Bill, compared with a single rule book and convergence at the European level. It is not just one or two people and it is not just you, with respect, saying it either. Unless I have been missing something, this seems a really rather large problem with this Bill. Would you agree?

Hugh Savill: Possibly. It all depends on what judgment-led regulation means.

Q637 Mr Ruffley: If we can't even define it, then we are in trouble, aren't we?

Hugh Savill: At the most basic level, if it means exercising judgment by somebody with experience, that is surely excellent and that would be a good thing.

Q638 Chairman: But within what range?

Hugh Savill: That is precisely the point.

Q639 Chairman: When I was responsible for the insurance industry, we were worried that the regulators were spreading their effort evenly across all firms. I tried to get them to focus on areas where there was reason for concern. So there was judgment in the amount of attention you devoted to individual firms and individual issues. That is not judgment-based regulation; it is judgment-based supervision and prioritisation.

Hugh Savill: That is also a good thing.

Q640 Chairman: But is that what they are talking about?

Hugh Savill: If it is, that would be good.

Chairman: I think we ought to find this out in the course of our investigation.

David Mowat: I thought what they were talking about is the difference between judgment-based regulation and rules-based regulation. It came up in the Enron case in which something wasn't right. You could look at it holistically and it was not right, but on a rules-based system it followed rule 1 to there to there to there. You could get round it.

Chairman: But how do you legislate for judgment-based regulation?

Baroness Drake: Is judgment-based regulation not inseparable from the information issue? They go hand-in-hand. Underneath this Bill, the knowledge that the regulators or the banks had was insufficient for them to regulate efficiently. You cannot separate, in my view, the concept of judgment-based decision-making from a collection of the requisite information in order to make an informed judgment. They are not separable in that sense.

Mr Ruffley: Do you mean by that that we have rules and then on top of that we have judgment? That would make sense. It is both.

Baroness Drake: Yes, because I assume the view is being taken, when you stand back and look at what happened in 2007 and in the run-up to 2007, that those with the authority to intervene didn't, either because they were insufficiently informed about what was going on or they didn't have the political conviction or courage. Therefore, you cannot go on any more tick-boxing or just setting down principles. You have to have people with the ability and knowledge to take a judgment in those circumstances.

Lord McFall: In terms of the contemporary financial environment we are in, if I remember, it could go back to the Northern Rock example, Mr Chairman, where the regulator put their best regulators on to large companies and the less good regulators on to small companies on the basis that larger companies provided larger risks. The debate at the time was about the business model of Northern Rock. People in the City were saying, "This company was an outlier. For example, in the first half of 2007 it was responsible for 20% of all new mortgages. Did you not look at the business model? Did you not exercise some judgment as a regulator?" There was a lot of discussion about that. It is a matter of whether we have transposed that and said the regulator must exercise some judgment on the business model and other aspects rather than just simply looking at the rule book. I feel that that history is something worth keeping in mind.

Chairman: Indeed. Are there any more questions to our witnesses—the Chairman having displayed his ignorance and been further exposed?

Q641 Mr Ruffley: On judgment-based regulation, would you agree with Barclays' assessment? They have written to this Committee saying, "'Judgment' must not slip into

arbitrary and inconsistent supervision." Is that not also at the heart of the problem we are probing here? Would you agree with that?

Hugh Savill: We agree with that. It is perhaps a little strongly expressed. Those are harsh words, and the kind of people we have in charge of our bodies, I am certain, would not wish to end up there. I think this points to the need for consultation at all stages. If you exercise a judgment-led approach, fine, you make that judgment. You make it within the borders of what you know to be your powers. It is then worth asking people, "If we do this, what's going to happen?"

Q642 Baroness Drake: This follows on from that. The ABI expressed the view that compatibility with EU law in their view was a rather late consideration in formulating the current proposals. Are you saying there is a design flaw in this Bill as a consequence?

Hugh Savill: It need not be. It did rather read as if the people had written the UK structure and then somebody had come along and said, "Where are we going to fit Europe into this?" It looks like an afterthought. That does not mean to say that the Bill necessarily has flaws in it, because it can easily be constructed that way.

Chairman: Thank you very much indeed. We are very grateful for your evidence, even if, because of it, you have exposed a degree of ignorance on the part of the Chairman. We will fill in that gap in due course. We are grateful to you for what you have provided, which will help us in our future deliberations. Thank you.

Association of Financial Mutuals; Association of British Credit Unions Limited (ABCUL); Building Societies Association; Association of Independent Financial Advisers; Institute of Financial Planning; International Regulatory Strategy Group; Financial Services Practitioner Panel; FSA Smaller Businesses Practitioner Panel; Financial Services Consumer Panel and Office of the Complaints Commissioner – oral evidence (QQ 438-557)

Transcript to be found under Association of British Credit Unions Limited

Association of Independent Financial Advisers (AIFA) – written evidence

About AIFA

The Association of Independent Financial Advisers (AIFA) is the representative body for the IFA profession, with membership on a voluntary and corporate basis.

There are approximately 16,000 adviser firms that employ 128,000 people, and turnover is estimated at £6.5 billion (including £4.5 billion from life policies, £1 billion from fund management and £1 billion from mortgages and general insurance). Around 20% of the UK population regularly use an IFA, with c45% consulting one from time to time.

IFAs currently account for around 70% of all financial services transactions in the UK (measured by value). As such, IFAs represent a leading force in the maintenance of a competitive and dynamic retail financial services market.

AIFA welcomes the opportunity to contribute to the call for evidence of the Joint Select Committee, and would be delighted to provide further evidence and insight as the committee deems appropriate. Our response focuses primarily on the FCA and the interplay between regulatory entities, which most impacts our membership.

Introduction

AIFA clearly recognises the important role that regulation plays in making the retail financial services market a safer place for consumers, and a place in which they can have trust and confidence. We are therefore fully in favour of cost effective, proportionate regulation which builds on that which already works.

Regulatory intervention has become the hallmark of the retail financial services market given the significant importance it has to individuals. However while AIFA welcomes the need for regulation as a means of making the market safer for consumers, we are also adamant that it must improve its effectiveness, and make absolutely clear its purpose. Constant regulatory flux deters financial investment in firms and weakens consumer trust in the sector. In some cases the implementation of the regulatory system actually threatens to undermine the existence of the market as a viable entity, restricting the ability of consumers to obtain the products and services that they need.

As previously publicised, AIFA has therefore identified six high-level principles that we believe should apply to the governance of regulation:

1. **We believe regulation must enable better outcomes for more consumers**. This means regulation must not only protect consumers from unscrupulous market participants, but also facilitate more access to advice for consumers, particularly at this stage in the economic cycle.

2. **We believe it is essential that regulation has the appropriate checks and balances in place to ensure accountability**. In the past the system of accountability for the regulator has relied too heavily on internal self-assessment, with the result that there were few external effective checks and balances in places. The regulators should therefore be held more tightly accountable to the delivery of their objectives in the most efficient and cost-effective way.

3. **We believe regulation must work in a proportionate and risk based way, focusing on those aspects of the financial services industry that pose the**

greatest risk. However this has certainly not been the case under the FSA who have tended to pursue actions they viewed as 'bomb-proof', and cascaded them to adjacent markets. The result of this approach has been that IFA firms, who pose no systemic risk to the economy, and are working in the best interests of their clients, have faced intrusive supervision from FSA to a far greater extent than large banking institutions at the other end of the 'risk' scale.

4. **We believe regulation must change less, with fewer "new ideas" and more consistency of delivery.** Although the history of regulation under FSA has been relatively short, there have already been a considerable number of waves of different requirements with the result that a degree of regulatory fatigue has set in. The costs of coping with FSA regulation keep rising, and the combined effect of this and fatigue is to drive members of the market out - to the detriment of consumers. We must see the creation of FCA and PRA as evolutionary.

5. **It is essential that the regulator use its resources in the most cost effective and economic way**, **in order to deliver the best possible value for money for both the industry and ultimately consumers.** By definition, consumers will not be able to obtain the products and services they need if the provision of those services is eliminated or made expensive by the actions of the regulators.

6. **Finally we believe regulation must take fully into account the European dynamic at play**. With the ability of the European Supervisory Authorities to write binding technical standards that are directly applicable to UK firms, and increasing amounts of financial regulation now emanating from Europe, it is therefore crucial that the UK is best placed to achieve positive engagement on the continent in the coming years and ensure we remain a leading player, for the benefit of consumers.

Specific Questions:

1. **Is the separation of prudential and conduct regulation into a "twin peaks" system the right approach?**

AIFA acknowledges that the 'twin peaks' approach is different, but remains unconvinced it is necessarily better.
Whilst a focus at the macro-prudential level is necessary, AIFA believes that further evidence as to how such a structure would work for the whole market, rather than just from a financial stability perspective, is necessary. Designing a model that successfully addresses financial stability but that is simply incongruent with the sectorial approach taken at a European level poses different threats to the UK which may not have been fully considered.
AIFA also believes that we should be mindful of the potential detriment for consumers and advisory firms where a system is designed to address the failings of the past without also considering future challenges or side-effects.

3. **Is it appropriate to make such major changes to the regulatory system by way of amending legislation, rather than starting afresh?**

AIFA believes that there are advantages to both approaches. In deciding to amend existing legislation AIFA hopes that the corporate memory – and responsibility – of the regulator can be maintained. Whilst FSA is right to consider 'new' approaches it must be remembered that many of the staff, rules and initiatives were founded by and contributory to the 'old'

regime. As highlighted by the amendments to FSMA rather than new Bill, FCA is an evolution. This means that not only should corporate memory survive, but corporate responsibility and accountability for the longer-term projects such as RDR and MMR should also remain.

4. Are the accountability and governance arrangements for the Bank of England, FPC, PRA and FCA satisfactory?

Whilst the entities will be 'independent' regulators founded by statute, as public bodies they must seek to tackle an impression held by some that they lack accountably.
Clearly, FCA has direct accountability to HMT, and AIFA also supports a greater role for the Treasury Select Committee in taking a proactive role with FCA in addition to this. We also support the new statutory footing of the Smaller Business Practitioner Panel, the maintenance of the Practitioner and Consumer Panels, and the creation of the Markets Panel.
The role of an independent assessor of value is important, as is the retention of the NAO in an auditing capacity of the FCA and PRA.
However AIFA believes that there are further improvements that can be achieved: as part of the cultural shift we expect to see in the FCA, we believe that responsiveness is important for consumer trust, and also industry respect. The structures will provide the formal accountability, but the culture must be seen as being responsive. We would therefore like not only to see clear objectives and increased accountabilities set out for the FCA but a requirement to articulate the principles by which it will conduct itself in a manner that is responsive to the community it serves, and that which it regulates.
Within the wider regulatory structures we also believe that there should be greater formalised engagement with the industry on behalf of the PRA. It is clear that the PRA should not be accountable to industry but it should be consultative with it. AIFA believes that there is scope for either the Panels – or the Chairs of the Panels – to also be enshrined in the PRA structure, rather than the current proposals which allow the PRA to decide themselves how best to interact with practitioners.

9. Can Parliament take an informed decision about the proposals for the FPC without details of the macro-prudential tools at its disposal?

AIFA believes that fundamental reform of the regulatory architecture requires clarity of all aspects before an informed decision can be made. This includes not only the macro-prudential tools, but other aspects of the structure which remain as yet unpublished. Given the interaction between the bodies, the importance and robustness of the Memorandums of Understanding is of particular importance. AIFA believes that this detail is also necessary for Parliament to make an informed decision. Later in our submission we highlight the potential multiple interventions that could be taken by differing parts of the regulatory structures to address an identical issue.

12. Are there any risks in the Government's proposed 'judgement-based' regulation?

By its very nature, a judgements based regime implies a regulator must have the necessary skills and expertise to judge and second guess senior management in firms; this change is untested in our regulators.
Regardless of the success of this approach, such a cultural change immediately highlights the need for appropriate and robust appeals mechanisms for firms. The draft bill allows firms to make referrals to the Tribunal, but removes elements of the Tribunal's powers to amend

regulatory decisions, instead relying on a referral back to the regulator. AIFA has also witnessed regulators suggesting that Judicial Reviews are a possible route of challenge.

When one considers the vast number (24,500) of small firms in scope of the FCA, it is clear that an accessible route to appeal is necessary for all. This may include the Tribunal, but AIFA has in its submission to FSA and HMT also argued that a greater role for the Regulatory Decisions Committee (RDC) or equivalent is necessary as a check and balance. If a judgement based regime is a success, the presence of such appeals mechanisms will be negligible.

14. Given that the PRA and the FCA will inherit FSA staff does the draft Bill do enough to ensure a new regulatory culture and a more proactive approach to regulation? Will these two new bodies have staff with the appropriate skill and expertise?

AIFA believes that one key element of the success of FCA will be achieved by its culture. FSA acknowledges this in its Approach paper, and AIFA welcomes an approach that seeks to command the respect of both consumers and firms. A culture of transparency and openness is vital to the success of FCA, and in engendering a spirit of accountability.

AIFA notes the strong and consistent messages with regard to the use of industry-sourced information during discussions about Product Intervention with FSA. A regulator which is respected will want to engage with the industry, and will see the value in such relationships. It is interesting to note in this regard, that in the early years of the RDR, the FSA operated a highly collaborative approach but that as staff have changed and the political and economic environment has altered, the approach has been much less responsive and that this may be seen recently to have compromised a successful outcome for the reform programme.

With regard to FCA skills and expertise, AIFA supports the approach proposed by HMT with regard to competition, which sees a role for OFT rather than an extension of scope for FCA. This will allow FCA to refer out to specialist economic regulators where appropriate.

As previously highlighted, ‘judgement’ led regulation could require FCA to secure staff with skills over and above the industry. An appropriate alternative approach – and check and balance – is the provision of a robust appeals mechanism, which allows industry the right to appeal; this could in turn allow greater flexibility and reduce cost.

15. Are the FCA's primary objectives appropriate? Is significant emphasis given to the promotion of competition?

While we support the objectives, we also believe the FCA should have a clear responsibility to enable better outcomes for more consumers. This means regulation must not only protect consumers from unscrupulous market participants, but also facilitate more access to advice for consumers, particularly at this stage in the economic cycle. But there is evidence to suggest that in recent years, UK regulatory practice has failed the consumer in a number of ways. The number of people saving has fallen dramatically, the cost of advice has risen, consumer confidence and trust have been damaged, and efforts to promote public awareness through information and disclosure overload have been largely ineffective.

The FCA therefore needs to address the wider public policy agenda in order to help consumers re-engage with their long term financial well-being and making more, and better, provision for themselves. This should involve closing the savings and protection gaps as a statutory objective of the FCA. If the FCA has a remit that is overly-focussed on protection for individual customers without a balancing need to demonstrate the effect on the greater good, we risk a further erosion of the savings culture in the interests of incremental improvement in outcomes for investors.

With regards to the promotion of competition, AIFA feels that there is a balance. Whilst an overriding need to consider competition is important, AIFA feels that a more public articulation of the impact on competition of regulatory initiatives would be beneficial: in effect we believe the regulator should be obliged to publish a 'competition/benefit analysis' in the style of existing 'cost/benefit analysis'. This would also allow stakeholders to consult on the likely competitive impact of any given regulatory initiative.

From the perspective of economic competitiveness, AIFA supports HMT in not creating a new economic regulator in the FCA. However, we feel that FCA should provide further clarity of its intentions in this area.

Whilst FSA's paper acknowledges that FCA is not a price regulator, it goes on to illustrate the need to make assumptions on the 'value' of transactions. Whilst reviewing explicit fees – MEAFs for example, or intra-fund expenses that in a binary manner could negate returns, an assessment of 'value' is quite different.

Value by definition is a subjective view of both the service/product offered, and the cost. If FCA attempts to operate in this space, we fear that they will either immediately undermine their work in the area of consumer responsibility by second-guessing perceived value, or have to intervene in cost, which is merely price regulation. We believe further work is necessary on this point.

17. Does the draft Bill strike the right balance between the responsibilities of consumers and firms? Are the FCA's new powers in the area of consumer protection appropriate?

AIFA has historically supported the notion of consumer responsibility including Mark Hoban's positive comments last year relating to consumer responsibility. We have previously supported the decision to drop the consumer champion aspect of the FCA, which we believed detracted from the important consumer responsibility objective. We must be clear about the responsibility of all market participants in financial transactions.

Indeed we consider the wider issue of consumer responsibility to be an important factor within the regulatory architecture debate. AIFA's consumer research into this area suggests that consumers are more willing to accept responsibility for their decisions if their confidence in firms increases. This plays well into the Government's desire to build trust in the market. AIFA would like to see consumers embrace their responsibilities without in any way minimising the responsibilities that firms, the regulator and other agencies owe to them. We believe that whilst in some cases additional responsibility may deter consumers, many will engage with financial services with greater attention to their requirements and the value of products and services.

Consumer responsibility is not just about the "entry" level decisions people take (whether to engage or not) but also carries on into their interaction with the financial decisions they have taken. No one would buy a car and not have it regularly serviced, and so it is with financial services products: on-going engagement will yield better results than neglect.

General consumer protection laws and the industry regulator offer protection from rogue and fraudulent bodies and consumers' rights are widely championed. With rights, however, come attendant responsibilities and the change in the regulatory landscape provides a timely opportunity to define these more clearly in order to help consumers achieve optimum outcomes.

AIFA's only caution with the FCA Approach paper is FCA's desire to engage with consumers directly. We believe this is desirable but raise concerns about duplication of work with MAS, both of which are industry funded. Co-ordination of activity is important.

18. Are the prudential regulatory responsibilities of the FCA towards FCA-only regulated firms given sufficient emphasis and detail?

AIFA believes that the prudential responsibilities – and change of approach to prudential regulation is a key area where significant improvement could potentially be achieved by FCA. AIFA has long argued that likelihood of failure is far less important than impact. Indeed, in our sector firms are often small and can experience the mortality of their owners (owners retire etc.) but there are no systemic risks to consumers, or to the smooth operation of markets.

Historically FSA has used profitability as an inverse proxy for likelihood of failure. At a time when many IFA firms are investing heavily in preparation for regulatory initiatives such as RDR this has resulted in a reduction in profit, which clearly does not indicate an increased likelihood of exit.

The prudential requirements for PIFs are themselves onerous in the extreme, and do not tally with the revised approach to prudential regulation proposed by FCA. Whilst AIFA has welcomed FSA's recent delay to the implementation of the revised requirements, we strongly urge FCA to use the revised prudential regulatory methodology as an opportunity to improve the capital requirements of firms. The revisions to the Article 3 provisions within the review of MiFID also make this urgent.

This work is also important in the context of FCA's new competition objective. Barriers to entry within the IFA sector are high: a new firm with an expected turnover of £250,000 could require regulatory capital of £47,000, before considering working capital and cash flow requirements. This places a significant barrier to entry for new firms, in a time when it is widely acknowledged that RDR will result in a number of firms leaving the sector.

19. Will the new regulatory arrangements reduce the risk and cost of dealing with miss-selling of financial products?

AIFA supports the continuation of FSA's powers in s.404 with regard to Consumer Redress Schemes. We believe in recent years that the FOS has been drawn away from its core mandate of the adjudication of individual complaints, and believe that the enhanced transparency between FCA and FOS with regard to identifying mass-detriment quickly improves the current 'issues of wider implications' referral framework.

However, we do not believe that the formal structures will per se reduce the risk of miss-selling. The s.404 powers are already in existence, and could have been utilised by FSA within the PPI miss-selling episode; as FSA is also at pains to observe, its more intrusive and interventionist approach has already begun, so by definition new powers in FSMA are not necessary for FCA to pursue its product intervention initiative.

20. Are the proposals for co-ordination between the PRA and FCA clear and adequate? What would be the advantages and disadvantages of having a Single Point of Contact and/or a joint rule book for dual-regulated firms?

AIFA remains concerned by the potential over and underlap of all three regulatory bodies. We also believe there is significant scope for duplication of activity.

If we consider the housing market bubble of 2007 within the current regime, AIFA is concerned that in the example of a small mortgage adviser there would be up to five UK solutions to the housing market, all potentially impacting a small mortgage broker's business model.

The mortgage adviser would be singularly regulated for both conduct and prudential requirements by the FCA; this would provide FCA two ways of tackling issues in the housing/mortgage market by either addressing the conduct of business or prudential requirements of the firm. However, FCA has a third method of addressing what could be

the same issue through FCA's regulatory interest in wholesale activities of lenders who use markets to securitise debt. As FCA's paper highlights, the design, marketing and miss-selling of mortgage-related securities is well documented in the recent financial crisis. This potentially provides FCA three approaches to tackle the same potential detriment.
However, the actions of the PRA with regard to the prudential requirements of certain large firms of lenders could also be brought into the equation, before the FPC's role in macro-prudential financial stability and FCA's subjection to FPC recommendations. AIFA remains concerned that despite the proposed principle of proportionality small firms could find their markets distorted by five individual actions to address a single problem by three UK regulatory bodies.

With regard to a single point of contact or rule book, AIFA notes two key issues:
Firstly, any single rule book for dually authorised firms would result in FCA-only authorised firms having a 'different' rule book by definition. This would involve either duplicating the FCA conduct rules or risks unlevelling the playing field or creating regulator arbitrage between small and large firms.
Secondly, regardless of whether a firm is prudentially regulated by PRA or FCA, all firms' conduct remains in the jurisdiction of FCA. To this extent, all firms have a single point of contact in the FCA.

21. How do the proposals in the draft Bill fit within the new European regulatory regime? What freedoms and constraints will the UK have to operate within that regime?

As previously highlighted, AIFA believes that the twin-peaks approach does not sit comfortably with the European regime. As demonstrated by the three sector-specific European Supervisory Authorities each with prudential and conduct remits, a twin-peaks approach by the UK creates difficult interaction. AIFA has previously highlighted its concerns at the PRA leading on the relationship with EBA and EIOPA. Whilst these bodies are engaged with Solvency II and Basel III they are also engaged with conduct related issues such as the Mortgages Directive (CARRPD) and the review on the Insurance Mediation Directive; equally whilst FCA leading with ESMA is appropriate for MiFID, it is not for the Capital Requirements Directive. AIFA is concerned that the UK is hardwiring into legislation an approach that is at odds to the European direction of travel, and may lead to significant confusion for regulated firms and cost inefficiencies.
Specifically looking at the role of regulation, the ESAs already have an ability to write binding technical guidance that is directly applicable on UK firms. There is the potential for future directives to include instructions of how to supervise against such directives which themselves will instruct FCA in their approach.
We also see a degree of duplication with the European bodies. ESMA can step into various roles in the event of crisis management, and for example has the ability to ban products. This duplicates FCA's proposed powers. From a legal perspective, we question the situation raised when ESMA does not ban a product, tacitly acknowledging that it is acceptable, and subsequently a firm based in continental Europe passports it into the UK where the FCA seeks to ban the same product.
We also feel that the issue of passporting itself warrants further scrutiny. AIFA is concerned that inwardly passported firms may be able to circumvent significant elements of the product intervention agenda. As an example, whilst AIFA believes that a continental-European-domiciled insurance company setting up a UK branch would find the majority of their host state's (UK's) conduct of business rules applicable, we question what power FCA would have over the product set of an inward passporting tied intermediary who is the sole route

to market in the UK for a European insurer; in this case the insurer themselves would not be passporting, only their wholly owned tied subsidiary. In this case we fear FCA will be unable to address product related issues at the parent entity.
This has the potential to put UK firms at a material disadvantage to those passporting in, and potentially causes detriment to consumers if products our own regulator would not deem as acceptable are available because it is simply outside the scope of the UK regulatory structures.

22. Does the draft Bill contain any proposals or omissions, not covered by the questions above, which cause concern?

Long-stop:
AIFA has supported the wider use of s404 Redress Schemes by both FSA and FCA and the resultant role of FOS as an individual complaints handler. We do believe that the wider use of s404 Redress Schemes, which are based on legal precedent, has alleviated the main barrier to the introduction of a long-stop in financial services, and we continue to call for an extension of the long-stop to the action of FOS, via FSMA.
Whilst historic arguments have focused on the cost of introduction of a long-stop, because the s.404 Consumer Redress powers are now in place, the marginal increase in cost in extending the long-stop to the Ombudsman is negligible. We understand that FOS would of course need the legal certainty of a statute of limitations being formally recorded within FSMA.

Cost:
Of concern to all market participants – and to consumers who ultimately foot the bill – is the cost of regulation. The on-going cost of regulation, and the cost of the transition to the new structures is particularly alarming for AIFA.
Whilst we welcome the continuation of the use of CBAs for new regulatory interventions, and the increased use of post-implementation reviews, AIFA believes that more weight should be placed upon the overall cost burden of firms. The current structure and its accountabilities does not provide for an aggregate view of the cost of all regulatory entities on smaller enterprises, still less is there any assessment or stress testing of the impact of incremental or additional costs on the overall availability of advice services to the consumer through a healthy and profitable advisory sector.
The use of previous miss-selling episodes to justify forward looking initiatives has limited scope and if conducted robustly and accurately the greater use of PIRs should provide a better view both the cost and success of regulatory initiatives.

September 2011

Association of Independent Financial Advisers; Association of British Credit Unions Limited (ABCUL); Association of Financial Mutuals; Building Societies Association; Institute of Financial Planning; International Regulatory Strategy Group; Financial Services Practitioner Panel; FSA Smaller Businesses Practitioner Panel; Financial Services Consumer Panel and Office of the Complaints Commissioner – oral evidence (QQ 438-557)

Transcript to be found under Association of British Credit Unions Limited

Association of Independent Financial Advisers – supplementary written evidence

In response to Mr Law's question to Steven Gay, regarding the number of complaints that would be excluded from the Financial Ombudsman Service by the application of a long-stop, I have enclosed the following information.

In the year ending 31st March 2008, FOS received 123,089 complaints (FOS Annual Review 2007/08). Around 2,000 of these complaints would have been time-barred if a 15-year long stop was in situ (FSA feedback statement 08/6) and this represents 1.7% of all complaints received at FOS in that period. The majority of cases that would be over 15 years old are pension and investment complaints, however, they are not exclusively from these sectors.

If this figure is broken down further, it is noted that for pension cases FOS agreed with consumers only 16% of the time 2007/08. For investment cases the figure was closer to 32% but this included Mortgage Endowment complaints, which was a mass complaint issue that is no longer prevalent in today's figures. Furthermore, such mass complaints could now (under the FCA) be subject to a section 404 consumer redress scheme, which would not fall to FOS and would be enacted under general law (where a long-stop would apply regardless).

We have asked FOS for an updated figure on the number of cases that would have been time-barred had the long-stop been in place today. However, FOS has not repeated this exercise since it was specifically completed for FSA in 2008 as part of its work on the RDR. Consequently FOS has only been able to provide an estimated current figure. It has said that the number of these types of cases has reduced substantially since the 2008 figure; this reflects the change in the products being complained about. FOS has seen a reduction of around 40% in the number of pension and investment related complaints - the two areas where generally the long stop would have an effect. Additionally, the majority of investment and pension related it receives currently relate to recent advice/issues.

This would leave only around 1,200 cases being subject to the long-stop. The uphold rate for investment and pension cases was around 40%. So it could be assumed that around only 400 eligible cases would be excluded by the long-stop being in place.

These 400 cases will need to be balanced against the costs to the wide industry. The costs to the industry of not applying a long-stop broadly fall into two camps: explicit tangible costs to maintain records, and implicit costs relating to corporate investment, impacting on business robustness, Professional Indemnity Insurance and the Financial Services Compensation Scheme.

The uncertainty generated by open-ended liabilities faced by firms prevents advisory firms becoming tradable assets and hinders firms' ability to attract new sources of capital. This in itself has a negative impact on consumers who are reliant on a robust industry for advice. As firms struggle to gain inwards investment and tradability they disappear, with the retirement of proprietors reducing local accessibility.

The lack of a long-stop disempowers consumers; removing the important messages around consumer responsibility. It could be argued that it is a contributor to consumer complacency

as it allows the assumption to be made that all responsibility lies with firms, whether providers or distributors, and the authorities such as FSA and FOS, and/or the government. Increased financial education will help consumers to engage with their finances better and the implementation of a long-stop could create further prominence of the need for them to do so.

11 November 2011

Association of Private Client Investment Managers; Association for Financial Markets in Europe (AFME); British Private Equity and Venture Capital Association (BVCA); Investment Management Association and National Association of Pension Funds – oral evidence (QQ 351-437)

Transcript to be found under AFME

AVIVA – written evidence

Aviva is pleased to respond to the Joint Committee's call for evidence on the draft Financial Services Bill. We broadly welcome the Government's proposals but still have some areas of concern.

- **Stability and consistency** – An effective regulator acts consistently and values stability. This consistency enables firms to comply with relevant rules in an efficient manner. Inconsistency and slow decision making can lead to unnecessary costs, which may be passed on to consumers.

- **Accountability and governance -** The governance arrangements in and between the various regulatory bodies are crucial to ensuring that they are effective. It is important that the independent members of the FPC, as well as the Boards of the PRA and FCA, reflect a balance of experience from within the financial services industry, including the insurance sector

- **Due process** – A shift to judgement-based supervision should be balanced with a strengthening, not an undermining, of challenge mechanisms for firms. The proposals to weaken the remit of the Tribunal should be dropped.

- **Europe -** It is paramount that the UK authorities co-ordinate effectively and influence and negotiate successfully in Europe and internationally. We recommend the establishment of a forum or secretariat to help enable this.

We enclose our written evidence in the attached appendix. We would welcome the opportunity to discuss our evidence with members of the Joint Committee.

Appendix 1

1. Is the separation of prudential and conduct regulation into a "twin peaks" system the right approach?

In a speech to the 2010 FSA Annual Public Meeting the FSA Chairman, Lord Turner, said that different regulatory systems offer different benefits, and that "there has always been some intellectual logic to what is called the 'twin peaks' approach". He concluded that the government had clearly decided that it wants to achieve structural change – so the remaining challenge is one of implementation.

It is clear that the debate as to whether to move to a 'twin peaks' approach is over, and the key question now is how to ensure that the new structure is proportionate and effective. We have long considered that it is the effectiveness of supervision, rather than the structure, that is important.

2. What lessons can be learnt from the approach of other countries to regulation of the financial sector?

Aviva operates in 28 countries worldwide and therefore has experience of many different regulatory structures and approaches.

Structure
In some countries we are supervised by a single regulator such as South Korea (the Financial Supervisory Service), France (ACP, Autorite De Controle Prudentiel Banque de France) and Ireland (Central Bank of Ireland). The primary advantage to a single supervisor is that an integrated approach can be taken to the regulation of individual groups. There are also advantages of taking a cross-sector and integrated approach to market and industry-wide issues which can enhance consistency and efficiency.

In this regard there has been a trend internationally for regulators previously split by business sector (i.e. banking and insurance) to merge. The FSA can be considered to have been in the vanguard of this development.

However, in other jurisdictions we operate in there are multiple regulators and sometimes multiple levels of regulation. For instance, regulation in the USA is done at the national and state level. National financial service regulators include the Securities and Exchange Commission, the independent Financial Industry Regulatory Authority and the recently created Financial Stability Oversight Council. Insurance is regulated at the state level where the biggest challenges are improving uniformity and efficiency. The state regulatory system has, however, largely functioned effectively to protect consumers and the soundness of the industry. The benefits of state regulation include the ability for firms to have regular and meaningful interaction with the regulators, whereas there might only be limited opportunities with a federal regulator. Also, the state regulator is closer to both firms and their customers, and there are benefits to being 'close to the ground'.

The advantages of a differentiated system are that individual regulators can develop a deep understanding and competency over their particular remit and can apply specific skills and approaches.

We believe that the proposed FSA approach is entirely new and we do not have experience of a regulatory environment where the split is done by prudential and conduct activities.

Supervisory approach
Overall, we believe that it is the effectiveness of supervision, rather than the structure, that is key to achieving good outcomes.

One lesson clearly learnt from the approach of some countries to regulation is that a 'one size fits all' light touch environment is not a sustainable regulatory model. We believe it is crucial that regulators regulate in an intelligent, case by case, way and reward good systems and governance. We are now experiencing what we believe to be over-regulation in markets that previously adopted a light-touch approach.

Stability and consistency

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 regulators 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 which may be passed on to consumers. 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 new regulators 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.

Naming and shaming

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.

3. Is it appropriate to make such major changes to the regulatory system by way of amending legislation, rather than starting afresh?

We have no comments on this issue.

4. Are the accountability and governance arrangements for the Bank of England, FPC, PRA and FCA satisfactory?

Overall accountability arrangements need to be better defined to make clear who is ultimately responsible for decision-making within the system and to ensure clarity and transparency of responsibility between and within the different regulatory institutions. We also believe it is important that the decisions can be challenged and independently reviewed where appropriate.

We remain concerned that the appointment processes for the Court of the Bank of England, FPC and the Boards of the PRA and FCA are not transparent enough. Also, there should be requirements for these bodies to contain a balance of experience from within the financial services industry, including the insurance and asset management sectors. We recommend that provisions are added to the draft Bill to require the Treasury to explicitly consider the balance of experience required when it appoints independent members to the FPC and the Boards of the PRA and FCA.

The PRA's accountability would be strengthened by engagement with the Practitioner Panel, and we would like to see the draft Bill mandate this. Consideration should also be given to

enabling the Chairs of the Practitioner, Smaller Business Practitioner, Consumer and Markets Panels to formally engage with the FPC.

Parliamentary scrutiny of the regulators is necessary. We recommend that senior leaders within the regulatory structure (including the Governor, Deputy Governors, Chairs and Chief Executives of the regulators) attend sessions at the Treasury Select Committee. The discipline of attending sessions would sharpen focus amongst the Boards and Executive Management on delivery of their objectives.

5. Are the FPC's objectives the right ones? Is the concept of financial stability adequately understood for the FPC to be able to perform against its objectives?

The concept of financial stability is still being developed and properly understood, as can be seen by the fact that the FPC will have to develop its macro-prudential tools. Because thinking about financial stability is still relatively new, we believe it important that the FPC act carefully, taking into account the views of other regulatory actors and stakeholders.

We therefore believe that the FPC should undertake rigorous analysis of the potential impact and likely effectiveness of macro-prudential tools before it uses them. It should take care to use its macro-prudential tools in a proportionate and risk based way. We propose that the FPC be required to publish a cost-benefit analysis and consult, before giving directions to the PRA and FCA, and before making recommendations to the PRA, FCA and others.

We note that much of the thinking on financial stability and tools to enhance it have focussed on banking and are applicable to banks. As insurers have very different business models and engage in different activities to banks the use of tools developed for banks on insurers would be inappropriate. It is important that the FPC recognises this and targets its tools appropriately.

6. Should the FPC be limited in the actions it can take which might affect the growth of the financial sector?

Because macro-prudential tools could have a significant impact on the financial services sector and the UK economy, it is important that the FPC uses them carefully and takes account of the implications. We therefore support the Government's proposal that the FPC be required to take economic growth into account in pursuing financial stability. This requirement, coupled with a requirement to undertake cost-benefit analyses and a balanced membership which includes insurers, should provide an appropriate framework for action.

7. How will the interaction between macro-prudential and monetary policies be handled by the FPC and the MPC?

We have no comments on this issue.

8. Has the right balance been struck between the powers of the FPC and the powers of the Treasury?

This question relates to question 6, and the need for the FPC to be part of a wider public policy setting. Whilst we respect the need for the FPC to be independent, it is appropriate for the Treasury to be able to put forward its views in a transparent way. We therefore welcome the proposal for the Treasury to make recommendations to the FPC regarding the Bank's financial stability objective. This should help the FPC pursue its objectives and assist joined up policy making.

9. Can Parliament take an informed decision about the proposals for the FPC without details of the macro-prudential tools at its disposal?

This is an important point. Macro-prudential tools could have a significant impact on the UK economy and consumers but Parliament and others do not yet know what tools the FPC will have at its disposal. It is for this reason that thought needs to be put into appropriate mechanisms, such as consultation and cost benefit analyses, which will help ensure that the tools are only used when appropriate and proportionate.

10. Does the draft Bill adequately deal with the risks posed by the shadow banking system?

We believe that the provisions in the Bill which enable the FPC to recommend extensions to the regulatory perimeter provide appropriate safeguards – this will enable particular institutions or activities to be made subject to regulation where the risks could impact on overall financial stability.

11. Are the PRA's objectives clear and appropriate?

We welcome the fact that the PRA now has a specific statutory objective governing its responsibilities for the insurance sector.

We hope that the absence of a specific reference to promotion of the UK's financial services sector in the regulatory objectives will not lessen HM Treasury's and the authorities' appreciation of this.

12. Are there any risks in the Government's proposed 'judgement-based' regulation?

Yes. As the Chief Executive of the FSA said in a June 2011 speech on the PRA, *"It is inherent in the judgement-based system that both management and regulators will, at times and in hindsight, make mistakes.*" In our view, this makes it all the more important that decisions can be challenged and independently reviewed where appropriate. The ability to challenge decisions does not undermine judgement-led decision making, but means corrective action can be taken in the event that decisions made were not thought-through. The knowledge that decisions may be challenged and reversed may also lead to higher quality supervisory decisions.

An important way to maintain the challenge that currently exists is to reverse the HMT proposal that the Tribunal will not be able to direct the regulators. HMT proposes that the Tribunal should only be able to remit certain decisions back to the regulators for them to reconsider the matter. Instead, the Tribunal should continue to be able to direct the regulators to take a specific action.

13. Is the Government's proposed approach to 'orderly' firm failure satisfactory?

We would stress the inappropriateness of applying regulatory tools such as the Special Resolution Regime, which was designed to mitigate the risks posed by bank failures, to insurers. Banks and insurers have fundamentally different business models and their failures will have different impacts. Faced with a very large event, an insurer can fail; but in contrast to what we have witnessed in the banking sector, winding up an insurer is an orderly process that does not generate systemic risk.

14. Given that the PRA and the FCA will inherit FSA staff does the draft Bill do enough to ensure a new regulatory culture and a more proactive approach to regulation? Will these two new bodies have staff with the appropriate skill and expertise?

The PRA and the Bank of England's paper, 'Our approach to insurance supervision', the FSA's paper on the Financial Conduct Authority's approach to regulation and the FSA's Discussion Paper on product intervention indicate strong senior management support for a more pro-active approach to regulation. The attitude and actions of senior management will be more important than the text of the Bill in developing the culture of the new organisations.

Under a judgement-based approach it is more important than ever that staff are experienced and understand the business models, industries and products that their decisions will impact.

15. Are the FCA's primary objectives appropriate? Is significant emphasis given to the promotion of competition?

We consider the FCA's primary objectives to be broadly appropriate. 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.

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. There is a risk that without formal FCA recognition of the benefits of financial services that it could engage in continual and far reaching consumer protection activities that could lead to unintended consequences - such as reduced consumer engagement with financial services. This could lead to wider public policy issues, such as low rates of long term saving or protection from risks. We recommend that the consumer protection objective be amended to require the FCA to have regard to the potential benefits of consumers accessing financial products that meet their needs.

16. Are the responsibilities of the FCA towards the regulation of markets appropriate?

We have no comments on this issue.

17. Does the draft Bill strike the right balance between the responsibilities of consumers and firms? Are the FCA's new powers in the area of consumer protection appropriate?

We welcome the proposal that consumers should take responsibility for their own decisions.

Perhaps the most important area where the FSA and FCA intend to take consumer protection action is on product intervention. We welcome the spirit underpinning the policy – i.e. the desire for earlier intervention to tackle badly designed products, or those products which are targeted at inappropriate customer segments or sections of society. However, there may be unintended consequences of such a policy. Specifically, frequent use of product intervention rules could put at risk product innovation and harm competition. An overly interventionist approach could result in a narrow and homogenised product suite which does not benefit consumers.

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. One way to achieve this is to amend the consumer protection objective to the effect that the FCA should have regard to the potential benefits of consumers accessing financial products that meet their needs.

We also believe there are areas where new consumer protection powers could harm the reputation of firms, and the industry as a whole, without leading to significant benefits for consumers. This could occur, for example, when a regulator publishes a warning notice but decides not to take forward enforcement action. Regulators should consider representations from firms before publishing warning notice and, when they do so, should also publish the views of the firm.

As the FCA will have stronger consumer protection powers we believe it important that firms have *more* opportunity to challenge decisions, not *less* -as proposed in the Draft Bill. So, the HMT proposal that the Tribunal will not be able to direct the regulators should be reversed. HMT proposes that the Tribunal should only be able to remit certain decisions back to the regulators for them to reconsider the matter. Instead, the Tribunal should continue to be able to direct the regulators to take a specific action.

18. Are the prudential regulatory responsibilities of the FCA towards FCA-only regulated firms given sufficient emphasis and detail?

We have no comments on this issue.

19. Will the new regulatory arrangements reduce the risk and cost of dealing with miss-selling of financial products?

Initiatives such as the Retail Distribution Review and the shift towards product intervention are likely to have more of an impact on the incidence of miss-selling than the regulatory structure. We have long considered that it is the effectiveness of supervision, rather than the structure, that is key.

20. Are the proposals for co-ordination between the PRA and FCA clear and adequate? What would be the advantages and disadvantages of having a Single Point of Contact and/or a joint rule book for dual-regulated firms?

We note the Treasury's intended approach is for operational matters such as inter-agency coordination to be governed though a series of Memorandums of Understanding (MoUs) and not through primary legislation. We welcome the fact that the PRA and FCA will be under a 'duty to co-ordinate' and be obliged to produce a MoU setting out how they will deliver this duty.

The new authorities should share information and resource to prevent duplication of activity, interaction with firms and to minimise operating costs to both themselves and dually-regulated firms. To help achieve this, firms should have a single process for standard interactions like notifications, changes to permissions or SIF approvals.

We strongly believe that the Bill should include a specific requirement on the regulators to identify areas of activity that can be undertaken centrally to reduce firm costs and enable more efficient interaction with firms.

The White Paper states that the Government does not believe it would be appropriate to require the regulators to put in place a joint rule book. We disagree with the Government. A single UK view is necessary for negotiations in developing European regulation and therefore a single UK rule book should naturally flow from this and would mitigate the risk of differing interpretations of the same EU requirements between the new authorities.

21. How do the proposals in the draft Bill fit within the new European regulatory regime? What freedoms and constraints will the UK have to operate within that regime?

As the twin peaks structure will not map easily across to the new European regulatory regime it is critical that there are robust co-ordination processes in place to enable the UK authorities to agree EU engagement strategy. 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.

We believe that there may be merit in setting up a forum or secretariat in relation to EU and international engagement. It could help co-ordinate strategy and support activity by the regulatory actors (but should not be a barrier to action).

The new European Supervisory Authorities 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. They should also be well equipped to engage with international bodies such as the International Association of Insurance Supervisors, International Organisation of Securities Commissions and the Financial Stability Board.

22. Does the draft Bill contain any proposals or omissions, not covered by the questions above, which cause concern?

We believe that the draft Bill offers a good opportunity to update the Financial Ombudsman Service (FOS). We agree that the industry needs an independent arbiter of complaints for those cases when there is an impasse between firm and consumer. However, we have some concerns about the FOS' accountability, the quality of decision making and of the risk of wider application of FOS decisions. There remains a risk that a poor decision made by the FOS may be applied widely to other similar cases. At the moment there is little room for challenge after an Ombudsman has given his ruling.

We would like to ensure that there are appropriate checks and balances to guard against seriously erroneous decisions. An adverse determination may have the potential to cost millions of pounds and the lack of a viable means of appeal is fundamentally unfair to firms. Firms should be able to refer decisions with a material impact to a higher authority; and the tests for doing so, while high, should not be prohibitively so. Currently, where firms have cause to challenge an adjudication they must ask for the case to be referred to an Ombudsman, after which the only recourse is to apply to the High Court for judicial review. The threshold for establishing grounds for judicial review is very high and the process is very costly.

We recommend that firms, trade associations or the FOS should be able to refer significant cases to the FCA or the Tribunal. Our preference is for firms to be able to refer significant cases to the Tribunal as this would encourage the FOS to be cognisant of the baseline legal obligations.

September 2011

AXA Group – written evidence

A Joint Committee (the Committee) has been appointed by both Houses of Parliament to conduct pre-legislative scrutiny of the draft Financial Services Bill. It consists of 6 MPs and 6 members of the House of Lords. The Committee has published a request for written evidence. The Committee has raised generic questions about the proposals and specific questions about the details of the draft Bill as follows:

Generic questions

The Committee is interested in whether the draft legislation will or could:

- Prevent another financial crisis.
- Handle a financial crisis.
- Deal with bank failure and protect the public purse.
- Increase or decrease the risk of regulatory arbitrage of financial businesses.

Specific questions

1. **Is the separation of prudential and conduct regulation into a "twin peaks" system the right approach?**

   We feel that this is only the right approach if there is sufficient clarity and attention to the detail in the arrangements between the two regulators to ensure the scope of responsibility, and associated accountability, is clear and transparent. This proposed approach could lead to considerable inefficiencies, additional costs and overlapping jurisdictions between the PRA and FCA. For example, there is a potential for the two regulators to reach different conclusions regarding the approval of a firm and/or individuals. We are concerned that the proposed dual registration may cause confusion to consumers.

   We are concerned that the regulatory changes proposed will result in a fragmentation of the regulatory system. The risk is that this will lead to duplication, overlapping responsibilities, numerous fees and may result in operational weaknesses and avoidable complexities.

   We are concerned with the initial cost of implementing the changes as well as the potential ongoing supervisory costs due to the dual regulation of firms. The Government has estimated the cost of implementing the proposed changes to be between £195-325 million and ongoing costs of £25m to £100m. We agree with the Treasury Select Committee's recommendations (paragraph 37 – 41- conclusions and recommendations) in its report published 3 February 2011 concerning the cost of regulation. This should be revisited to ensure that the cost of the proposals do not outweigh the benefits.

2. **What lessons can be learnt from the approach of other countries to regulation of the financial sector?**

   No comment.

3. **Is it appropriate to make such major changes to the regulatory system by way of amending legislation, rather than starting afresh?**

   Amending the existing legislation is the quickest way to achieve the Government's changes to the regulation system. However, we are concerned with the speed with which the Government is making these regulatory changes. We think the Government

should take the necessary time to ensure the reform of the regulatory regime is fit for purpose and is proportionate rather than rushing the changes through. We believe this draft Bill should only be presented after full consideration has been given to the proposals by this Joint Committee.

4. Are the accountability and governance arrangements for the Bank of England, FPC, PRA and FCA satisfactory?

We have set out our concerns regarding each entity Below:

The Bank of England

We welcome the Treasury Select Committee's (TSC) inquiry into the accountability of the Bank of England. We believe the Government must consider the TSC's findings and further conclusions reached during the pre-legislative scrutiny before taking these proposals further as we feel that there is too much responsibility given to the Bank.

FPC

We believe the FPC's accountability measures should be strengthened. Any decisions made by the FPC to respond to potential risks identified should be supported by evidence and take note of EU directives and other international developments. The FPC should be required to publish information about the macro prudential tools it will use. These must reflect the diversity of the financial services sector and not be focused on banking, for example,, to ensure sufficient consideration is given to other financial sectors such as insurance and investment management.

We believe all of the external members of the FPC must be appointed by the Chancellor of the Exchequer. We believe these external members should have diverse industry experience and not just from academia.

The experience of the committee members should be balanced and the governance structure should allow for challenge by all members. This is key in view of the EU developments and the fact that the European Systemic Risk Board (ESRB) has a strong banking focus.

We note the interim membership of the FPC. We are disappointed that the recently appointed independent members of the FPC do not adequately reflect the diverse nature of the financial services industry. Although the Government recognises the importance of insurance expertise within the FPC this does not appear to be fully reflected in the current make-up of the interim committee.

The Government should also consider the Treasury Select Committee's recommendation in its report dated 7 February that one of the external members should have 'recent experience of risk management at the highest level'. It is not apparent that the current external membership reflects this recommendation.

PRA

We note that the Government has given the PRA an insurance objective. However, we remain concerned that the PRA will have a more banking focus as a subsidiary of the Bank of England. We also question why the ex officio Chairman of the PRA will be the Governor of the Bank of England as we feel the governance would be strengthened if

the chairman was independent of the Bank of England. We note that the Board of the PRA will have a non executive majority. It is essential that the experience of the non executive directors reflects the firms regulated by the PRA. We note that appointments to the Board of the PRA will be made by the Bank of England with approval by the Treasury as such we question how independent the PRA will be. We think the chairman and other members of the governing body should be appointed by the Treasury as currently required for the FSA, under Schedule 1 of FSMA 2000.

We believe that any decisions made by the PRA must be approved by its Board which should include non-executive directors except where a conflict of interest may arise.

We also note that draft Bill does not set out the internal organisation structure of the PRA and acknowledge that this is the detail to be agreed at a later date. However, we are concerned that insurance firms may be subject to regulation designed for the banking industry. As such we feel it appropriate for the PRA to be structured on a divisional basis so that banking and insurance firms are dealt with separately. We feel that this will help ensure appropriate decisions are made with respect to minimum capital requirements and other prudential requirements.

FCA

We welcome the proposed inquiry into the accountability arrangements for the FCA and until their recommendations are published have no further comments.

5. Are the FPC's objectives the right ones? Is the concept of financial stability adequately understood for the FPC to be able to perform against its objectives?

The FPC's objectives must consider the diverse nature of financial services and the risk of each sector to the stability of the financial system. The FPC's responsibilities must also consider the global factors which could impact the resilience of the UK system.

The draft Bill outlines that the Court of Directors will determine the Bank's strategy in relation to the Financial Stability Objective. We believe that both the Government and the Bank should clearly set out what they understand to be financial stability before the Bill goes to Parliament. We feel that "Financial stability" should also be considered in from an international perspective given the increasing global nature of financial services.

6. Should the FPC be limited in the actions it can take which might affect the growth of the financial sector?

The FPC will be given power of direction over the PRA and FCA. Any powers of direction must consider the diversity of the financial system. For example, recommendations applicable to banks would be over burdensome to other sectors. The FPC must also consider the EU and international initiatives so that the UK remains a competitive market.

7. How will the interaction between macro-prudential and monetary policies be handled by the FPC and the MPC?

No comment.

8. Has the right balance been struck between the powers of the FPC and the powers of the Treasury?

Please refer to our earlier comments in response to question 4.

9. Can Parliament take an informed decision about the proposals for the FPC without details of the macro-prudential tools at its disposal?

We believe that Parliament must understand the macro-prudential tools the FPC will use so that it can assess whether the FPC will achieve its financial stability objective. Parliament must also be able to scrutinise the Bank's strategy in relation to financial stability so that it can understand whether these tools will be sufficient to meet the FPC's objective.

10. Does the draft Bill adequately deal with the risks posed by the shadow banking system?

No comment.

11. Are the PRA's objectives clear and appropriate?

We feel that the objectives could benefit from greater clarity. The PRA's general objective is clearly a micro-prudential objective (draft section 2B(2)). However the manner in which it will meet this (draft section 2B(3) objective appears to focus on financial stability issues which is a macro prudential objective. We believe the PRA should be focusing on the financial soundness of individual firms and not looking at wider macro prudential issues which is the responsibility of the FPC. This is the Government's aim for these regulatory proposals, with 'a new macro-prudential body , the Financial Policy Committee, and a new micro-prudential supervisor, the Prudential Regulation Authority.' If there is regulatory overlap there is the potential that 'centres of excellence' will not be achieved which is clearly the aim of the Government's regulatory reform.

We agree the PRA should have an insurance objective. However we are unclear how firms and the regulator can provide protection for those who may become policyholders of a firm.

12. Are there any risks in the Government's proposed 'judgement-based' regulation?

We question whether a judgement led approach will work since EU directives now follow a more detailed and prescriptive approach. We also think the PRA needs to reflect the requirements set at European and international level.

We are concerned that this judgement led approach appears not to include any adequate or robust appeal mechanisms and that there is a risk that an 'unlevel' playing field results in respect of how comparable firms are supervised.

13. Is the Government's proposed approach to 'orderly' firm failure satisfactory?

It is essential that any recovery and resolution plans should reflect the diversity of the financial system. Recovery and resolution plans applicable to banks will not necessarily be appropriate for other firms. If an insurer fails, its liabilities will fall due over an extended period which allows time for management action and regulatory intervention. This is reflected in the rules governing the payment of a protected contract of insurance where continuity of cover may be secured by transferring the business to another insurer.

14. Given that the PRA and the FCA will inherit FSA staff does the draft Bill do enough to ensure a new regulatory culture and a more proactive approach to regulation? Will these two new bodies have staff with the appropriate skill and expertise?

The Bill can only set out the obligations and objectives of the PRA and FCA. How these will be met by the PRA and FCA will depend on the quality of the senior management team and staff. It is difficult to comment on whether the two new bodies will have staff with the appropriate skill and expertise. However it is essential the two bodies recruit staff with appropriate experience which should include industry experience.

15. Are the FCA's primary objectives appropriate? Is significant emphasis given to the promotion of competition?

We feel that there is a fine balance between protecting consumers and imposing excessive regulations. The FCA must ensure in discharging its 'functions in a way which promotes competition' that it considers the international character of financial services and the impact of any decision on the competitiveness of UK firms. The implementation of EU rules must not be 'gold plated'. This will ensure that UK firms can easily compete in Europe without additional onerous requirements and to help ensure that European firms with investments in UK financial services firms remain and do not withdraw from the UK market.

The FCA should also consider the appropriate type of protection as well as the appropriate degree of protection afforded to consumers. This will help ensure that the protection being considered is proportionate to the benefit so that the industry can work effectively and provide product choice to the consumer.

16. Are the responsibilities of the FCA towards the regulation of markets appropriate?

No comment.

17. Does the draft Bill strike the right balance between the responsibilities of consumers and firms? Are the FCA's new powers in the area of consumer protection appropriate?

The draft Bill does provide some balance between the responsibilities of consumers and firms, particularly with the inclusion of the general principle that consumers should take responsibility for their decisions.

However, we have some concerns regarding the new powers of intervention the FCA will be given with regards to products. We believe that, rather than create new regulations, the Government should allow regulatory change already in progress, such as the RDR and enhanced supervisory approach, to take effect and require the FCA to focus on consistent supervision and enforcement of the existing requirements to ensure firms treat customers fairly.

The widespread problems that have arisen in recent years have not necessarily been attributable to the product itself but the sales process. Firms are always looking to develop products to provide enhanced benefits which will benefit consumers. This provides a healthy competitive market. Therefore, we believe that the FCA should not just focus on products but also look at the sales process.

We are not in favour of the regulator stipulating mandatory minimum standards for products. We think this should be reached through industry level agreement and codes of practice. Providing minimum product standards could also stifle innovation and the competitive market place. We note that the Treasury Select Committee in its report on the preliminary proposals (para 118) recognises that 'competition is a highly effective means of protecting consumers' interests'.

The Government states that the FCA will not be conducting a product pre-approval process. However we feel that there is a risk that consumers will perceive the interventionist approach as a pre-approval mechanism which is misleading. We are not in favour of any pre-approval approach.

We are not in favour of the new power to publish warning notices. This seems to be contrary to natural justice and the principle that an individual is innocent until proven guilty. We are particularly concerned that publishing a warning notice could ruin the reputation of both firms and individuals who may later be found not to be at fault. We feel that if warning notices are to be given these must be directed at the relevant individual/firm only after the outcome of the full investigation/hearing. We have recommended that the Government should review the number of warning notices issued by the FSA compared with the number of final notices in order to assess whether this new power for early publication of enforcement action is appropriate.

18. Are the prudential regulatory responsibilities of the FCA towards FCA-only regulated firms given sufficient emphasis and detail?

Yes.

19. Will the new regulatory arrangements reduce the risk and cost of dealing with mis-selling of financial products?

There are a number of factors which should reduce the risk and cost of dealing with mis-selling financial products in addition to the new regulatory arrangements.

Firms have been focusing on delivering the FSA's Treating Customers Fairly outcomes in order to help ensure the fair treatment of consumers and reduce consumer detriment.

Current and proposed regulatory changes to improve the financial services market will also help reduce the risk of financial products being sold badly. These include for example the FSA's enhanced supervisory approach, the Mortgage Market Review, the Retail Distribution Review, changes to the Payment Protection Insurance market.

We also note the Government's commitment to the FCA taking earlier and more proactive action than the FSA. However we are not in favour of additional burdensome regulation where the cost of regulation outweighs the benefits. We would not be in favour of a very restricted market where regulation stifles innovation and limits consumer choice.

20. Are the proposals for co-ordination between the PRA and FCA clear and adequate? What would be the advantages and disadvantages of having a Single Point of Contact and/or a joint rule book for dual-regulated firms?

We understand that the primary legislation will specify the legal duty for the PRA and FCA to coordinate their activities and that the detail on how the PRA and FCA will coordinate these activities will be set out in a Memorandum of Understanding. However it is essential, to minimise regulatory overlap, that the regulators are open

and transparent when creating these mechanisms. It is essential for the regulators to consult stakeholders and this requirement should be set out in the primary legislation. We welcome the proposal that the Bank and the FSA will be required to produce a draft of the MoU in time for the introduction of the Bill to Parliament. The joint Committee should also be given the opportunity to scrutinise the MoU.

We remain concerned that there is the potential for the dual regulator/twin peaks approach to lead to considerable inefficiencies, additional costs and overlapping jurisdictions. It is essential that the PRA and FCA do not duplicate each others' activities.

We have previously commented in response to the Government's earlier consultation papers that a centralised body would be appropriate for the following activities:

- Authorisation of firms and individuals, including variations of permissions
- Collection of all fees and levies.
- Inward and outward passporting
- Notifiable events
- Changes in control
- Close links reporting
- Changes to standing data.
- Appointed Representatives
- A relationship manager to coordinate supervisory activities for dual regulated firms.

We feel that this will help ensure coordination of activities. This centralised body will have the appropriate expertise to provide both prudential and conduct approval and allows expertise to be built up in a centre of excellence which should create greater efficiency.

21. How do the proposals in the draft Bill fit within the new European regulatory regime? What freedoms and constraints will the UK have to operate within that regime?

The proposed UK architecture does not appear to align to the new European Supervisory Authorities structure. These authorities have been established based on sectors rather than on function, for example, prudential and conduct. It is essential that the UK Regulators continue to influence and guide the setting of EU rules. It is therefore essential that UK representatives on the ESAs have a high degree of technical skill as well as the skills necessary to influence as appropriate. In particular we remain concerned that insurance firms may not be appropriately represented on EIOPA, due to the PRA's potential banking focus.

We note the proposals regarding international coordination and the MoU between the new regulators. However, the regulators must ensure that as it focuses on establishing its new domestic regulatory approach, any EU and global regulatory changes are not overlooked.

We think there is a need for a central international division to represent the UK on the new EU supervisory committees and other international fora. This international division could also ensure that the existing memorandum of understanding currently

between the FSA and other international regulatory bodies continues with the appropriate new regulator.

22. Does the draft Bill contain any proposals or omissions, not covered by the questions above, which cause concern?

No.

September 2011

Bank of England – written evidence

This note offers some preliminary responses to the Joint Committee's call for evidence. The Joint Committee asks whether the draft legislation will or could better

- Prevent another financial crisis
- Handle a financial crisis
- Deal with bank failure and protect the public purse

In short we believe that the legislation can contribute materially to these objectives

- Through improving the regulation of banks, insurance companies and the largest investment firms by creating the Prudential Regulation Authority as part of the Bank of England, with specific responsibility for promoting the safety and soundness of authorised firms. Transferring responsibility to the Bank will bring greater integration with the Bank's lender of last resort, market intelligence and analytical functions; but it does not in itself guarantee successful outcomes. However the Bank and the FSA have published two documents setting out a new regulatory approach, which will be forward looking, directed at the principal risks facing institutions, informed by the macro-prudential analysis from the FPC, and incorporating, for the first time in the UK, a Proactive Intervention Framework to ensure that problems once identified are effectively tackled. This approach, building on developments already in train within the FSA, marks a significant departure from the former prudential framework. Copies of the two launch documents are attached.

- By emphasising the need to resolve the affairs of a failed bank with minimum disruption to the financial system as a whole. The key change here was the creation, in the 2009 Banking Act, of a special resolution regime in the Bank of England, and in the subsequent work to create Recovery and Resolution plans for major banks in the context of international work on the resolution of SIFIs. The draft Bill makes clear that the aim is not to prevent failure but to anticipate and limit the impact of failure.

- By putting oversight of settlement and clearing systems in the Bank alongside payment system oversight, so benefitting from the Bank's role at the heart of the sterling payment and settlement process.

- By creating clear lines of accountability for dealing with financial crises, large and small. Prime responsibility for managing crises lies with the Bank, but with two crucial caveats: first, any decisions involving the use of public funds are taken by the Chancellor; and second, the Governor will be under a statutory duty to keep the Chancellor informed at all times and in particular to flag concerns that might at some stage require a decision on the use of public funds.

- Through the creation of the Financial Policy Committee (FPC), ensuring that systemic risks that may not be evident to a prudential or securities market regulator are identified, and that the Committee has the powers necessary to improve the resilience of the system. The FPC has already been formed on an interim basis within the Bank and is developing its analysis of the macro-prudential tools made possible by the proposed legislation, and the processes under which the Committee will operate.

We elaborate on these points in an Annex to this paper, answering a number of the Committee's specific questions. As the Committee may be aware from the Bank's recent evidence to the Treasury Committee, we have some specific concerns about details of the Bill in its present form, and these too are covered in the Annex.

We will be happy to provide further evidence and to discuss with the Committee these and any other points relating to the proposed legislation and the Bank's role in implementing it.

August 2011

ANNEX

SPECIFIC QUESTIONS POSED BY THE COMMITTEE

In the responses below we have retained the Committee's numbering of the questions but ordered and grouped some differently to avoid repetition.

1 *Is the separation of prudential and conduct regulation into a twin peaks system the right approach?*

We believe it is. There is a difference in culture and approach: the conduct supervisor traditionally looking backwards to identify and punish misdemeanours; the prudential regulator looking forward to identify risks and to ensure that a firm's management is addressing them. The conduct supervisor can measure success partly by enforcement, convictions and fines: the prudential supervisor seeks to ensure the continued prudent management of firms in the interests of the system as a whole. Putting these two cultures together was a mistake, and in our view directly contributed to the FSA's taking its eye off the build up of prudential risks in a number of major institutions.

2 *What lessons can be learned from the approach of other countries to regulation of the financial sector?*

There are many possible ways of organising regulation, but regardless of institutional structure the most important lessons from our and other countries' recent experiences are:

(a) the need to restore an emphasis on prudential regulation, and for prudential supervision to focus on risks to the system as a whole rather than the failure of any one institution

(b) the need for effective procedures ensuring that firms can be wound down and resolved in the event of prospective failure. The need to think ahead to the management of failure should be a starting point of effective regulation, not an add-on

(c) the need for senior staff, and particularly those at the interface with regulated institutions, to have the expertise, experience and maturity to exercise judgment

(d) not letting prudential regulation take second place to "quick wins" on enforcement and consumer redress

(e) the drawbacks of complexity in bank structures and opacity of risk management techniques. Supervisors need to have the confidence to insist on simplicity, including in their own rules.

We have in particular studied the "twin peaks" regimes in Australia, Belgium, France and the Netherlands. The benefits of clearly delineated responsibilities and roles were clear – as were the importance of strong mechanisms to ensure co-operation. We noted the risk that the conduct regulator might become over legalistic; however that risk arises also where the functions are combined in a single body, with consequent risk to the effectiveness of the prudential regulators.

3 *Is it appropriate to make such major changes to the regulatory system by way of amending legislation rather than by starting afresh?*

As a general point, we think that the legislation could have been made simpler, more direct and therefore more effective if it had not been decided at the outset to establish the new prudential regime by way of a series of amendments to the Financial Services and Markets Act (FSMA).

FSMA is essentially a piece of securities legislation adapted to, inter alia, prudential regulation. Securities and investment regulation is concerned with compliance and enforcement and punishing breaches. Prudential regulation is essentially forward-looking, and our intention is to place greater emphasis on this as set out in the two launch documents.

4 *Are the accountability and governance arrangements for the Bank of England, FPC, PRA and FCA satisfactory?*

The Bank recognises and supports the need for effective accountability arrangements for its new responsibilities. It has demonstrated its commitment to accountability on its monetary policy decisions and is determined to replicate this for the FPC and PRA.

Accountability on policy issues should be to Parliament, to the public and to Government. The arrangements proposed for the FPC have much in common with those for the MPC. A record of the policy meetings will be published, setting out the decisions taken and the balance or argument surrounding those decisions. A twice-yearly Financial Stability Report will be published under the FPC's authority. All members will be able to set out their personal views in public on the issues raised by the decision and the records. So the presentation of policy will be far from monolithic and this will assist the Treasury Committee and relevant Committees of the Upper House in exploring the issues in hearings. And also following the MPC precedent, newly appointed members will attend confirmation hearings at the Treasury Committee. This applies of course to the "internal" members as well, for they too are for the most part Government appointees.

The FPC will include six members from outside the Bank: four independent external members, appointed by the Chancellor; the head of the FCA and a (non-voting) Treasury member. The PRA will have independent members as well, and although a subsidiary of the Bank will make its own Annual Report to Parliament. The Bill provides that in the event of a regulatory failure a report should be provided for the

Treasury and for Parliament; there will also be a formal complaints scheme.

We believe that these arrangements taken together provide for effective accountability to Parliament and the public for the Bank's new Financial Stability functions. We do not however think it would be right to retain the Practitioners Panel and other forms of accountability to the industry, which are essentially legacies of the old self-regulatory arrangements that preceded FSMA.

In relation to the internal management of the Bank, the Executive is accountable to a Board ("Court") of non-executive Directors, which under arrangements set out in the 1998 Bank of England Act keeps under review the Bank's performance including its financial performance and efficiency. The Court, and separately the non-executives, make an Annual Report to Parliament, and may be called to give evidence to the Treasury Committee at any time.

5 *Are the FPC's objectives the right ones? Is the concept of financial stability adequately understood for the FPC to be able to perform against its objectives?*

9 *Can Parliament take an informed decision about the proposals for the FPC without details of the macro-prudential tools at its disposal?*

We believe that the FPC's objectives as set out in the proposed legislation are appropriate. Financial Stability is not a new concept: the Bank has had a Financial Stability Objective for many years (although this has been a statutory objective only since the 2009 Banking Act). As set out in the White Paper, the Interim FPC will undertake an analysis of the potential regulatory tools that might be deployed and will make recommendations to the Treasury (for public debate) in time for the Committee Stage of the Bill.

6 *Should the FPC be limited in the actions it can take which might affect the growth of the financial sector?*

The growth of the financial sector is not a good in itself, and unconstrained growth may involve social costs as recent experience amply demonstrates. Certainly the sector plays an important role in supporting economic activity, and there is therefore already a provision in the draft legislation (9C(4)) that the FPC is not required or authorised "to exercise its functions in a way that would in its opinion have a significant adverse effect on the capacity of the financial sector to contribute to the growth of the UK economy in the medium or long term". We think that strikes the right balance, and certainly would not support, either for the PRA or for the FPC, a duty to have regard to the growth or competitiveness of the UK financial sector or the success of London as a financial centre. Effective regulation itself underpins the standing of markets and firms.

7 *How will the interaction between macro-prudential and monetary policies be handled by the FPC and the MPC?*

It is important that both sets of policymakers are aware of, and to some extent can anticipate, the actions of the other in order that they can formulate the appropriate policy stance to meet their individual objectives and take account of the interactions

between policy settings. This will be achieved primarily through the substantial cross-membership between the two Committees, and through shared staff support.

Some commentators have suggested that there might be scope for the two sets of policies to conflict. We do not believe this is likely to be a material problem in practice. The MPC and FPC have quite different objectives – the MPC for meeting the inflation target, and the FPC for ensuring the stability and resilience of the financial system as a whole. They will also have a completely distinct set of instruments. It is conceivable that the FPC might occasionally choose to 'tighten' its policy instruments (for instance, to slow the expansion of the financial system) at a time when the MPC might wish to 'loosen' its own policy stance (for instance, because the medium term outlook for inflation had fallen). But far from reflecting a conflict between the two frameworks this shows the value of extending the policy toolkit. By itself, monetary policy could not conceivably achieve both objectives simultaneously. Equipping the FPC to pursue macro-prudential stability reduces the constraints on monetary policy, and vice versa.

8 *Has the right balance been struck between the powers of the FPC and the powers of the Treasury?*

The powers that the FPC will exercise come from Parliament and it is the Treasury that must sponsor (for example) the direction making powers under Clause 9K, which require positive affirmation by Parliament.

Beyond this, the Treasury will have an important oversight role. In setting the Financial Stability Strategy, the Bank must consult the Treasury. The Treasury may at any time, and must at least annually, make recommendations to the FPC (Clause 9D). And the Treasury has a seat on the FPC. However after experience of the Tripartite, the intention was to make it absolutely clear who was to be responsible and held accountable for macro-prudential interventions – and that, under these proposals, would be the Bank. Any decisions that involve the use of public funds would however of course remain for the Chancellor.

21 *How do the proposals in the draft Bill fit in with the new European Regulatory regime? What freedoms and constraints will the UK have to operate within that regime?*

The Committee should be aware that there is a significant risk that the discretion of national regulators may be curtailed by the tendency in European law to maximum harmonisation. For example, the European Commission has recently published a draft Capital Requirements Regulation (CRR) and a draft Capital Requirements Directive (CRD), through which it intends to bring Basel III into EU law.[2] The aim is a Single Rule Book for banking regulation. This means that national authorities will not be able to adopt more stringent rules even if national conditions warrant them. There is no economic logic for this view. In particular, where national regulators wish to take measures to limit exposures of their taxpayers these proposals would prevent them doing so. The Commission is taking a doctrinaire view of harmonisation that goes beyond that warranted by policy needs.

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[2] http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm

While the FPC is likely to have scope to utilise certain pre-defined macroprudential tools, such as the countercyclical capital buffer in Basel III, the trend towards maximum harmonisation in EU regulations may make certain other tools difficult to implement fully without the risk of legal challenge.

Similarly, the European Market Infrastructure Regulation, which implements G20 commitments on central clearing in the EU, may constrain the FPC's ability to use one of the tools set out in the February 2011 consultation document (a tool relating to changing margin requirements for derivatives transactions).

10 *Does the draft Bill adequately deal with the risks posed by the shadow banking system?*

There is no agreed definition of "shadow banking", but we define the term to mean the provision of bank-like services (credit intermediation, payment or deposit services) by entities not regulated as banks, and which take bank-like risks (maturity transformation and/or leverage). A single entity acting precisely as a bank should of course be regulated as one. But a number of entities each undertaking some aspects of banking activity and risk can interact with each other so that the system as a whole acts as a bank. The entities most frequently seen in these roles include money market funds, securities lenders, asset-backed commercial paper conduits and structured investment vehicles. Some have declined in size since the crisis; others are still substantial.

The G20 FSB has work in hand to identify and monitor the scale of such activity and to consider regulatory options. In the latter context it is important to distinguish between activities that represent clear systemic risks and those that do not. Typically the systemic risks arise where there are close connections to the banking system itself, and may be addressed through oversight of the regulated banks. Many non-bank entities can fail without posing risks to the system or burdens on the taxpayer. A number of hedge funds did so during or after the crisis. Only the investors lost money.

The Bill gives the FPC the objective of identifying systemic risks arising from unregulated (including shadow-banking) activities. It can highlight specific shadow banking risks in its Financial Stability Report and in other public pronouncements, and it can use its powers of recommendation and direction to contain any risks to the system. Where necessary it can also recommend to the Treasury that an activity be brought within the regulatory perimeter.

If the FPC is to discharge this responsibility effectively, it will require sufficient information to identify and tackle the risks to the extent appropriate to meet its objective. As noted in the reply to question 22 below, the Bill does not fully provide this.

11 *Are the PRA's objectives clear and appropriate?*

Yes. The PRA is to promote the safety and soundness of PRA-authorised institutions, avoiding adverse effects on the stability of the UK financial system and minimising the impact of failure. Importantly, the Bill emphasises that the PRA is not required to prevent individual firms failing.

It is right that insurance supervision should have a separate objective, since the nature of insurance business and the risks it gives rise to are very different from those of banking. We do however have a concern about Clause 3F of the draft Bill, which allocates to the PRA sole responsibility for protecting the "reasonable expectations" of with-profits policyholders. This is a nebulous concept and we think that the legislation should explicitly provide a role for the FCA in advising the PRA on these matters.

12 *Are there any risks in the Government's proposed "judgment-based" regulation?*

14 *Given that the PRA and the FCA will inherit FSA staff does the draft Bill do enough to ensure a new regulatory culture and a more proactive approach to regulation? Will these two new bodies have staff with the appropriate skill and expertise?*

The Bill itself cannot deliver a change in culture. It is for the Bank to ensure that the PRA delivers the style of supervision set out in the Government's Consultative Documents and the Bank/FSA launch documents for banking and insurance regulation.

We acknowledge that this will be a considerable challenge. Relevant FSA staff will be transferring to the PRA on TUPE terms. Work has already started to assess the competencies of those likely to join the PRA by this route and the extent to which further recruitment and organisational change will be necessary.

13 *Is the Government's approach to "orderly" firm failure satisfactory?*

This is an integral part of the new regulatory model and is we believe necessary to effective regulation. The Bank and the PRA will continue to attach high priority to the development of recovery and resolution plans for all institutions, and to extending them to cover SIFIs in line with FSB and EU policies.

20 *Are the proposals for co-ordination between PRA and FCA clear and adequate? What would be the advantages and disadvantages of having a Single Point of Contact and/or a joint rule book for dual regulated firms?*

We think the Bill is sufficiently clear in identifying the regulators' duties as well as the regulatory principles to which they must have regard in order to achieve these results.

Given the separate application of prudential and conduct rules, we see no advantage in having a single rule book and we are not aware of a twin peaks regime overseas that applies this approach. We are aware that some firms have asked for a "one stop shop" – but it was in acceding to that request 13 years ago that the Government created the FSA, which is now clearly seen to have resulted in a blurring of supervisory mandates and a failure to give adequate focus to prudential regulation.

That said, the regulatory principles in the Bill should operate to require the regulators to give active consideration to a single point of contact on particular processes (eg data collection).

22 *Does the draft Bill contain any proposals or omissions, not covered by the questions above, which cause concern?*

As noted in our response to question 10, we are concerned that the FPC does not have a power to gather information directly. It can formally recommend to anyone that they should provide it with information but has no powers to require them to do so. Consequently, the FPC's ability to ensure that it has the information it needs relies heavily on the extent of the regulators' own information powers. These powers are relatively extensive in relation to UK regulated firms but much more limited[22] for unregulated firms. The Treasury has a power to extend the scope of this power to cover further classes of unregulated person if they pose, or would likely to pose, a serious threat to financial stability. Clearly a balance must be struck between protecting against risks from outside the regulated community and imposing a burden on unregulated firms. But the current requirement to show a "serious threat" before the scope can be widened will make it more difficult to identify and monitor the scale of these risks.

The FPC can make recommendations but not binding directions on the timing and the means by which the regulators implement an FPC direction. Although the Bank has accepted the current formulation of the FPC's direction power, we would have preferred if the legislation had permitted for some macro-prudential tools to confer on the FPC the right to direct the regulators as to how they should implement an FPC direction and on what timeframe.

The Bill enables HMT to allow the Bank to elaborate on *existing* requirements for CCPs but not to set any new requirements. This limitation has been imposed on grounds that the upcoming EU regulations (the European Market Infrastructure Regulation) will provide the regulatory framework for supervision of CCPs and may not let national authorities set requirements of their own. Even if this were not the case, the Bank would be unable to respond to an FPC request in this area as the Bill gives no power for the Bank to impose legal requirements on CCPs.

The draft legislation will introduce a new "business model" condition that firms must satisfy, and continue to satisfy, in order to remain authorised. As drafted, this requires the firm to show that its business model is suitable. We would prefer that the clause was drafted to require the firm, above all, to satisfy the regulator as to its "prudent management"; a suitable business model would be one of the criteria of prudent management rather than the condition itself.

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[22] The power to gather information relevant to financial stability was introduced by Financial Services Act 2010. It applies to the following persons:

a) Managers and holders of interests in an investment fund where that fund holds financial instruments that are either traded in the UK or issued by UK issuers (even if the fund has only one holder)
b) Service providers to authorised firms where the failure to provide the service would pose a serious threat to financial stability
c) Anyone prescribed by order made by HMT provided that HMT can only do so if it considers that they carry on an activity that poses, or is likely to pose, a serious threat to financial stability or else carry on an activity that if not carried on would pose this risk.
d) Any person connected with any of the above.

Bank of England – oral evidence (QQ 762-847)

THURSDAY 3 NOVEMBER 2011

Evidence heard in Public Questions 762 - 847

Members present:

Mr Peter Lilley (Chairman)
Mr Nicholas Brown
Baroness Drake
Mr David Laws
Lord McFall of Alcluith
David Mowat
Mr George Mudie
Lord Newby
Mr David Ruffley
Baroness Wheatcroft

Examination of Witnesses

Witnesses: **Sir Mervyn King,** Governor of the Bank of England, **Paul Tucker,** Deputy Governor (Financial Stability) of the Bank of England, and **Andrew Bailey,** Deputy Chief Executive-designate of the Prudential Regulation Authority, examined.

Chairman: Good morning, gentlemen. We are extremely grateful to you for coming and agreeing to appear before the Committee and to help us in our consideration of the Financial Services Bill. Thank you for getting us off to a prompt and early start. We would like to begin questioning with Mr Mowat.

Q762 David Mowat: My first question is about the ICB recommendations on the ring fence. Earlier this week we had a session with leaders of the main banks. They seemed to accept the recommendations, or at least were prepared to implement them, or intended to implement them. Is your judgment that the ICB got it about right?

Sir Mervyn King: It is a difficult and complex business. Each person will be tempted to move more or less in that direction. I am broadly comfortable with where they are. It is a very good report. The Government created a commission of outstanding individuals, and it would be unwise to go against their recommendations. They thought it through very carefully. I would recommend that you implement this as soon as possible.

Q763 David Mowat: Have you given any thought to how you would regulate the ring fence?

Sir Mervyn King: The one point that occurs to all those who might be in the regulatory community, depending upon whether the Bill is passed, is: to what extent should the definition of the ring fence be a role for the regulator, as opposed to a role for Parliament in setting out the legislation? Our strong view is that as far as possible this should be done in legislation and not left to the regulator. I say that because the difficulty that will arise with this approach is that the banks and their lawyers will have enormous amounts of money, time and resources to come up with all kinds of clever ways to try to get round the rules set out in legislation. Unless those rules are pretty clear the regulator will be chasing the banks round in a circle and will come under enormous pressure.

One of the major problems in regulation in the last 10 to 20 years has been that of regulatory capture. By that I do not mean people were bought off but that the sheer weight of resources, time and legal effort put in by banks to try to persuade regulators that what they were doing was compliant with the rules made life extraordinarily difficult for the regulators. I would suggest that, as far as possible, you take the ring-fencing aspect of the Vickers Commission proposals in a separate Bill and make sure those are got right in the process of legislation.

Q764 David Mowat: Your view is to be as prescriptive as possible in setting out how the ring fence would work, which gives less wriggle room, if you like, in how it might be implemented?

Sir Mervyn King: Yes, absolutely. One has to be clear about the principles behind it. There would be things that might have to be left to the judgment of the regulator, but there cannot be any confusion about the principles upon which the regulator has to act down the road. As little as possible should be left to the regulator. They will already have an enormous job in making judgments about the riskiness of the balance sheets of banks. I would rather the efforts and resources of the PRA be devoted to judging the risks which banks are taking on their balance sheets than a perpetual legal game of trying to define the ring fence.

Q765 David Mowat: If a ring fence works properly in the way you are suggesting, in terms of it being that prescriptive, what is in it for the composite banks to have a retail subsidiary that is so separate? Is it additive to shareholder value to do that?

Sir Mervyn King: You make money out of having happy customers, not unhappy customers. That is normally the way one does it.

Q766 David Mowat: Is there anything else that you would have liked to see in the ICB report?

Sir Mervyn King: They have examined this in great detail. We talked to them about it. This is now the only game in town. The banks have said they are prepared to accept and implement this. I don't think there is any merit in reopening this, so we should go ahead and implement it.

Q767 David Mowat: If I may move on to Europe, we have had evidence from a number of people who have said that the principal issue in terms of regulation is not necessarily structure but people and how they exercise judgment, and all that goes with that. Therefore, within reason most structures could be made to work effectively, and yet the twin-peak structure that we are putting in place is quite different from the European structure that overrides it in terms of the sectoral versus matrix approach to it. Do you see that being a problem, or is it something we can work with?

Sir Mervyn King: No. The reason we want to move towards a twin-peak approach is precisely to deal with the point made in your first sentence, which is that it is a question of judgment and culture, not structure. I was in favour of the 1997 reforms, but I came to see that it proved extraordinarily difficult to enable the regulators to make judgments in the field of prudential regulation when the same people were being asked to carry out conduct of business, enforcement and consumer protection regulation, which by its nature has to be rule-based, is highly legalistic and will appear to be rather bureaucratic. It is very important to get away from that when it comes to prudential regulation.

As to prudential regulation, the reason it has become so legalistic and bureaucratic—it matters that we avoid this—is not because of the FSA but the firms themselves. Their lawyers will tell them that, provided they cannot find a specific rule that prohibits an activity, they can go ahead and do it. That stops the firms themselves thinking, “Is this taking too much risk on the balance sheet? Is it an activity in which we ought to be involved at all?” The judgments which ought to be made about the ethics, ethos and the culture of the bank itself tend to get undermined when you end up with a game in which the regulators are continuously rewriting the rules because at the same moment the firms are devising new products to get round the detailed legal rules which were in place before in order to avoid the spirit of regulation.

I give two examples of where we think it will be important for regulators to exercise judgment and why we need to make a break from the style of regulation we have seen in the past. One is that I would like Andrew and his colleagues to be able to say to a bank—this is a hypothetical example but is clearly relevant to what happened before the crisis—“Your leverage has gone up from 20 to one to 40 to one in the past four or five years. You have not broken any rules. Nevertheless, this is a highly risky set of activities to undertake, and we want you to reduce your leverage.” The only way that regulation can have an effect is if the regulators have the freedom to impose their judgment and not base it purely on a myriad of detailed rules.

Another example would be to say to a bank, “The structure of your bank is so complex and opaque, with so many offshore and onshore legal entities, that we don’t understand the risks you are taking. We are not entirely confident that you do either, but certainly outside investments cannot assess it. We think that degree of opacity is inconsistent with a sensible and stable contribution to financial stability.” These institutions are operating not only for themselves; they are big enough to affect the economy of the whole country. Therefore, the regulator has to be free to make a judgment about that degree of opacity, even though nothing is done that could be said to violate a specific detailed rule. That degree of judgment is vital. The choice is yours. If you want to stay with a highly legalistic and bureaucratic regime for regulation, which many of the institutions would

prefer, please do not give it to us. We would not want to take on that responsibility. If you want judgment to be exercised, we are prepared to take it on.

Q768 David Mowat: For the avoidance of doubt, you don't see a conflict between the ESA structure that the Europeans are developing and the twin-peak structure that we have?

Sir Mervyn King: I don't think so. We are the only country in Europe to have a Financial Policy Committee which has a direct parallel at the European level in terms of the European Systemic Risk Board, so in that area we are much closer to Europe than other countries. Broadly, all countries recognise that they have different structures to deal with banking and insurance regulation. For a long time we were out of kilter with the majority in taking this away from the central bank. I don't have a particularly strong argument to say why it has to be in the central bank, but the Prime Minister and Chancellor put to me reasons why they wanted it in the central bank. After the experience of the past four years I thought they were pretty compelling reasons. It makes sense to go down the road which the Bill proposes, but the choice is yours.

Q769 David Mowat: My final question is about the Capital Requirements Directive and the way we co-ordinate with Europe on that. At one time it looked as though it might make it difficult for us to impose higher capital requirements on our institutions than the Europeans would find acceptable.

Sir Mervyn King: It is still a problem. The Commission's current proposals still want to impose maximum harmonisation. I am completely baffled as to why they want to do it. I can think of no logical or economic reason why you would want to have maximum harmonisation, other than a theology of convergence for the sake of it. But the whole spirit of the agreement under Basel I, II and III was to have a level playing field in terms of common minimum requirements. No one could conceive of any reason why you would object to a country wanting to impose higher requirements, for example to protect their taxpayers. At the European Systemic Risk Board the vast majority of the people round the table were equally baffled as to why there was a case for maximum harmonisation, and I believe that an increasing number of governments in Europe will come to the same view. This is a problem.

The Commission takes the view that some of the things we want to achieve by implementation of the proposals of the Vickers Commission, or macro-prudential regulation through the Financial Policy Committee of the Bank, could be done through what is known as pillar 2 of the capital requirement. Again, that seems rather bizarre to us, because it is clear from the legal basis of pillar 2 that this is for individual institutions, but clearly that is not macro-prudential. Macro-prudential is something that applies to all banks, and that is naturally pillar 1. I cannot see any reason why anyone should object to a country using pillar 1 to have higher capital requirements. I absolutely agree there need to be common minimum capital requirements, and it is good that Europe is now taking this through the European Parliament to get European legislation. We are ahead of other countries in this respect, but I am completely baffled as to why they see any need or reason for having maximum harmonisation.

Q770 Baroness Drake: To stay with that point, we have seen Mr Enria. His evidence to us prompted your letter to Mr Lilley in which you clearly expressed your concerns about the approach to maximum harmonised regulation. To put the blunt question, in your view does the directive as currently drafted give the UK sufficient discretion on a comprehensive range of tools?

Sir Mervyn King: No, but it has not gone through. This is now a proposal by the Commission.

Q771 Baroness Drake: How confident are you that we can alter this?

Sir Mervyn King: There will be a period of almost 12 months during which this will be debated before Heads of Government decide in the end what the legislation will say, so there is all to play for, but the current proposals by the Commission, for reasons I do not understand, rule out things which most people I know in Europe think are eminently sensible.

Q772 Baroness Drake: How confident are you that those 12 months will lead us to a position that will allow the UK to apply the kind of macro-prudential approach to regulation that it would wish?

Sir Mervyn King: I am not in a good position to answer that, because it will depend on the political negotiations among all the members of the European Union. I know that the Government are very aware of this issue and will be taking it forward, but that is not a judgment for me; it is for you and your parliamentary colleagues.

Q773 Baroness Drake: Is it possible to come up with a definitive set of recommendations on macro-prudential tools before that issue is resolved?

Sir Mervyn King: Yes. At European level the European Systemic Risk Board has proposed a set of amendments to the Commission's proposals that would make our ability to conduct macro-prudential regulation much easier. At the level of the Financial Policy Committee we will be putting to the Government by next spring some suggestions about the instruments that we recommend the Treasury put before you in Parliament to be delegated to the FPC.

Q774 Chairman: When we asked Mr Enria to justify the proposal that there should be a maximum, he put forward a novel explanation. We have subsequently written to him to question him about it, but I would be interested in your observations. He said if one country or individual countries were allowed to set prudential requirements higher than the minimum it could in some way siphon off capital from subsidiaries in other countries to wherever the parent company was domiciled, and that could weaken those other banks.

Sir Mervyn King: No; that is false. There is no fixed lump of capital allocated across a particular group. If supervisors say that more capital is required, the bank can obtain it. I don't think that holds any water at all. To take the example of HSBC in this country, which has not been as involved in some of the problems in Europe, or the subprime mortgage market—it has many activities in Asia—for quite a long time it has had a high capital ratio,

often higher than many of its competitors. No one has argued that somehow it is unfair and wrong for HSBC to have a higher capital ratio and therefore it is attracting business because it looks a more sound or strong bank. That is what we want banks to do. It is very peculiar that this argument should be used.

The whole point of Basel, to go right back to the beginning, was that people were worried that in some countries regulators were tempted to lower the minimum capital requirements, to attract business and banking to their shores. The Basel framework is designed to prevent that by having a common playing field to set minimum requirements. What happens above that is something individual banks should decide within a country. We are not going to impose a regulation to say that if a particular bank in Britain wants to have double the capital requirement we should tell it to stop. It is a bit like the idea that children cannot be allowed to play the piano because some are better than others. At one level the whole approach is mad. When we discussed it at the European Systemic Risk Board all the central bank governors round the table raised their eyebrows. They could not understand the economic logic of it. I think the Commission members have got themselves into a position from which, for reasons of theology to a large extent, they find it hard to back off. I very much hope they will reconsider it, because I don't believe that abandoning maximum harmonisation would in any way undermine the single rule book, what they are trying to achieve in Europe, a common European regulatory framework or the role of the ESAs. I cannot understand why this is an argument that people are pursuing at this stage.

Q775 Mr Mudie: In June you came before the Treasury Committee and said that, in relation to the Court, you were content that they were not experts in policy. There is a view that it would be hard, if not impossible, for them to hold the executives to account unless they had a degree of expertise in policy. I understand the view you have expressed that you cannot have them second-guessing the executives, but is there not a middle ground between having no expertise and second-guessing? Is there not a middle ground that should be explored, and what are your views on that?

Sir Mervyn King: There is certainly a middle ground to be explored in terms of the kind of people on it, but it would be a mistake to think that a body like the Court should be the vehicle for holding us accountable for policy. It seems to me that we should be accountable to Parliament and the public for policy decisions of the MPC, FPC and PRA. There is a large range of vehicles of accountability. As you said on the Treasury Committee, in terms of monetary policy we have a good track record of accountability in that respect. I see the role of the Court as primarily one of saying, "If you have an independent central bank, there has to be some accountability for the use of resources, remuneration and so on." That should not be directly to the Treasury or Government, because that undermines independence, and that is enshrined in European treaties which apply to us. But there has to be a body which will determine the Bank's budget; the remuneration of everyone in the Bank, but particularly the remuneration of senior members of the Bank; and indeed to deal with questions about the procedure of the committees. If any individual member of those committees is unhappy about the resources to which they have access, or about the way the committees are working, they can turn to the Court. Certainly, the individuals on the Court have to be people who are experienced, senior and know something about the issues, but in my view they are not there to say to the MPC, "You made the wrong decision on interest rates"; to the FPC, "You made the wrong decision on capital requirements"; and to the PRA, "You made the wrong judgment on that bank." That is something for the Treasury Select

Committee, or whatever is the parliamentary vehicle for accountability. The Federal Reserve and European Central Bank have absolutely nobody like the Court at all. The executives run the bank and on policy they are accountable to their parliaments.

It makes sense to have a body like the Court. It is good practice in the public sector that we do not set our own salaries, that there is transparency about all that and to have a governing body to manage the affairs of the Bank, but it makes no sense to extend that to policy decisions. That is where we should be accountable to Parliament, and it is for you to decide what the right vehicle for that is.

Q776 Mr Mudie: The business of not reviewing policy leads to the current argument between the Chairman of the Treasury Committee and the Court on the release of documents relating to the review of the Bank's actions during Northern Rock in 2007. Was a review conducted, and if so, why are the minutes and full documentation being denied to the Treasury Committee? If you are saying that it is the Treasury Committee and Parliament that must conduct the exercise of accountability, why are these documents being refused?

Sir Mervyn King: There are two separate issues: one is about the minutes, and the other is about reviews. There were several reviews of the Bank's actions and behaviour during the financial crisis. The most important and in-depth one was conducted by you on the Treasury Committee under Lord McFall. It was not just the Northern Rock report; there were several other reports. You had all the information; you asked us questions; it was a challenging process.

Q777 Mr Mudie: This was of you directly in the Treasury Committee?

Sir Mervyn King: Yes, absolutely.

Q778 Mr Mudie: The question that exercised the Committee was that the Court, the governing body, were asked whether they had conducted a review, and they said yes. The Chairman of the Treasury Committee said, "Provide me with all the documentation, including the minutes", and the Court is refusing. Do you think that is proper behaviour by the Court in terms of Parliament being able to exercise accountability?

Sir Mervyn King: It is perfectly reasonable for any body to withhold minutes written and constructed on the basis that they would not be put into the public domain. They contain statements about individual members of the Court. I think these are minutes which were constructed in the knowledge that they would not be publicly revealed. We have put into the public domain the internal reviews of the Bank on its provision of liquidity. This was presented to the Court and received and approved by them. We published those two reports in our new red books in both January 2008 and October 2008. We completely reviewed what happened. Like every central bank, we changed our method of liquidity provision. We reviewed what went wrong, explained it to the Court and they approved it. This was published in October 2008. There have been reviews and they have been published.

Q779 Mr Mudie: In the last few days a prominent banker has had a breakdown and has been given medical leave for six months because of the pressure of running a bank. In the proposed changes, there is a view that too much power, but above all responsibility, is being placed on your individual shoulders—I don't want to make it personal; it is not your shoulders but the post's shoulders. You are going to be part of the design, but you are handing over to who knows. Are you quite adamant that the holder of the post can chair and participate in various international and national regulatory matters? If there is a view that changes would have to be made because it is too much to put on someone's shoulders, do you have a view on what changes should be in the field for consideration?

Sir Mervyn King: Yes, I do. I certainly don't want to be adamant on anything. It is already a big job and, to be honest, it has changed in the last three years. We are already in a position where I have to spend a lot of time on monetary policy, the Financial Policy Committee and the PRA—we are spending a lot of time on designing and constructing the PRA—plus the international commitments. How am I coping with this, and what are we doing in terms of the post? Before the crisis, I chaired all the minutes meetings of the Monetary Policy Committee, where we drafted the minutes. That I delegated to Charlie Bean, so I do not chair all the meetings of the MPC that I did before. On the Financial Policy Committee, the driving of the work is the responsibility of Paul Tucker, and he chairs the Bank's Financial Stability Committee, not me. In terms of the PRA, most of the work is done by Hector Sants and Andrew Bailey, and the Governor will be involved only in a question about a major institution.

I say two things in conclusion. First, I am convinced that if there were to be a major problem in any of these areas and these responsibilities were in the Bank of England you would want to call the Governor of the Bank of England before the Treasury Select Committee and ask what went wrong. I don't think you can do that unless the Governor is chairing those bodies. I would draw a distinction between chairing the bodies and the amount of time involved. It is not just an additive thing. Most central banks are involved in these things. We would be returning to a more conventional central bank portfolio. The reason my view has changed since 1997 is that my experience of the crisis has led me to believe that when you have a financial crisis like this the central bank is inevitably and inextricably involved with the liquidity and capital position of banks, macro-prudential measures and monetary policy. You have to construct a mechanism by which a lot of the activities that the Governor was doing before 2007 are now delegated to the Deputy Governors, of which there will be three. This year one of the major strategic objectives in the Bank of England is to tell the whole of the Bank that each level will be delegating more authority down, because we have to do that for the Bank to function.

Secondly, if you are not persuaded by that argument, the right thing to do would be to take a responsibility away from the Bank of England completely, not try to pretend that you can have—

Q780 Mr Mudie: For example?

Sir Mervyn King: The only one you could conceivably take away that would make sense would be the PRA. The FPC and macro-prudential is inextricably linked with the sort of issues that central banks are bound up with. If your opinion is that it is too much, then the PRA is the body you should take away from the Bank of England. I would recommend that it should then be a separate stand-alone body, but if you would like the Bank of England to do

it, it is manageable, provided it is understood that the Governor will delegate many of the responsibilities he was doing before.

Q781 Mr Mudie: The Bank oppose practitioner panels. In view of the sensitivity of the additional powers, there is an argument that practitioner panels could save you from decisions with unintended consequences. Is the opposition still firm, or is any rethinking going on about the possible use of practitioner panels?

Sir Mervyn King: We are opposed to statutory practitioner panels but not consultation. We have a very good track record in engaging in a great deal of consultation: in 2008 on our money market operations; in 2009 on the way the asset purchase facility operated.

Q782 Mr Mudie: We won't go there.

Sir Mervyn King: We won't go there, but we did consult. We are currently doing a consultation with firms about a big increase in the range and type of collateral in all our operations. It is important not to set up a panel with a fixed membership of nine, 10 or 15 people, but each time we consult we do so very widely with the people doing the jobs about the issue on which we are trying to consult. That will be a different group of people each time. We are very keen to get away from a lot of the apparatus that has grown up around FSA which is highly bureaucratic, in large part legalistic and does not generate particularly useful responses.

The key point I make to you is that there is a big difference between consultation and accountability. We should not be accountable to the industry but to Parliament and the public. We should consult the industry, and you should be able to ask the industry, "Do you think the regulator is doing its job? Did it consult you appropriately? Is it carrying out its task in a fair and sensible way?" I do not think we should be accountable to the industry; that is the slippery slope to regulatory capture which was one of the major problems leading up to the crisis.

Paul Tucker: This would be a change in mindset for the supervisors.

Q783 Mr Laws: I want to ask one question that follows up Mr Mudie's questions about the Court. I understand your arguments about the Court. You have explained that it has an important but relatively modest role.

Sir Mervyn King: No, it is not modest. It is a well-defined role in terms of the management and resources of the Bank. Perhaps I may give one example. The audit committee of the Court meets very frequently, is pretty intrusive into the activities of the Bank and does a very good job in ensuring we use our resources, public money, efficiently. We report to the Court every three months with a detailed set of papers about the financial position of the Bank. The members of the Court, who are senior chairmen and chief executives of FTSE100 companies, have said to us that those papers and reporting mechanism are as good as anything they have seen in a FTSE100 company, so we are held to very high standards in comparison with much of the public sector.

Q784 Mr Laws: But when we turn to the letter from Mr Tyrie documenting the Court meetings that have taken place and see the period during the financial crisis taking off in September 2007, the Court met six times during that month and seems to have been discussing the most sensitive and difficult issues which you were dealing with in the Bank at that time. They related to policy, the state of the markets and the actions you were taking to stabilise the banking sector. That is not what I would have expected to happen given the strategic role that you have been suggesting.

Sir Mervyn King: They were not discussing policy but the use of the Bank of England's balance sheet. Their responsibility is to ensure that the Bank of England's balance sheet is used in a sensible way, so their decision at the end of this would never be, "Do we carry out the operation or not?" because almost all of these were decisions for the Chancellor given that public money was at risk. All of those operations were decided by the Chancellor. The question was: should the Court recommend that the Bank of England request an indemnity from HM Treasury for that activity to protect the Bank of England's balance sheet? That is their locus in this, because as a board of the organisation they have a responsibility for the finances of the Bank, and obviously the balance sheet of the Bank is very large.

Q785 Mr Laws: That was a decision you would not have been able to make without them signing off?

Sir Mervyn King: If the Chancellor decided that we would do the operation then we would do it. What I would say to the Chancellor is, "The Court's view is that the Bank of England needs an indemnity in order for them to carry out the operation." Take the extreme case of a lender of last resort loan to Northern Rock. The Court could not have said, "We don't think you should give the loan to Northern Rock." The Chancellor has the final word on that. That was very clear at the time; it is clear under this Bill. Neither I nor the Court could say no. What the Court could say is that in its view it would wish the Treasury to give an indemnity to the Bank to protect their balance sheet. The Treasury does not have to do that but the Court would subsequently reveal that they had requested an indemnity.

Q786 Baroness Wheatcroft: To pursue that line of questioning and talk about the Court, several of those who have come to give evidence to us have said it is time for the Court to metamorphose into the same structure as a traditional company. We have heard your views up to a point on the role of the Court. Alistair Darling, for instance, was quite open in his view about how it should be restructured. I understand what you are saying about accountability to Parliament and to the people, but that is after the event. If you look at a corporate structure, the idea is that the chairman and chief executive have a body of outsiders, non-executives, to whom they can talk before doing things. Can you see any merit in changing the role of the Court to provide that sort of sounding board before the Bank take drastic actions, or are you confident that having non-execs on the FPC and the other committees is sufficient?

Sir Mervyn King: It would be dangerous to regard the Court as a body that should try to influence the policy decisions of the Bank, and you in Parliament ought to be extremely worried about that. You appoint through the Government the officials of the Bank and can hold them personally accountable. We certainly consult with a wide range of people, but it should not be restricted to a small group. The Court has no responsibility for policy; it is not held accountable for policy, so why should it have a special ex ante input into it? The right

form of accountability for an independent central bank is ex post; that is what "independence" means. There is clearly a natural tension between independence and accountability, but it can be dealt with. If you look at what happens to central banks overseas, you will see that the Court here play a bigger role than central banks overseas normally experience, but their role should not be in the area of policy. It should be for us to come and defend our policy decisions directly to you. We cannot turn round and say, "We rather sympathise. We did not think it was a very good idea but the Court thought it was so we had to do it." I don't think that would be very satisfactory at all.

Q787 Baroness Wheatcroft: Is that why you are happy with the arrangement at the moment for the Financial Policy Committee to have a minority of outsiders on it? Several people have suggested to us that there should be a majority of outsiders. I know that the chairman of the FCA will be on it, but I am not sure there will be six outsiders.

Sir Mervyn King: There ought to be. They are quite different institutions with different responsibilities. It is six/five. The MPC has worked very satisfactorily with five/four. There is something slightly odd about a Bank of England committee having only a minority of Bank of England people on it. It is almost an outside committee with some Bank of England representation. We have gone further than any central bank in the world in having outsiders on our committees, which has been a success, but once you have a majority you are changing very much the character and nature of it. The executives of the Bank do have a natural concern about the continuing reputation and existence of the institution and that is part of our responsibility, which we should always be seen to carry out.

Q788 Baroness Wheatcroft: It is a big responsibility, as you said at the beginning. Perhaps I may ask you about the overwhelming responsibility for financial stability that you are taking on. The Bank has always had a financial stability objective. Are you confident that as a group we are clear what financial stability actually is? Opinions seem to differ. Would it help if there were firmer objectives as to what financial stability might be?

Sir Mervyn King: Let me say what I think broadly financial stability is and why I don't think that a precise definition is something on which we should pin every hope. Financial stability is about ensuring the financial system can play its role in three areas: the payments system, so that people can make payments all the time; the transfer of savings into investment, providing savings vehicles that can be used to finance corporate investment; and the allocation of risk in the economy towards those who are most willing to bear it. That is the social role that all financial markets play.

The reason I was unhappy about the Bank's financial stability role before the crisis was that, although no one could define financial stability terribly clearly, what mattered more to me was that we had no tools to do anything about it other than write financial stability reports. What matters in terms of holding the FPC accountable is that you in Parliament will decide what instruments we will have. They could be counter-cyclical capital requirements; some people think they could be loan-to-value ratios. There has to be a public debate about this, and you in Parliament will decide what instruments we will use. They will be delegated to us and you should hold us accountable for the use of those instruments and the commentary of the FPC in the financial stability report. For the first time we will have some instruments we can exercise, and the main focus of accountability should be to say, "Why

did you change or not change those capital requirements?" and, "Explain yourself in terms of the instruments we gave you to use."

Q789 Baroness Wheatcroft: Perhaps I might ask Mr Tucker a question. Financial stability was one of your main roles under the previous regime. Is it always easy in a boom to spot the time at which financial stability might require intervention to calm things?

Paul Tucker: It is very difficult with absolute certainty, but a lot of misleading stuff is said about this. The world was full of bankers who thought there was a dangerous boom. There was a massive problem of collective action. In a way, it was a rather old-fashioned problem, in that no individual big bank was brave enough to say, "We will stop lending into this boom", because if they were wrong and it was not an unsustainable boom they would destroy their business by handing their franchise over the road. People were saying that kind of thing in 2006 and 2007.

Q790 Baroness Wheatcroft: They had to keep dancing?

Paul Tucker: Quite so. He is being ridiculed for that, but it is a rather good piece of analysis about the nature of the problem. The classic role is for someone to stand outside the private sector and say, "This needs to slow down." One thing that will help that is to put analysis into the public domain. We did that in the past, but there is a hell of a difference between somebody who has instruments giving a warning and somebody without instruments giving a warning. People read our Inflation Report not because it is a terrific analysis of the outlook for inflation but because we, and only we, set sterling interest rates. The market will be much more heedful of analysis and warnings in the Financial Stability Report coming from the Financial Policy Committee if and when they see that the FPC can act. Over time, the Financial Policy Committee would need to demonstrate that it was prepared to act. That goes back to what the Governor said about accountability.

The proposal under the Bill is that the directive instruments for the FPC will be set out in secondary legislation, and the Treasury Committee and commentators more widely will be able to say, "Given the FPC's, the public's and the market's analysis of what is going on, why are they not using these tools?" or, "Why are they using this rather than that tool?" Just as in 1997 the level of debate about monetary policy shot through the roof, this kind of framework will change the debate about financial stability in this country in a durable way. The durability of it will make a huge amount of difference. The worst kind of boom is one that brews slowly over a very long time. It is much harder. That is what makes everybody complacent. Having the Financial Policy Committee appear regularly before the Treasury Committee or wherever, and no doubt before a committee in the Lords as well, will keep not only the FPC on its toes but also those issues in the public mind when otherwise people would tend to lose interest in them.

Q791 Baroness Wheatcroft: Are you nervous at all that you might come under some political stress not to calm things down, presumably? I am very conscious of the Governor saying regularly that the pricing of risk was wrong but nobody wanted to listen.

Sir Mervyn King: We will certainly come under pressure—there is no doubt about that—and that is why you have an independent central bank trying to resist that pressure.

Paul Tucker: This will be the point at which bankers and perhaps politicians, public and businesses all find themselves in agreement about something and disagreement about the FPC. As the Governor said, that is precisely why society has an independent central bank, but framed in a way that Parliament chooses.

Q792 Chairman: Perhaps I may carry further the comparison between the Monetary Policy Committee and the Financial Policy Committee. The Monetary Policy Committee has not only an instrument but a fairly clear remit, ultimately set by Treasury and Parliament, for an inflation objective which is measurable and therefore it is easy to hold it to account. By contrast, the objective of maintaining financial stability is not easily measurable until you have failed, which we hope does not happen, and you know it is not there. It has been suggested to us by HSBC and Barclays that it would be helpful to have a more measurable objective to maintain a sustainable supply of credit. What are your observations on that?

Sir Mervyn King: That should not be the objective of the FPC, simply because I don't think they can deliver it given the sort of policy instruments that will be available. What does "sustainable supply of credit" mean? If it is zero, which is where we are now, that is certainly sustainable, but that is not desirable. The natural supply of credit will vary over the business cycle. What matters is that the committee should focus on the resilience of the financial system. Just as we say in monetary policy that the best contribution it can make to economic growth is to provide a backdrop of price stability in the long run, equally the best contribution that the Financial Policy Committee can make to ensuring there is an adequate supply of credit is resilience of the financial system. For example, if you start to see that leverage ratios of banks are rising rather more rapidly, or to levels that look to us to be excessively risky, that is when the FPC should step in and slow down the whole process and maybe reverse the rise in leverage ratios. It is that sort of policy decision that is important and which is the best contribution that can be made, but, just as monetary policy cannot abolish the business cycle, so the Financial Policy Committee will not be able to avoid the fact that there will be ups and downs in sentiment and expectations which are bound to lead to movements in asset prices.

Q793 Chairman: They were not talking about asset prices but the supply of credit.

Sir Mervyn King: It is the supply of credit, too.

Q794 Chairman: The rationale appeared to be, first, that the problem was caused ultimately by an excessive expansion of credit and, therefore, that needs to be moderated, which is implied by this; and, secondly, that in a recession the danger is that there is not enough growth of credit and there should be an obligation on the FPC to try to get credit going. They also thought that the tools available in the Pacific countries, which are much more interventionist where central banks have powers to set almost a corset on credit growth, possibly were necessary to control credit, which perhaps was rather surprising coming from bankers.

Sir Mervyn King: We can debate this, and no doubt over time we will get more experience. To the extent that "supply of credit" is used in a rather vague sense, what you have just described is exactly what the FPC will try to do, because credit is another way of looking at the size of the balance sheet of the banking sector. Certainly, the role of the FPC is to

behave symmetrically, which is to slow things down in a boom but to try to make clear that the buffers of capital and liquidity that banks hold can be run down in a downturn. We now go to enormous lengths in the debates in Europe to make clear that when we ask European banks to hold more capital, it is not the same as saying that the capital requirement has gone up, but that if you put more capital into a bank it has a bigger buffer above its minimum capital requirement, which can be run down when times are bad.

I totally accept the idea that we should be responsible for a symmetric response. It is just that I worry about a rather mechanistic definition of "credit", and it certainly cannot be credit to the real economy, because that will move up and down according to many factors outside the control of the FPC. I believe that if we had a Financial Policy Committee that has some success in moderating extreme movements in the size of the balance sheet of the banking system that would mitigate the credit cycle and help the Monetary Policy Committee, because it would relieve it of some of the pressures that made monetary policy rather difficult in the run-up to the crisis.

Q795 Mr Ruffley: Governor, to return to your answers relating to accountability, you very much downplayed the role of the Court in scrutinising the policy decisions of the executives of the Bank, which I understand. You said that they ask some basic questions but they don't get into the area of, "Did you make the right policy decisions?" Is that a fair statement?

Sir Mervyn King: Yes.

Q796 Mr Ruffley: You have also said that you and the executive decision makers on the MPC, and soon to be the FPC, are accountable to Parliament. In the Commons, that is the Treasury Select Committee. In the course of your cross-examination by that Committee, what papers did you produce of an internal kind that were not otherwise in the public domain?

Sir Mervyn King: We wrote papers at the specific request of the Treasury Select Committee. Whenever we were asked to write a paper we did so. That was a paper that had not existed before and was not in the public domain.

Q797 Mr Ruffley: How many substantive pieces of work did you produce which revealed things to the Treasury Select Committee that were not already in the public domain?

Sir Mervyn King: I cannot remember the number of papers we produced—maybe Lord McFall can—but we certainly produced whatever we were asked to produce. I remember that when the Treasury Select Committee was chaired by Lord McFall I always made an opening statement which was not in the public domain and gave an update of the views of the Monetary Policy Committee that had within it some real policy substance.

Q798 Mr Ruffley: Have you any idea how many questions you answered before the Treasury Select Committee in relation to the Bank's decisions in the financial crisis?

Sir Mervyn King: I should think hundreds, if not thousands.

Q799 Mr Ruffley: You answered thousands of questions.

Sir Mervyn King: Let me tell you one fact that I do know, and of which I am completely confident. This is the 31st parliamentary hearing that I have attended in four years, which means seven or eight a year. I suspect that is a record compared with anyone else, but I have not checked it. That is a very large number. If you add to that that I now give six televised press conferences a year on the MPC and FPC, and four speeches, that is a very high degree of accountability, which I think exceeds anything else.

Q800 Mr Ruffley: I am not doubting your diligence in attending parliamentary committees.

Sir Mervyn King: We answer the questions that you put to us.

Q801 Mr Ruffley: I am aware that you come regularly and hardly ever miss. My reason for asking these questions is simply this: you will also be aware that an incredibly detailed review was carried out by a leading accountancy firm of the decisions made by the FSA in relation to RBS. You are aware that a very substantial piece of work was done.

Sir Mervyn King: Indeed, and I have seen it.

Q802 Mr Ruffley: Yes, and after a great deal of reluctance on the part of the FSA, the Treasury Select Committee is seeing bits of it. But here's the thing. As I understand it, that piece of work involved large numbers of accountants crawling over what the FSA were doing. They were calling for papers and cross-examining people. I suggest that there is no way of earth that the Treasury Select Committee, or even a Lords committee, has the same level of access to your decisions and minutes that a big accountancy firm has had in reviewing the decisions of the FSA. Do you understand the analogy I am drawing?

Sir Mervyn King: I don't think it is a good analogy.

Q803 Mr Ruffley: Why isn't it a good analogy?

Sir Mervyn King: Because in relation to the FSA and RBS, it is a report about an individual institution and its activities.

Q804 Mr Ruffley: And the FSA's decisions in relation to that institution. That is what we are talking about: individual executive decisions by the FSA. To my understanding, that is an incredibly detailed piece of work, pulling out the wiring. Parliament, with the best will in the world, has not had access to the policy decisions and how they were arrived at in the case of the financial crisis and your executive directors.

Sir Mervyn King: The Bank had a very different set of responsibilities, for which there is no parallel. Everybody involved in taking those decisions at one time or another appeared before the Treasury Select Committee. You can ask them whether they agreed with the decision or were party to it. We were not taking specific decisions vis-à-vis individual

institutions of a regulatory kind at all. All our operational activities were done through publicly stated facilities, the terms and conditions of which were made publicly available. That cannot be done by a supervisor. The supervision by FSA of RBS was something which by its nature could not be made public. All our operations were made public.

Q805 Mr Ruffley: I take the point. A final question, Chairman, if I may. We have already heard from Mr Mudie that the Court has refused to provide the Treasury Select Committee with minutes of the Court relating to the financial crisis. Summarising it, you said in reply to Mr Mudie that this would be terribly unfair to the individuals because they were giving advice, exchanging opinions and did not think that would ever be made public. Is that a fair summation?

Sir Mervyn King: Cabinet minutes are not published; even the private discussions that you have on the Treasury Select Committee are not published. When you have a private discussion where it is clear that for internal purposes a detailed verbatim record of the discussion is made, which is clearly not intended to be made public, it does not make sense ex post to expect that to be made public.

Q806 Mr Ruffley: I don't understand how, in the new era that you seem to be applauding of transparency, openness and accountability to Parliament, you are comfortable with the Court falling back, as I understand it, in relation to the Treasury Select Committee's request, to the position that it is not covered by FOI. It should not be for Parliament to listen to arguments from the Court saying, "This is not FOI-able information." Should you not be willing on an agreed basis to make these minutes available so the Treasury Select Committee can see them, in camera if necessary?

Sir Mervyn King: Every document we have sent to you you have put in the public domain almost immediately, so that is a deliberate flouting of FOI. I go back to the basic point.

Q807 Mr Ruffley: Are you suggesting that the Treasury Select Committee has behaved improperly?

Sir Mervyn King: No, but you have not offered to keep it in camera. We asked about that.

Q808 Mr Ruffley: If the Chairman of the Treasury Select Committee, Andrew Tyrie, and other members—Mr Mudie and I are also on that committee, as you will know—in the interests of accountability to Parliament, asked to see the minutes of the Court relating to the financial crisis, a request that has so far been refused, and offered to look at them in camera and not release them, you would support our request?

Sir Mervyn King: I am not going to make a comment.

Q809 Mr Ruffley: Why not?

Sir Mervyn King: Because I am not chairman of the Court.

Q810 Mr Ruffley: You are the Governor of the Bank of England.

Sir Mervyn King: But according to the accountability of the Court, Mr Ruffley, I am not chairman of the Court. I thought you applauded that.

Q811 Mr Ruffley: You don't think the Court would take cognizance of what the Governor of the Bank of England says? I am putting you on the spot here, Governor, for one very simple reason. I am taking you at your own word. You are saying you want the Bank, a very important institution of this country, to be accountable to Parliament, and we applaud that, but on the first test where we say, "Make available the detailed minutes and we, the Treasury Select Committee, will look at them in camera", you are telling me you will not suggest to the Court that this is a good idea?

Sir Mervyn King: No, I am not. Let me tell you exactly what the analogy is. If you turn to me today and say, "Will you make available the verbatim transcripts of the meetings of the Monetary Policy Committee, as chairman of that committee?", I would say no, because there is no authority under which we should release the verbatim discussions. The committee could never work if you asked to see the verbatim discussions. What we do produce is a set of minutes that we publish, with a record of everyone's views and votes, after 13 days. That is a sensible degree of transparency. It is not sensible to require that every discussion be written down verbatim and published, and that is one reason why Cabinet minutes are not published. The minutes of the Court in the era to which you refer are exactly analogous to that. If you think in future the minutes of the Court should be published, I would be strongly in support of that; I would say yes, and we should do it, but you cannot go back and change the rules of the game retrospectively.

Chairman: Those questions are somewhat tenuously related to the function of this Committee, and I can only hope that the Treasury Select Committee will do some of our work in future and save us some time.

Mr Ruffley: It is accountability to Parliament.

Chairman: I said "tenuously related", not "unrelated".

Mr Ruffley: It is not even tenuous. This is accountability to Parliament.

Q812 Chairman: Thank you, David. I allowed you to ask the questions. Perhaps we can continue the train of questions.

I was asking about the objectives of the Financial Policy Committee. There is another alternative on the table for defining the objective and that is the objective of the European Systemic Risk Board, of which you are vice-chairman: it is controlling systemic risk across the financial system as a whole. Might that be a more meaningful definition of the objective which could be inserted in the Bill?

Sir Mervyn King: It could be. The difficulty is that that is shared with the PRA, because the purpose of the regulation of banks is not to worry about the individual institutions as such. We must get to a point where the failure of an institution is not seen as a failure of

regulation but of the management. Indeed, we want to be in a position where banks that are badly run do fail. The worst position to be in is the one we have almost got to where the regulators believe that if any bank on their watch fails this is a sign of failure by them, so they will prop up and keep in existence bad managements and badly run banks. It is very important that Parliament understands that the purpose of regulation is about ensuring that the system as a whole is safe and that banks that are badly run do fail, but that their failure does not jeopardise the rest of the system. That has to be the objective, and that is why the resolution approach—one of the great achievements of the Treasury Select Committee was to push hard for the resolution framework—is so important. It enables us to allow banks that are badly run to fail.

Paul Tucker: Perhaps I may add one word to that in terms of the Bill. It is not so far away from the ESRB definition but it has the more precise language of legislation. Summarising the objective of the FPC, it is "to remove or reduce systemic risks with a view to protecting and enhancing the resilience of the financial system". Systemic risk is defined as meaning "a risk to the stability of the UK financial system as a whole", which is the language of the ESRB, "or to a significant part of that system". I suspect that the language "the system as a whole" comes from very old Bank of England documents; it is very much a Bank of England phrase. I don't think we are so far away from that, but in language suitable for legislation rather than a less formal committee.

Sir Mervyn King: I understand and applaud the wish to have as clear a definition as possible, but that does not resolve the problem. The best way to hold us accountable is to say, "These are the instruments at your disposal. How did you use them, or not use them?"

Q813 Mr Laws: If the Chancellor said to you, as somebody who is going to be very busy in the future with all these new responsibilities, that you might prefer to have a single MPC/FPC body rather than two bodies with rather overlapping personnel and functions, would you object to such a change?

Sir Mervyn King: I would try to set out the pros and cons of it. It would be closer to the way the Federal Reserve operates. It would be very difficult to maintain the voting structure and behaviour of the MPC and to have externals with the degree of expertise that they have. The reason the MPC works is that there is one proposition on which to vote: what is the level of bank rate now? What is the level of asset purchases? Hence, it is possible to have a voting system with a clear majority and minority. Once you start to extend the responsibilities of a committee to cover a whole range of instruments there is no longer a single proposition. Each member of the committee might have his own preferred bundle, and you just have to move towards a more consensual approach. The Financial Policy Committee operates in such a way, because we operate consensually in order to get to the point where we think "This is the question this month." We can then vote on that question, but we have to operate consensually to say, "Well, this is the question this month."

Voting plays a much smaller role in the Federal Reserve FOMC than it does on the Monetary Policy Committee, and the board of the Federal Reserve even more so. What you would lose if you went to a combined committee is the ability to have on it monetary policy experts who do not have financial sector expertise, and they would not be able to be part-time externals. I do not think you would get people from academic life. They would find it harder to give up their employment for a longer period to be on the committee to acquire

the expertise. Equally, the people we now have on the FPC, who have great financial sector expertise, would not be natural candidates to set interest rates. You would end up with more generalists. You can certainly do that. I can see the attractions of saying, "Rather than go into two set of committee meetings, let's just have one, and it is easier to organise", but I think you would lose something.

One of the contributions of the Monetary Policy Committee—I look to members of the Treasury Select Committee here as to what they think about it—is that members of the committee have been willing to stand up in public and say, "My expertise in monetary policy leads me to think of a different approach from the one the majority wants." They have the self-confidence to do that. They can vote against it, and those votes are recorded in public. If you had one committee you would be forced towards a more consensual approach. People would find it harder to speak for their own position because it would be less clear, and we would lose a lot.

Q814 Mr Laws: Do you think that at the moment you don't have the expertise on the MPC which would allow that committee, if it was the model, to do the FPC's job as well?

Sir Mervyn King: The external members on the FPC, together with at present Adair Turner and Hector Sants, bring to the FPC knowledge and expertise that the MPC could not bring. Another advantage we have on the FPC at present is that Adair and Hector are on the FPC so when we say to them, "As a group, do we think it would be a good idea to make a recommendation to the FSA to do the following: raise or lower counter-cyclical buffers for banks? Could you actually do it? How would it mesh with your current responsibilities?" they can say, "Yes, we think it is a good idea; we would support it", or they can say, "We do not think legally you can do it unless you framed it in this particular way." Those conversations have proved very useful. That is part of the constitutional arrangements proposed for the new FPC. We would lose a lot of expertise on the FPC if we had to have a group of people doing both.

Q815 Mr Laws: Thinking about how the new system will work and whether it will lead to much better policy outcomes, perhaps I may ask you to replay history for us. You took over the Bank in 2003. If when you took it over you had had the structure proposed in the Bill, the FPC as well as the MPC and the macro-prudential powers, and you also had foresight of everything that happened beyond that so you did not have to answer in relation to judgments you might have made, what would you have done differently in terms of economic policy, particularly macro-prudential policy, from 2003 onwards to avoid the problems we have today?

Sir Mervyn King: I cannot say with any confidence what we would have done.

Q816 Mr Laws: Assuming you had known the future.

Sir Mervyn King: Let's suppose we did not know the future but just the facts which were evolving. I think the FPC would be sitting round reading the analysis and warnings in the draft financial stability report. Supposing we had the authority, for example, to move up the leverage ratio of banks and set a requirement that it could not go up above a certain limit, the committee would have been forced to confront the issue of whether it was sensible to

allow banks to raise their leverage from, say, 20 to one to over 40 to one. I don't know what the committee would have done, but it would have been impossible to avoid that question, whereas the question never arose in the Bank.

Q817 Mr Laws: Ignore the rest of the committee. With all your expertise and knowledge of what has happened, what would you have done?

Sir Mervyn King: I would have put a limit on the leverage ratio of banks and simply prevented the balance sheet from expanding so quickly. One of the lessons from this is that both the ECB and ourselves asked the question, "Do we think that the growth of broad money, double-digit rates—sometimes 15% or more—threatens the inflation target?" In most post-war periods we would probably have said yes, but we judged that it did not threaten the inflation target. I think we were right. What we failed to do was ask the question, "Well, if it does not threaten the inflation target, what does it threaten?"

Q818 Mr Laws: Without going back into too much history, at that time you were not looking for other tools to deal with the problem you could see emerging but you could not deal with through monetary policy.

Sir Mervyn King: We had been given very clear tools by Parliament and our responsibility was to use them, and responsibility for dealing with banks had very clearly been given to the FSA.

Q819 Mr Laws: Would you have targeted any particular sectors? We had a house price boom across a lot of the western world at that time. You have talked about constraining banks in general. Would you have wanted to do anything to hit particular sectors and constrain them?

Sir Mervyn King: If I had been asked to constrain a particular sector it would have been the financial sector, because two thirds of the total lending by the banking system in the five years running up to the crisis was not lending for house purchase or companies for investment but to other institutions in the financial sector.

Q820 Mr Laws: Do you think the controls you would have used would have ended up being a rather blunt instrument that might have damaged credit to parts of the economy that you would have wanted to keep flowing?

Sir Mervyn King: I do not think that having a limit on the leverage ratio would in those circumstances have damaged the flow of credit to the real economy. It would have been profitable to lend to the real economy, and we would have been trying to diminish lending to the other parts of the financial sector. It is a question that I cannot answer with any certainty. Any instrument you use to try to slow down the growth of the banking sector's balance sheet runs the risk that a particular project that might have got finance would not.

Q821 Mr Laws: We would still have had a house price boom in those circumstances.

Sir Mervyn King: We would, for the simple reason that right around the world long-term interest rates fell to extraordinarily low levels. I don't believe that the UK on its own could have prevented that. We could have tried to lean against it; indeed, if you go back to the debates in the Monetary Policy Committee in the late 1990s and 2000s—you see it from our speeches and minutes of the meetings—there was debate in the MPC about whether we should keep interest rates somewhat higher in order to dampen down the imbalance that was emerging in our economy between rapid domestic demand growth and weak net trade. That would have gone some way to help, but with an open financial system where the level of real interest rates across the world is being depressed by a very high level of world saving, particularly coming from Asia, it is very hard for us to do anything about the level of long-term real interest rates, and that is a major driver of asset prices.

You can try to have a higher interest rate at home than overseas by pushing the exchange rate up to a level where people then expect it to fall, but clearly that would have damaged the real economy. That was the debate going on. Is it worth accepting slow growth for low target inflation for a period to avoid the damage that might be done from these imbalances growing? That is a matter which monetary policy makers and economists will debate for much of the next 10 to 20 years. I don't want to say there is a simple answer to it, but, rather than sacrifice the objective of maintaining steady growth with low inflation and price stability within the inflation target, it is worth considering how far our experience with the instruments given to the FPC can mean we do not have to face this unpalatable choice of saying that we will sacrifice growth and steady inflation in order to prevent imbalances in the financial sector moving up.

Paul Tucker: If I may add to the answer to the previous question, because the Governor has talked about the cyclical response of reducing the maximum leverage ratio. I am not sure this is really hindsight. I think we would have been focused on whether the structure of the credit markets was adequate. You can see a flavour of this. We have had two meetings in the FPC. In one of them we said there was a boomlet in the exchange-traded fund market. It has moved from being purely a vanilla market to something more complex and sophisticated, and we made some pretty concrete points that have resonated in a quiet way across the official sector around the world, as well as with the FSA. The analogy about a decade ago was the biggest revolution in capital markets for probably a quarter of a century: credit becoming tradable. In a world where there are derivatives on credit and credit can be bundled up into securitisations, it took a long time for the authorities to ask whether that market had an adequate structure. I am saying this because in the Bill and the papers that the Treasury have published the FPC is asked to focus on two dimensions: one is the cyclical dimension of whether you can slow down a boom and make the system more resilient against a bust, but the other is to focus on vulnerabilities, the structure of markets and fixing those. If you have the biggest change in the structure of capital markets in a generation, that is the kind of thing the FPC would have focused on. That is one of the reasons why the Bank will be involved in the supervision of clearing houses, which is one of the big reforms going on across the world at the moment.

Sir Mervyn King: We did draw attention to these points in speeches in the FSR before the crisis. We were very clear that structured credit products were creating real risks. I said in a speech that the label on the champagne might refer to an increasing number of triple-A structured credit instruments, but by the time investors got to what was left in the bottle it could taste rather flat.

Q822 Mr Laws: When was that speech?

Sir Mervyn King: That was the Mansion House speech in June 2007—many years.

Paul Tucker: We published our first articles on credit derivatives, CDOs and so on at the beginning of the decade. I don't want to say that we saw everything at all. My point is that part of the job is to identify the right terrain. The capital markets are doing extraordinary things all the time. You have to identify those markets where you need to drill down further and ask, "Is the structure of this market adequate?"

Q823 Mr Laws: There is clearly a risk that you could have one committee with its foot on the brake and another with its foot on the accelerator at the same time. There could be quite a conflict between the macro-prudential and monetary policy tools. Are you confident of your ability to resolve those tensions? Is it essentially the overlap in personnel that allows that, or is it something else?

Sir Mervyn King: I don't see that it is a question of brake and accelerator. The virtue of the FPC is that it can remove dilemmas that the MPC might face and would be worried about. For example, the MPC was worried to some extent that the imbalances in the economy and expansion of the banking sector balance sheet was an argument for raising interest rates by more than would be justified by the need to maintain inflation close to the target, and hence steady growth. If the FPC can deal with that problem and remove the dilemma it will make the job of the MPC easier. Far and away the most likely outcome is that the existence of the FPC will make the MPC's job easier, not more difficult because there is a tension between the two.

Q824 Chairman: Could there conceivably be occasions when the MPC and FPC are pushing or pulling in different directions?

Sir Mervyn King: The FPC is going to be focusing on a particular aspect of the financial system, and dealing with that does not pose challenge to the MPC; it makes the job of the MPC easier. I find it very hard to come up with convincing examples where they would be taking steps that would make the other committee's job more difficult. Maybe it is possible to imagine such examples, but I do not find any of those put up so far very convincing. There is overlapping membership, and there are all kinds of other ways in which we can ensure the MPC members talk to FPC members. We are all in the same building. I don't see that as a being a major question.

Q825 Lord Newby: You talked at some length about the relationship between the Bank and Parliament. Could you look at the relationship between the Bank and Treasury both in peacetime and wartime, as it were. In peacetime the setting of the macro-prudential tools will be very much the role of the Treasury. It seems to me they are in the driving seat because they have to propose to Parliament what the tools will be. Once Parliament has passed the secondary legislation it is in effect passed across to you. Are you happy, first, about your input into the setting of the tools, and that the Treasury is going to listen to you when you say, "We'd like one of those, please"; and, secondly, co-ordination thereafter?

Sir Mervyn King: There is no reason to be unhappy at this stage. It is too soon to tell, but we will be publishing our views. We have been asked to give our views publicly, so I am sure the Treasury will listen very carefully, and you or various parliamentary committees can quiz them on why they did or did not listen to the advice of the Financial Policy Committee. We will be publishing a consultation paper around the turn of the year which will set out the various types of instrument one could imagine being among the instruments about which the FPC will make recommendations. The FPC will make recommendations in the spring. I do not see any obvious reason to suppose that the interests of the Treasury are different from those of the FPC. They set it up and it was their wish to create the committee, so I cannot see why they would want to make it impossible for it to operate.

Q826 Lord Newby: Looking back, one of the reasons the tripartite arrangement did not work was that, at least according to some participants, the relationship with and views of the Treasury and Bank diverged. That depends crucially on a relationship between the Governor and the Chancellor. Under the legislation you would be required to meet the Chancellor every quarter. First, do you think that is an adequate formal requirement? Secondly, at the moment how often, as this process is developing, do you see the Chancellor to talk about these issues?

Sir Mervyn King: Very regularly, and I did with the previous Chancellor too. We always pencilled in a regular monthly meeting, and other meetings were held as well. I have a private meeting with the Chancellor at least once a month. At present I seem to spend most of my weekends with the Chancellor. Typically, we discuss other things on those weekends, but we can also take the opportunity to discuss domestic matters. There are also meetings with other groups of officials, including the FSA, that take place regularly. We are not short of meetings. The quarterly meeting is not a good guide to the frequency of actual meetings; it is a statement of how often I have to tell him clearly and officially whether we think there are developments that would threaten public funds.

Q827 Lord Newby: Moving on to wartime when there is a crisis, the main onus for decision making rests with the Bank with which, on your evidence, you are clearly very happy. The relationship with the Treasury seems to be that you tell them what you are doing and say, "We may need some cash", and, "Please can we have the cash?" During the last crisis when the question of who was in charge was raised, those of us who were asking questions of Ministers felt that at the end of the day the Treasury was in charge because it did have the cash. Is there not a tension here in that your formal responsibility is to be in charge but the paymaster, which is the Treasury, is always in charge?

Sir Mervyn King: Yes, and that is the truth. There was a lot of confusion about this issue which all came up in the context of Northern Rock. People wanted to know who was in charge in the sense of who could take action vis-à-vis Northern Rock. The answer is that no one could because there was no legislative framework that enabled anybody, whether it be FSA, Bank or Treasury, to resolve a failing bank. I am very pleased to say that the Treasury Select Committee pushed very strongly for a proper resolution framework, and it was introduced in 2009. We have a resolution framework, and it is very clear how that operates. It is also absolutely clear that any decision that involves the use of public money is taken by the Chancellor. That was true then and it is true now, and it would be true under the new arrangements. There is no ambiguity about that at all.

Q828 Baroness Drake: Under the new framework and with the proposals in the Bill, if there is a crisis which part of the proposals makes it clear that if there is a disagreement between the Chancellor and the Governor that the former's view will prevail, so we are clear as to why you think the new proposals would give that absolute clarity?

Sir Mervyn King: In one part of the Bill or another, in one of the many pages, it states that decisions on putting public money at risk are for the Chancellor and the Governor will have a statutory obligation to inform the Chancellor well before there is any question of a decision having to be made. The concern of the Treasury, quite rightly in my view, is that they do not want the Governor to turn up at five o'clock in the afternoon and say, "A big bank is about to fail. It is your choice, Chancellor, but you have 15 minutes to decide whether to put in £40 billion." You cannot do that to a chancellor; you have to make sure that all the way through the Treasury, the Chancellor and his officials are informed about how things are developing. Indeed, right through the Northern Rock crisis, and every other episode we have been through in this financial crisis, that was the case. Whether it was Northern Rock, Bradford & Bingley, or the resolution framework—the new framework applied to Dunfermline Building Society—the decision about how much public money was committed was always that of the Chancellor.

Q829 Baroness Drake: That is the point at which the Governor takes the view that he expects a call to be made on public funds so that would clearly trigger a shift to the Chancellor, but one of the issues is the extent to which there can be any greyness about the judgment made by the Governor as to when that potential call on public funds arises. How far does it have to go before that shifts towards the Chancellor?

Sir Mervyn King: The framework we have—it was true throughout the crisis—was that information was always fully shared. I believe the FSA told the Chancellor when they were concerned about individual institutions, and we would do that. There is a statutory obligation in the draft legislation.

Paul Tucker: The language is quite careful. Cutting through it, essentially the Bank must immediately notify the Treasury at the point at which it might reasonably be expected by the Bank, the Secretary of State and the Chancellor that public money might be used. The language is "reasonably be expected" and "immediately", so the Governor cannot hang around.

Sir Mervyn King: The discussions that we have now with the Chancellor, as with the former Chancellor, are very often of the kind, "We don't expect this to require public funds, but I am worried that in this situation it could deteriorate in such a way that it might lead to the potential use of public funds. We must make some contingency planning; we must put some arrangements in place in case this deteriorates." That is very much the subject-matter of our conversations now. We are discussing a whole range of contingency arrangements.

Paul Tucker: The Bank and FSA have said that they will introduce a system where each institution is staged: Stage.1 is "okay"; Stage.5 is "dying and needs to be resolved", and all the intermediate cases. What we will do with Treasury officials is work out a framework whereby, if you reach stage *x,* there has to be communication at staff level. The existence of the PIF, the Proactive Intervention Framework, is already making it easier for the Bank's

resolution team and the FSA to work together. It will provide a good platform and put structure around Treasury and Bank staff interactions as well.

Q830 Mr Brown: I want you to say something to the Committee about the risks and difficulties in scoping what is happening in the shadow banking markets worldwide, but perhaps focusing on the United States of America because of the very large sums of money that seem to be involved there. Before I do that, I was very much struck by what you told us about the accountability arrangements. The Bill does not propose any change to the accountability arrangements as they affect Parliament; accountability is through the Chancellor and Treasury Ministers and to Select Committees, essentially the Treasury Select Committee and the parallel arrangements in the House of Lords. Do you identify a need to have something separate and specific so there is some form of public oversight and dialogue in your new role as regulator?

Sir Mervyn King: Let me answer the question on accountability and then perhaps pass the question on shadow banking to Paul, or perhaps Andrew, who has been here all this time, will come in. On accountability—I hesitate to tread on the toes of what you do in Parliament—it is really for your arrangement. Congress uses its existing committee structure to hold regular sessions with the Federal Reserve. The Treasury Select Committee does that with us. As to whether there should be a separate committee for the Bank of England, or a sub-committee of the Treasury Select Committee that deals with regulation, that would be a very sensible step forward, but it is not for us to decide. I would certainly welcome that. We have always said that because the responsibilities of the Bank will be extended, or if they are, you have to look carefully at the governance and accountability of the Bank, and, to be very clear, we would expect that to be increased. It would be very natural for the Treasury Select Committee to have separate hearings on regulation. They could be hearings to which it would be natural to invite Hector and Andrew; they could be hearings on the macro-prudential instruments. Paul could share that. I do not have to go to all these sessions. It would be good if people started to meet more of the executives of the Bank because they are the people doing a lot of the work. I would welcome that expanded accountability. It is a greater burden on the Treasury Select Committee, but I am sure you will find a way through that. I do not think it is something you can delegate. You are there representing the public to hold us to account. I meet lots of people who say that they saw me being grilled by the Treasury Select Committee. I will not tell you what they say, but it is something they take very seriously, and you are there to do that.

Andrew Bailey: There is a general sentiment that the FSA has been less accountable to Parliament than the MPC. That comment is often made. That must undermine the ability of the FSA to do these functions; it is a criticism which must be taken seriously. As the Governor said, it is important to have better accountability. To go back to one of Mr Ruffley's points, you ought to think about how to deal with the fact that in micro-supervision you are handling a lot of very sensitive commercial information. You may want to consider the question of how you have a robust in camera process to do that. It would concern me if the accountability mechanism was in some sense compromised by the inability to talk about the things that you really need to talk about.

Q831 Mr Brown: That is very helpful.

Paul Tucker: Shadow banking is a very hot international topic. The Summit of Leaders in Cannes which is going on over the next few days will conclude, I think, one big batch of reform in the area of banks' capital and resolution. It will tell the Financial Stability Board to get on with its work on shadow banking, and a paper and pretty big work agenda on that was published a few weeks ago. First, domestically the Financial Policy Committee will have the power, if the Bill passes, to make recommendations and to give directions to the FCA where lots of the shadow banking system will reside, if it is obviously not in the PRA. Secondly, the FPC is given the duty under the Bill to make recommendations to the Treasury about when the perimeter of regulation should be changed, so that something that lies outside both the PRA and the FCA can be brought inside in some way, or some reshuffling between the PRA and FCA can go on. We need information to do that. The market intelligence function of the Bank will be absolutely vital. My personal very strong belief, which the Governor shares, is that this system will not work over the years and decades unless the Markets area of the Bank and its market intelligence capability are completely engaged in that, which they are at present.

The next question is about information powers. The PRA and FCA have information powers. The Bank has the right to ask the PRA and FCA for information, but we are working up some ideas to take to the Treasury about the Bank/FPC having an information power to require information for bits of the system beyond the regulated perimeter in order to support any recommendations to the Treasury that the perimeter should be changed. If we ever find ourselves wanting to recommend that the perimeter be moved, we will need an evidential basis for it, not just chatter.

Q832 Chairman: Could the Committee have a note on what you are putting to the Treasury?

Paul Tucker: Yes.

Q833 Mr Brown: The total sums of money involved in this are huge.

Paul Tucker: They are.

Q834 Mr Brown: As a lay person, the financial service products seem to me fiendishly complex. I am not certain I could adequately describe how they work and what they do. Are you certain that you have a grip on everything that is done, not just the complexity of the instruments but the actual products that underpin them and make them up?

Paul Tucker: We have access to sufficient people both in the official sector and around the world to do that. Will we occasionally miss things? We will. Will we occasionally miss big things? If we keep this market intelligence function over the years and decades, I would truly be hopeful of not missing the big trends. One of the great things about the financial markets is that they love talking about what they are doing. Even though they make mistakes, they are gripped by what they do and effectively reveal to the official sector what is going on. It does not come through the hard data, but you need to be intelligent about how you turn an anecdote into a solid evidential base.

Andrew Bailey: I give you an example. We have just been through this. You have to see through complexity to some pretty straightforward principles. The Governor talked about leverage. Unfortunately, I had to spend the whole of this weekend dealing with MF Global. When you cut through it all, that firm was over-leveraged and essentially had a funding model that could not withstand the stress. It could not withstand rating agency downgrades and it blew up. There was an enormous amount of complexity about how they were doing it; there were reverse repos here and there—all sorts of things—but, when you get down to it, it was leverage and the inability of the management to see they had constructed a model that could not withstand a pretty simple stress.

Q835 Mr Brown: What is the public interest defence for this complexity? How is it in the public interest?

Sir Mervyn King: An awful lot of the complexity you see at present is to get round detailed rules and regulations.

Q836 Mr Brown: I rather suspected that.

Sir Mervyn King: That is why we feel so strongly that the culture of regulation needs to get away from this game in which the regulators write ever more complex regulations and the banks and their lawyers write new products, which are essentially the same as the previous ones but are defined in such a way as not to be caught by the latest rule and regulation. This leads to a very expensive and unnecessarily complex system. There are two very important things we have to do to get over this. One is to make sure that regulation is about judgment so that the examples I gave you earlier about complexity, opacity and simple leverage developments, are ones in respect of which Andrew can say to a bank, "Look, frankly we do not understand why your organisation needs to be so complex. We cannot work out what you are doing, so you will have to change it. You have not broken a rule, but too bad; you have to change it." If you do not want regulation of that kind I do not think you will ever get any proper regulation.

Secondly, we have to recognise that regulators cannot regulate everything; there is a limit to what regulation can do. In my judgment it comes pretty quickly. Once regulators get bogged down in excessive detail they will never be a match for the banks, so we have to have a framework in which most of these firms can fail. If they screw up, we just let them go; they are bust. We must have a system that enables us to allow the failure of a firm not to undermine the rest of the system. That is why MF Global this time was quite a good example of a company where, frankly, there was no public interest in saving it.
The public interest was in making sure that it was possible to administer the failure of the institution without it causing damage to the rest of the financial system. That was what we did not have when Northern Rock failed, and that is what we have now. As to the very large global cross-border institutions, we have not yet solved that problem but we are working on it at international level, and maybe we will find a solution down the road.

Paul Tucker: The Leaders will make a big announcement on this in the next few days, unless they decide not to. There is a big package of measures coming out.

Q837 Chairman: From whom?

Paul Tucker: The G20 summit; it is part of the package.

Q838 Mr Brown: Is the amended legislation that we have under consideration here fit for purpose, or is there anything you would say to us about strengthening your hand in these matters as regulator?

Sir Mervyn King: There are two things. This is not an easy Bill to read because it has been constructed in the form of amendments. I am sure you are expert at reading documents like this.

Q839 Mr Brown: We have been given a crib which is the full legislation with the amendments inserted.

Sir Mervyn King: Lucky you! When I get a document that has two completely different sets of page numbers, one at the top and one at the bottom, it is a world I am not used to. First, the Financial Policy Committee needs stronger powers to obtain data. We have to do it at present through the PRA which can really obtain data that are relevant only to their regulatory purposes. We would like a power for the Financial Policy Committee and the Bank itself to obtain data. Secondly—this is most important—as to the recommendations or directives that the Financial Policy Committee can make to the PRA after the legislation comes into effect, it cannot say the means and time over which those can take place. This seems to us a bit bizarre, because if we say, for example, that we think that the capital requirements on banks need to go up to slow things down we want to be able to say, "It is important that you do it within six months", but we cannot do that under this legislation. We also want to be able to explain that it should be done in such a way rather than for the PRA to decide themselves. Those are the two areas where some strengthening of the powers of the Bank and the FPC would be appreciated.

Paul Tucker: We also want to make clearer the threshold conditions to be authorised as a bank. One of you—perhaps you should draw lots—should read the existing threshold conditions and ask whether they'd be comprehensible to a CEO, CFO or member of the public. We want to get back to a statement in fairly plain language of what you need to pass to be a bank and, separately, to be an insurer. I know that Hector Sants agrees with me about that.

Q840 Mr Brown: If I asked you to send us a note setting out your views in comprehensible language, would you do that?

Paul Tucker: Yes.

Sir Mervyn King: We would be happy to do that.

Q841 Chairman: On the question of information, should the power to obtain data be modelled on the US Office of Financial Research? As a related question, you once said, Governor, that you did not want to impose onerous obligations on banks to provide endless

Sir Mervyn King: The PRA can do that; they have the powers. It is important to go down a route where we do not say to the banks, "You must send us this data every three months", and nothing is ever taken off the list. During the crisis, and even quite recently, when we wanted information it turned out that the regulators did not have data relevant to the problem at hand. It is a different approach to data collection. It is trying to get away from the provision of a lot of routine information, management reports and detail, which has no relevance to the PRA and no one would ever look at, and focusing on the stuff that we ought to look at. Rather than burdening the banks with a massive data reporting requirement, we should make it clear to them, "We think you ought to know the answers to the following questions, and from time to time we will want to know the data, too, but do not send it to us until we ask for it." One of the changes in the culture of the supervisors that we are trying to bring about is to get them to think about the data they require to do their job, not take from their drawer a long list of questions they have been given and tick or not tick the boxes but sit down and say, "What do I need to know about this bank to judge whether or not it is too risky?" It will take a long time to change that culture, but those are the kinds of people we are committed to growing, developing and turning into effective supervisors.

Andrew Bailey: From time to time we do it now. I do it in running supervision. We say, "We want this by close of business tomorrow." Sometimes I get protests from chief executives of banks and I say to them, "Look, I'm not asking you for anything you should not have yourself to run your business."

Q842 Lord McFall of Alcluith: For the record, I was aware of the demands that the Treasury Select Committee put on you and your staff during the crisis, both in terms of information it required and your appearances before the Committee. Both yourselves and the FSA, given the structure that existed, were on every occasion very willing to engage. It is important to make that clear. Governor, the position of Greece, the implications for stability and growth across the eurozone but also for the UK are very much in our minds at the moment. Do you believe that the European institutions that have been established for that purpose, the ESRB, of which you are vice-chairman, and others, are structurally sound and are designed to take on the big issues like cross-border resolution in Europe and elsewhere?

Sir Mervyn King: They are. One thing I confess being pleasantly surprised about in the ESRB was the genuine commitment of the senor people around the table to engage in a serious discussion of the issues. In most of the international meetings, when you have 60, 70 or 80 people around a table, you would not want to listen to the discussion. Frankly, it is rather pointless, but this was not. People were very disciplined about the time they took up and were clear about the interventions, I suspect because they realised that what was at stake here was very great. I have been impressed by the way the ESRB have worked. Whether we can translate this into action is a different question, because the ESRB can make only recommendations and it is up to ECOFIN and the supervisory bodies to do something about it.

This is linked to the question of judgment and flexibility. If we were meeting four years ago we would have said, "We have weights to calculate the riskiness of banks, and there is a zero risk weight on sovereign debt. What we really ought to be worrying about is not that but the risk weight on subprime mortgages." Four years on, what seems absurd about the current system is a zero risk weight on sovereign debt when we know that that can be a highly risky instrument. One of the challenges for regulation is that if you want to have an international agreement on risk weights as part of the Basel framework it is very difficult to have something that can change quickly, because often it takes years of negotiation to get to an agreement. Then you find that within a year or two those risk weights look outdated. You need that framework but it needs to be supplemented by discretion at national level which gives supervisors a degree of flexibility and agility to respond to problems.

Q843 Lord McFall of Alcluith: I want to pick up your point about the character of lending in the financial system in the previous five years. We had debates on assisting the real economy, particularly the regional economy. That was important. Will these institutional changes assist that process? If the Bank of England and others are not issuing corporate bonds, who can do that? Who can answer the question that Adam Posen posed when he said that we lack a spare tyre for lending to manufacturing and small businesses?

Sir Mervyn King: I think that is something that the Treasury and BIS can do. The Chancellor has said he wants to make announcements in his pre-Budget statement. We will see what comes out of that, but there is no doubt these are crucial questions for the economic future of the country. It is important they are seen as issues to be debated in Parliament where the Government have responsibility to act.

Q844 Lord McFall of Alcluith: Will the institutional changes assist that?

Sir Mervyn King: I am not sure it will make very much difference to that. That is not a reason for not realising that these are crucially important questions.

Paul Tucker: Indirectly, it will help in the following sense. The part of the economy which gets most badly damaged when the banking system implodes is the part of the economy that depends entirely on banks: SMEs and households. It is indirect, but anything that makes the banking and financial system more resilient will make it less likely that households and small firms will find themselves where they are now. It is exactly as the Governor described when dealing with monetary policy. That is the contribution we can make. It is not the good things in themselves but it is a precondition for having the good things.

Q845 Chairman: Do you envisage that the FPC will have powers to restrict lending to particular sectors, like the financial sector, and direct it to other sectors, which was the implication of the recommendations from HSBC?

Sir Mervyn King: That is to be debated and discussed. I am nervous about that, partly because that trying to second-guess details very often goes wrong. If the FPC could manage to have a major influence on the rate at which the banking sector as a whole was expanding or contracting its balance sheet we would take an enormous step forward. There will be examples of the creation of particular kinds of financial instruments that we think pose specific risks. For example, we talked a great deal about structured credit products and

CDOs before the crisis. If we had been able to do something to throw a lot more light on that so people came to the realisation much earlier that they were riskier than they had been led to believe, and to make it more difficult for the ratings agencies to pretend they were triple-A-rated instruments it would have been a big plus, but I suspect that will be more in the area of financial products than in deciding whether we should encourage lending to manufacturing versus services, and so on. That is a slippery slope that is not one on which the FPC have particular expertise and certainly no legitimacy in trying to distinguish between different parts of the real economy.

Paul Tucker: What we have said so far in the record of the FPC meeting is that one instrument we may ask for—it is not concluded yet—is the ability to alter risk weights on particular sectors. To go back to Mr Laws' question, the classic in the boom leading up to the crisis would have been to require banks to hold more capital to lend to other parts of the financial system. That would probably have had the effect of dampening it. But it turned out that that lending was just a lot riskier than anyone had thought when they had initially calibrated the risk weights. It is important to emphasise that this is not to do with a form of active macro-economic management. You write a set of minimum requirements; you do your best to cater for the future; but things come along that the international community did not think of, for example, things in Ireland which are different from the UK or Wall Street. You need to be able to flex and say, "We need a greater degree of resilience right now about lending into parts of the financial sector."

Sir Mervyn King: That is why relying on detailed risk weights can be dangerous, because the appropriate risk weights can change over time. The lesson of successful regulation in other industries is the need to focus on robustness and simplicity. If you start to make the regulation too complicated not only will the regulated use their lawyers to get round it but the details will turn out to be the wrong ones. Thinking about robustness and simplicity are the key.

Q846 Baroness Wheatcroft: We are talking about expertise among regulators. You talked about clearing houses. Would there be some merit in putting exchanges under the same regulatory authority as clearing houses? Would that make more sense? Would there be more expertise there? That takes me to a broader point. Judgment-based regulation requires the right people to exercise the judgment. One theme that has cropped up repeatedly as we have talked to people from industry is their nervousness about the quality of the people, not I hasten to add from the Bank of England but those coming from the FSA. They have seen a drift of talent away from the FSA, particularly in this period of limbo, and they are very worried about whether the new structure will have the quality of people to exercise the judgment they want and is required. Should there be some form of compulsory secondment scheme from industry? Do you see any way of getting the right people into regulation?

Sir Mervyn King: At first sight, it seems attractive to put exchanges in with central counterparties. The drawback is that the one kind of regulation that the PRA should not get involved in is the inevitably legalistic and detailed rule-based regulation on insider trading, compliance and conduct of business. If you could separate the two, maybe. Our present feeling is that it is quite hard. The one thing we definitely don't want is that kind of regulation vis-à-vis exchanges.

On the broader question of people, let me make a general comment first. 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. Two of the most effective regulators I have known in my career were Paul Volcker and Gerry Corrigan. They were people who never got paid very much money during their careers. They were very powerful and effective regulators because they were committed to a life of public service and found it intellectually fascinating, and it mattered for their country. Just as we have managed to do in the area of monetary policy and financial stability, we want to attract people, certainly recruiting them when they are young but others in mid-career, who want to work on public policy. I do not think we want to mimic some of the salary scales of the FSA, nor do I think that we want to attract people who take short-term periods out of the financial services sector to get two or three years' experience and then go back. We want people who want to make careers as regulators. We will need experience and knowledge, but, most of all, we want people who have the expertise to be regulators. 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.

Q847 Chairman: Governor and Deputy Governors, thank you for your extremely thoughtful and lucid responses to the Committee. They are very helpful to us and will assist us in carrying forward our investigation into this voluminous Bill.

Sir Mervyn King: We wish you well. If you need any other information from us, just let us know.

Bank of England – supplementary written evidence

In our written evidence to the Joint Committee on the Draft Financial Services Bill, the Bank raised concerns over the European Commission's current proposals for the reform of financial regulation. This topic was referred to in the hearing you held with Mr Enria, Chairman of the European Banking Authority (EBA). Having read his evidence, I would like to provide further thoughts on the European Commission's proposals.

Minimum requirements not maximum harmonisation

The draft Capital Requirements Regulation (CRR) and the draft Capital Requirements Directive (CRD) are the legal instruments with which the European Commission proposes to bring Basel III into EU law. As you are aware, the Commission plans to introduce the new requirements as a maximum harmonised regulation. This would explicitly remove the universal discretion for national authorities to increase prudential rules to guard against systemic risk.

This approach concerns us greatly. The objective of a "single rule book" does not require such rigid common maximum capital requirements. It does require minimum harmonised capital requirements as provided by the Basel Accords. The reason for allowing countries to set capital requirements above the common minimum is to allow them to protect their own taxpayers when it is clear that other countries in Europe would not share the cost to taxpayers of bank failures. The recent crisis has shown that such costs can be significant.

The European Commission argues though that a maximum-harmonised single rulebook will create a "level playing field" for financial services across Europe. However superficially attractive, this is an unhelpful metaphor; financial services is not a game, and the purpose of financial regulation is not to create opportunities for the players but to protect the spectators.

And it tackles the wrong problem. The dominant theme of financial regulation has been the 'race to the bottom', rather than a 'race to the top'. Rarely do financial services companies approach their national regulators to tighten the regulatory burden. This is why minimum regulations have been the concern of international agreements for some time, with national discretion to exceed them as required.

The economic rationale for minimum requirements is well understood. The same cannot be said for maximum harmonisation, where no persuasive evidence has been provided that the loss of flexibility will be outweighed by other benefits. Tighter regulation in one country may in the short-term give a competitive advantage to other countries' banks. It will also have a positive spill-over effect on the resilience of the banks in other countries, given the interconnectedness of the global banking system. By contrast, a failure to tighten regulation would expose the system as a whole. Under maximum harmonisation, other countries may therefore be put at risk if national regulators in one country are unable to tackle an increasing systemic risk within their own financial system.

Does the draft CRR/CRD provide enough flexibility for prudential policy?

The financial crisis has shown the need for a *macroprudential* approach to financial regulation -tackling risks at the system level. To consider such risks, the Draft Bill provides the statutory basis for the Financial Policy Committee (FPC), and provides it with powers of direction over certain macroprudential tools. HM Treasury's February 2011 consultation document set out a number of such tools that the FPC might utilise to achieve its objectives. The FPC has already begun to consider which of these tools should form part of its future toolkit. By requiring the maximum harmonisation of rules, the current draft of the CRR/CRD may close off the necessary flexibility and legal clarity required for the FPC to use all of the tools listed. We are therefore concerned that maximum harmonisation may prevent the creation of a successful system for tackling systemic risks. The need for flexible macroprudential policy has support outside of the UK authorities. The IMP's recent UK article IV Staff Report supported the need for "flexibility for national authorities to use a range of macroprudential tools".

In his evidence, Mr Enria suggested that there was enough flexibility within the draft *CRR/CRD* to allow for the necessary national discretion to counter macroprudential risks. While the *CRR/CRD* does make specific provision for national regulators to use a counter-cyclical capital buffer, and have the ability to change the risk weights on real estate in the standardised approach, this is not the comprehensive set of macroprudential tools envisaged in HM Treasury's consultation document. For example, the *CRR/CRD* may prevent the use of higher risk weights on intra-financial system exposures, which increased strongly in the run-up to the crisis.

Other mechanisms via which flexibility might be provided were suggested, but none provide the operational effectiveness and legal clarity of a minimum-requirement implementation of Basel III. One suggestion was to use Pillar 2 provisions for "classes of banks". This does not appear to be a desirable approach. 'Pillar 2' is the term used in the Basel Accords to refer to the microprudential supervisory review of individual firms. Pillar 2 is therefore not designed for macroprudential purposes. It is a 'bottom-up' approach, which starts at the level of the firm, rather than the system as a whole. It is also inherently non-transparent. Pillar 2 flexibility will, however, be important to the Prudential Regulation Authority as a means of implementing its judgement-based supervisory approach. Another significant concern, therefore, is that the multiple binding technical standards on Pillar 2, to be issued by the EBA, will limit this flexibility.

A strong EU coordination mechanism for macroprudential policy has also been advocated. However a requirement for EU level coordination would undoubtedly hamper national authorities' attempts to take timely action to combat macroprudential risks by placing another barrier in the path of national regulators. This is important given that macroprudential policy may already be prone to what the IMP refers to as a "bias for inaction".[23] Moreover EU level action will be blind to the preferences of Member states, and their taxpayers, who in the last resort pick up the cost of failure.

Conclusion

[23] "The Do's and Don'ts of Macroprudential Policy", speech by Jose Vinals, IMF Financial Counsellor and Director, Monetary and Capital Markets Department European Commission and ECB Conference on Financial Integration and Stability, Brussels, 2 May 2011.

Despite the assurance provided by Mr Enria that "Maximum harmonisation is a big step forward [...]in the functioning of European markets,"[24]the analysis set out above suggests that maximum harmonisation may put at risk the future stability of European financial markets by limiting the scope of action available to national authorities to deal with emerging threats to financial stability.

My colleagues and I will be happy to answer any further questions you may have on this subject when we appear before your Committee this autumn.

30 September 2011

[24] Uncorrected oral evidence to the Joint Committee on the Draft Financial Services Bill Committee, 13 September 2011, Q 67

Bank of England – further supplementary written evidence

When we appeared before your Committee on 3 November we undertook to provide a note and some possible clauses that would meet our concerns about the Bill: specifically on powers to obtain information from certain unregulated firms in the context of shadow banking; and on powers for the FPC to influence how, and how quickly, regulators will put its directions into effect. I have asked Paul Tucker and Hector Sants to write to you about your other question on threshold conditions.

Information Powers

The Bank is given by the Bill a power to direct the PRA and the FCA to provide it with information. The PRA will of course be a part of the Bank but the FCA will not, so clear powers are required. Under the proposals as they stand, however, the FPC's ability to obtain information relies on the extent of regulators' own powers. These are relatively extensive in relation to UK-regulated firms. But the FPC's objectives and responsibilities are wider. In particular, the FPC has to make recommendations to the Treasury about the regulatory perimeter and for that it must be able to obtain information from those over whom the PRA and the FCA may have no authority. Put another way, the PRA has authority over banks, but the FPC needs the ability to find out about shadow banks.

We think therefore it is essential that the FPC should have a direct power that it can exercise itself, not through intermediaries whose powers may be constrained and which will anyway have their own priorities. It is, I think, relevant that the FSB recommendations on shadow banking - endorsed by the G20 leaders at Cannes last week- provide that "In establishing a monetary framework for the shadow banking system, the relevant authorities should have powers to collect all necessary data and information."

Our proposed Clause is at Annex A.

Implementation of FPC Directions: Means and Timing

It is intended that the FPC will be able to give Directions to the regulators in relation to macro- prudential instruments: the ability to do so and thus to insist on the micro-prudential regulators operating for the purposes of the system as a whole, is key to the new approach. One of the failures of the past decade was precisely not having a macro-prudential regulator capable of imposing a system-wide requirement. There is however one element missing. The FPC can direct a regulator to do something but it may not specify how and when it must be done. The Bill - clause 9C(6) - is clear that specifying timing and means is not allowed.

I think this a missed opportunity. It was the intention of the new framework that the FPC should be able to impose requirements on systemic stability grounds, and for this purpose it is very difficult, in my view, to justify limiting its power to specify timing and means. On many occasions the precise implementation of FPC directions can be left to the micro-prudential supervisor. But in other cases a key element of the FPC's policy position will be about when or how a particular tool is to be used and, in some areas, there is likely to be a premium on pre- emptive, targeted and well-timed action.

Obviously the FPC will be sensitive to any concerns of the regulators, though it will be aware of those concerns given the presence on the Committee of the chief executives of the PRA and FCA. Lord Turner and Hector Sants suggested last week that a means and timing power should be restricted to those areas where the FPC had a power to direct rather than to recommend, and that would be our expectation too, as the direction powers would be set out and agreed in secondary legislation and may include a statement of the general policy that would govern their use.

An amendment to Clause 9C (6) on page 6 of the Bill is attached at Annex B.

I hope that this, and the separate letter on threshold conditions, will be of assistance. I hope you will let me know if there is any other way that we can help the Committee.

Annex A

Proposed information power to enable the Bank to require information for the purpose of making recommendations to the Treasury on changes to the regulatory perimeter:

1. Power to require information

1.1 The Bank may, by notice in writing given to a person to whom this section applies, require the person--
(a) to provide specified information or information of a specified description; or
(b) to produce specified documents or documents of a specified description.

1.2 This section applies to a person where the Bank considers that the activities carried on by that person, or the way in which those activities (or any part of them) are carried on, are or might be relevant to one or more aspects of the UK financial system.

1.3 This section applies only to information and documents that the Bank considers are,or might be, relevant for the purpose of the Financial Policy Committee's function of making recommendations to the Treasury under section 9N(2)(b).

1.4 Information or documents required under this section must be provided or produced--
(a) before the end of such reasonable period as may be specified; and
(b) at such place as may be specified.

1.5 The Bank may require any information provided under this section to be provided in such form as it may reasonably require.

1.6 The Bank may require--
(a) any information provided, whether in a document or otherwise,to be verified in such manner as it may reasonably require; or
(b) any document produced to be authenticated in such manner as it may reasonably require.

Annex B

Amendment to enable the FPC to give directions on means and timing of implementation of macro-prudential measures:

"9G

(6) The direction may ~~not~~ require *or recommend* its provisions to be implemented by specified means or within a specified period, ~~but may include recommendations as to the means to be used and the timing of implementation~~."

14 November 2011

Bank of England and Financial Services Authority – further supplementary written evidence

As requested, this letter sets out how we think the Bill should improve upon the existing FSMA provisions for authorising firms. It also raises one other issue, which we have recently flagged with HMT. For clarity, Hector is signing this letter as chief executive-designate of the PRA.

Threshold conditions for authorisation of a bank/insurer

Paul Tucker mentioned this in the Bank's evidence to the Joint Committee.

The current threshold conditions are contained in Schedule 6 to FSMA. They are critically important to the style and content of regulation, as they set out what firms must do to become, and to remain, authorised. Failure to satisfy one or more of the threshold conditions means that the regulator may revoke or vary the scope of the firm's permission and impose requirements on it. Together with the regulator's statutory objectives, the threshold conditions form the basis on which the regulator will determine and enforce its supervisory judgments. It is therefore vital that they should be a crisp and clear statement of what is required of firms.

Currently, FSMA applies a single set of criteria to all regulated firms, with each condition applying
to a greater or lesser extent both to prudential and conduct requirements. This approach is, of course, a legacy of a regime based on an integrated regulator. For that to work, the threshold conditions in the original FSMA were set at a level of generality that was capable of encompassing both the prudential and conduct of business requirements of all types of regulated firm. One effect of that is they have not served as an adequate guide for prudential supervisors or for firms.

To remedy this in a Twin Peaks world, we propose that banking institutions and designated investment firms on the one hand, and insurers on the other hand, should be subject to threshold conditions designed specifically for their type of business. Set out in the annex to this note is one suggestion as to how the conditions could be re-drafted for deposit-takers and PRA-designated investment firms. They are deliberately written in a style that firms' CEOs and senior management, as well as legal advisers and our own prudential regulators, should be able to understand. They emphasise prudent management, financial resources, resolvability, and effective supervision of the firm being feasible.

Another set would need to be drawn up for insurers, and we are working on that.

The differences would serve to highlight the distinction between banks, insurers and other types of firm. More important, statutory threshold conditions along these lines would help to underline the vital point that the PRA has to exercise judgment about firms' financial safety and soundness.

Bank Holding Companies

There is another potentially important improvement that the Bill could make to the statutory regime, but which did not come up in evidence to your committee.

Compared with a generation ago, many of the UK's important banks and insurers now have holding companies. Currently, FSMA gives the FSA only indirect powers over unregulated holding companies of banks, and those powers are restricted to approving changes of control and limitations on intra-group exposures. As a result, supervision of groups headed by an unregulated parent is less effective than for those headed by a regulated firm. This was highlighted by the IMF in their recent Financial Stability Assessment Programme Report on the UK financial system:

> "***The regulatory authority should be provided with enforcement powers at the holding company level***. *The FSA's present powers to take supervisory or remedial actions are targeted at the regulated entities that fall within the consolidated group. In other words, the FSA can only impose consolidated obligations by acting through the U.K.-regulated entities, which may not be effective when those entities in the group are small relative to the non-U.K.- regulated entities over which the supervisor has no direct control. Legislation should be amended to provide holding company level enforcement powers.*"

The Bill (section 192A-I on p 157) provides a partial, but incomplete, solution by giving the PRA
and FCA a broad power to direct a holding company of a bank, insurer or investment firm to do (or not to do) something to avert a material adverse effect on the regulated subsidiary. This would apply only to those UK holding companies that are financial institutions. Pure holding companies and other group companies would seem likely to remain beyond the scope of the PRA's powers, and so its prudential supervision of the group as a whole would not be backed by regulatory powers.

This has the following effect. Although the UK prudential regulator is regarded, under the key international agreements such as the BaselConcordat, as the consolidated prudential supervisor of <u>groups</u> headquartered in the UK, its capacity to deliver varies according to the precise organisational structure of each international banking (and insurance) group. The current position amounts to a fault line in the global financial system.

We believe that a more comprehensive regime is now needed in the UK.

Annex

Draft Prudential Threshold Conditions for deposit-takers and PRA designated investment firms

Threshold Condition 1: Adequate financial resources

(1) The institution has adequate financial resources. To have adequate resources means, in particular, that the institution:
   (a) maintains or will maintain capital which, together with other financial resources available to the institution, are of such nature and amount as are appropriate for the activities it undertakes.
   (b) maintains, or will maintain, adequate liquidity, having regard to the relationship between its liquid assets and its actual and contingent liabilities,

to the times at which those liabilities will or may fall due and its assets mature and to any other relevant factors.

(c) carries out with integrity the valuation of its assets, liabilities which will or may fall to be discharged by it and losses which it will or may incur.

(2) All circumstances shall be taken into account in establishing whether the institution has adequate financial resources, including:

(a) The nature and scale of the institution's business;

(b) The risks inherent in the institution's business, including its business model, and in the business of any other person in the institution's group;

(c) The effect on the system from the way in which the institution carries on its business;

(d) The likely effect on the system should the institution fail; and

(e) The extent to which an institution can be resolved.

Threshold Condition 2: Business to be conducted in a prudent manner

(1) An institution shall conduct its business in a prudent manner. In particular, this means that:

(a) it maintains, or will maintain, adequate and appropriate management resources, including but not limited to, systems and controls, adequate accounting and other records, policies, plans and human resources to measure, manage and mitigate the prudential risk to the institution, or related persons, and to enable the institution to comply with the duties imposed on it under FSMA

(b) each of its controllers (taken as a whole), management and board of directors is fit and proper;

(c) the allocation and exercise of management responsibilities avoids the undue concentration of authority;

(d) the management of the institution is made up of individuals with an appropriate range of skills and experience to understand, operate and manage the institution's activities; and

(e) the Board of Directors provides effective oversight of management and a robust internal governance framework.

(2) All circumstances shall be taken into account in establishing whether the institution conducts, or will conduct, its business in a prudent manner, including:

(a) The nature and scale of the institution's business;

(b) The risks inherent in the institution's business, including its business model, and in the business of any other person in the institution's group;

(c) The effect on the system from the way in which the institution carries on its business;

(d) The likely effect on the system should the institution fail; and

(e) The extent to which an institution can be resolved.

Threshold Condition 3: Fit and proper business

The business of the institution is, or is likely to be, carried on in a fit and proper manner, including with integrity and the appropriate level of professional skills having regard to all the circumstances.

Threshold Condition 4: Legal status and Location of offices

(1) The institution must be either a body corporate or a partnership.

(2) If the institution is a body corporate constituted under the law of any part of the United Kingdom, its head office, and, if it has a registered office, that office, must be in the United Kingdom.

(3) If the institution has its head office in the United Kingdom but is not a body corporate, it must carry on business in the United Kingdom.

Threshold Condition 5: Effective supervision

The institution is capable of being supervised effectively by the PRA (including, where applicable, on a consolidated basis), having regard to all the circumstances, including:

(a) Where an institution has close links, whether those close links could prevent the PRA's effective supervision;
(b) Where the close link is subject to laws, regulations or administrative provisions of a territory which is not an EEA state (the "foreign provisions"), whether these foreign provisions or any deficiency in their enforcement would prevent effective supervision;
(c) Where an institution is part of a group, how the structure of the group affects supervision of the institution.
(d) Whether the institution is, or is likely to be, open and co-operative in its dealings with the PRA.

18 November 2011

Bank of England and Financial Services Authority – further supplementary written evidence

Last month we wrote to you with our thoughts on how the Bill should improve upon the existing FSMA provisions for authorising firms. We proposed that the threshold conditions for authorisation should be designed specifically for the type of business the firm undertook. To illustrate this, the letter attached our suggestion for how the existing criteria for authorisation could be re-drafted for banks.

Since then, we have done the same exercise for insurers. These are set out in the annex.

ANNEX
Draft Prudential Threshold Conditions for Insurers

Threshold Condition 1: Adequate financial resources

(1) The institution has adequate financial resources. To have adequate resources means, in particular, that the institution:
(a) maintains or will maintain capital which, together with other financial resources available to the institution, are of such nature and amount as are appropriate for the activities it undertakes.
(b) maintains, or will maintain, assets whose liquidity and risk profile are appropriate for its actual and contingent liabilities.
(c) carries out with integrity the valuation of its assets, liabilities, which will or may fall to be discharged by it and losses which it will or may incur and maintains or will maintain adequate reserves accordingly.

(2) All circumstances shall be taken into account in establishing whether the institution has adequate financial resources, including:
(a) The nature, scale and complexity of the institution's business;
(b) The risks inherent in the institution's business, including its business model and the business of any other person in the institution's group;
(c) The means by which the institution indentifies, measures, monitors and manages the incidences of risks in connection with its business;
(d) The effect on the system and policyholders from the way in which the institution carries on its business;
(e) The likely effect on the system and policyholders should the institution fail; and
(f) The extent to which an institution can be resolved.

Threshold Condition 2: Business to be conducted in a prudent manner

(1) An institution shall conduct its business in a prudent manner. In particular, this means that:
(a) it maintains, or will maintain, adequate and appropriate management resources, including but not limited to, systems and controls, adequate accounting and other records, policies, plans and human resources to identify, measure, monitor and manage and mitigate the risks that may arise from the firm's financial position to:

(i) the institution, or related persons, and i.policyholders and to enable the institution to comply with the duties imposed on it by or under FSMA
(b) each of its controllers (taken as a whole), management and board of directors is fit and proper;
(c) the allocation and exercise of management responsibilities does not, or is not likely, to prevent the business being conducted in a fit and proper manner (including through the undue concentration of authority);
(d) the management of the institution is made up of individuals with an appropriate range of skills, knowledge and experience to understand, operate and manage the institution's activities; and
(e) the Board of Directors provides effective oversight of management and a robust internal governance framework.
(f) *[it maintains proper segregation of its different businesses in accordance with its legal obligations]*

(2) All circumstances shall be taken into account in establishing whether the institution conducts, or will conduct, its business in a prudent manner, including:
(a) The nature, scale and complexity of the institution's business;
(b) The risks inherent in the institution's business, including its business model, and in the business of any other person in the institution's group;
(c) The means by which the institution indentifies, measures, monitors and manages the incidences of risks in connection with its business;
(d) The effect on the system and policyholders from the way in which the institution carries on its business;
(e) The likely effect on the system and policyholders should the institution fail; and
(f) The extent to which an institution can be resolved.

Threshold Condition 3: Fit and proper business
The business of the institution is, or is likely to be, carried on in a fit and proper manner, including with integrity and the appropriate level of professional skills having regard to all the circumstances.

Threshold Condition 4: Legal status and Location of offices
(1) The institution must be either a body corporate or a partnership (other than a limited liability partnership, a registered friendly society or a member of Lloyds).

(2) if the institution is a body corporate constituted under the law of any part of the United Kingdom, its head office, and, if it has a registered office, that office, must be in the United Kingdom.

(3) If the institution has its head office in the United Kingdom but is not a body corporate, it must carry on business in the United Kingdom.

Threshold Condition 5: Effective supervision
The institution is capable of being supervised effectively by the PRA (including, where applicable, on a consolidated basis), having regard to all the circumstances, including:
(a) Where an institution has close links, whether those close links could prevent the PRA's effective supervision;

(b) Where the close link is subject to laws, regulations or administrative provisions of a territory which is not an EEA state (the "foreign provisions"), whether these foreign provisions or any deficiency in their enforcement would prevent effective supervision;
(c) Where an institution is part of a group, how the structure of the group affects supervision of the institution.
(d) Whether the institution is, or is likely to be, open and co-operative in its dealings with the PRA.

12 December 2011

Barclays – written evidence

Summary of submission

The design of the UK's new financial services regulatory regime is of great significance to the future resilience of the financial system and the wider health of the UK economy. We fully support the role of the Draft Financial Services Bill Committee (the "Committee") in scrutinising this important legislation.

Barclays is broadly supportive of the overarching framework as proposed in the Draft Financial Services Bill (the "Draft Bill"). However, we believe that there remain crucial areas where changes are still necessary to strengthen and improve the legislative proposals. These areas could broadly be grouped under the headings of: balanced objectives; greater accountability; and, strengthened coordination.

Balanced objectives

- The Bank of England's (the "Bank") financial stability (or financial policy) objective could be made more definable if it focused on the sustainable supply of credit. This would still enable sufficient flexibility to address a range of potential systemic risks.
- Most importantly, we believe, that the Financial Policy Committee's (the "FPC") focus should mirror the Monetary Policy Committee (the "MPC") in being suitably set in the context of, and balanced with, the wider economic policy and objectives for growth.
- The Prudential Regulation Authority (the "PRA") and the Financial Conduct Authority (the "FCA") should recognise the role that regulated firms play in supporting economic growth. Whilst a shift away from pre-crisis risk tolerance is understandable, insufficient risk tolerance may have a negative impact on innovation and economic activity.
- Whilst we recognise the advantages of "judgement-based" regulation, flexibility must not be obtained at the cost of consistency, legal certainty and due process.

Greater accountability

- Government must continue to play a central role in financial stability policy as it will ultimately be held accountable to deal with a crisis situation.
- Accountability could be strengthened if the Treasury set a clear remit for the FPC, as it does with the MPC. The FPC could then be held accountable for delivering its strategy on the basis of the remit it has been given.
- Accountability and good governance would be improved by a stronger role for, and better balance of, independent members on the FPC.

Strengthened coordination

- The success and efficiency of the new system will partly depend on careful coordination between regulators and joint working wherever possible.
- The PRA and FCA must be mindful of European law and must ensure the UK maintains sufficient influence with global and EU developments.

2 Response to call for evidence

Introduction

Barclays welcomes the opportunity to submit evidence to the Committee. The proposed changes to the UK's financial services regulatory regime are of great significance to the future resilience of the financial system and the wider health of the UK economy.

Appropriate levels of parliamentary scrutiny will be vital to ensure that such important legislation is shaped properly, and so we fully support the role of the Committee. Indeed, we believe that parliamentary scrutiny of the regulatory regime will also be of huge importance, for accountability purposes, on an ongoing basis after this legislation has received Royal Assent.

The Committee requested views on whether the draft legislation will, or could better:

- **prevent another financial crisis,**
- **handle a financial crisis,**
- **deal with bank failure and protect the public purse.**

We believe that this draft legislation will help improve the focus on financial stability issues and will add to the reforms already made, or in train, globally and in the UK which have contributed to making the financial system considerably more stable than it was before the recent financial crisis started.

Alongside the Banking Act 2009 and the Financial Services Act 2010, this legislation should help to reduce the likelihood and potential severity of a future financial crisis.

However, although we are supportive of the broad framework of the legislation, we believe that there are a number of areas where improvements will be needed to enable the reforms to be effective and to prevent serious unintended consequences. These concerns and suggested improvements are outlined below in response to the Committee's questions.

Response to detailed questions

1. Is the separation of prudential and conduct regulation into a "twin peaks" system the right approach?

No system is perfect, but we recognise that benefits can be achieved through the separation of prudential regulation and conduct regulation. The previous system was designed to maximise efficiency in the supervision of firms, whereas the "twin peaks" system is understandably more focused on financial stability. A careful balance of the two objectives is needed.

The proposed system could be made to work well as long as there is effective coordination, through joint working wherever possible, between the two regulatory bodies.

2. What lessons can be learnt from the approach of other countries to regulation of the financial sector?

As stated above, no system is perfect. Unitary regulation can fail, and has failed, as well as "twin peaks". The structure is less important than the actual quality of regulation and the knowledge and ability of those carrying out the supervision.

However, some lessons can be learned from other jurisdictions. For example, the French model should be studied carefully as it illustrates good practice in coordination between regulators within a "twin peaks" model. The "Pôle commun" between the French regulators,

Autorité de Contrôle Prudentiel ("ACP") and the Autorité des marchés financiers ("AMF"), is a strong example of a memorandum of understanding which outlines good principles of coordination. This coordination can be seen in practice in the joint Annual Report from the ACP and AMF[25].

3. Is it appropriate to make such major changes to the regulatory system by way of amending legislation, rather than starting afresh?

Given the scale and complexity of the changes to the regulatory system, it would make sense to start afresh to enable clearer and more understandable provisions to be drafted.

However, we recognise that there are many important and strong points in the detail of the Financial Services and Markets Act 2000 ("FSMA") which could potentially be lost if legislation on such a complex area was started afresh. If a new Bill were to be drafted, there should be provisions made to take as much of this detail into account for review.

4. Are the accountability and governance arrangements for the Bank of England, FPC, PRA and FCA satisfactory?

No. We have a number of concerns about the accountability arrangements for the Bank of England, FPC, and PRA. The FCA arrangements are broadly satisfactory.

As we discuss below (in response to question 8 in particular), accountability should start with a proper division of responsibility between the regulator/central bank and the democratically accountable government. Ultimately, responsibility for financial stability and the setting of economic policy should rest with Chancellor and the Government more broadly. The Government should set a clear remit for the FPC to follow (see response to question 8 below) and then the FPC should be appropriately accountable to Parliament and the Government on how it delivers a strategy in the context of that remit. The remit and FPC strategy should be publicly consulted on, laid before Parliament and agreed by affirmative resolution.

Governance, and accountability, of the FPC would be strengthened if they mirrored the Monetary Policy Committee ("MPC") arrangements more closely. The FPC should, like the MPC, be a committee of the Bank rather than a committee of the Court of Directors of the Bank of England (the "Court"). At the very least, there should be shared membership of the independent non-executive members between the Court and the FPC. Otherwise, the FPC is only accountable to the Court through the shared executive directors of the Bank.

More generally, the Bank, FPC, and PRA, are, as currently drafted, overly dependent on a narrow group of individuals for a very broad span of important policy responsibilities. This raises concerns about concentration risk, 'group-think', and potential conflicts of interest. For example, the FPC will be given the power to make recommendations to the PRA which the PRA is then able to use its discretion as to whether it acts upon, or not. A situation where an institution chaired by an individual has to decide whether to accept recommendations provided by another institution chaired by the same individual appears to us to be inherently conflicted. The regulated community is required to put in place appropriate mechanisms to allow it to manage conflicts of interest, or to ensure that they do not arise, in the conduct of its daily activities. We do not see why the Government should not wish to place similar obligations on the regulators.

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[25] See http://www.abe-infoservice.fr/IMG/rapportGB.pdf for an English version.

5. Are the FPC's objectives the right ones? Is the concept of financial stability adequately understood for the FPC to be able to perform against its objectives?

The FPC's objective is to contribute to the achievement of the Bank's financial stability objective, so the Bank's objective is most worthy of attention.

We believe that the Bank's financial stability objective could be improved if it mirrored the monetary policy objective more closely. This could be drafted as:

> *"In relation to financial [stability] policy, the objectives of the Bank of England shall be –*
>
> *(a) to maintain a sustainable supply of credit, and*
> *(b) subject to that, to support the economic policy of Her Majesty's Government, including its objectives for growth and employment"*

This would mean that the Bank and FPC had a clearly definable objective, which we believe would be easier than trying to define financial stability more broadly. It would also provide sufficient flexibility to enable considerations of a range of potential systemic risks. We cannot think of a systemic risk that has no potential impact on the "sustainable supply of credit".

Most importantly, however, is that the monetary policy objective of the Bank is set suitably in the context of the Government's wider economic policy. Even if the financial stability wording of the Bank's objective is not changed, there should be an addition reflecting the Government's economic and growth objectives.

Financial stability is a difficult concept to define. In the Treasury's White Paper it states that "*stability is an important prerequisite for growth*". We agree. However, measures to enhance financial stability can have a significant and, sometimes direct, effect of dampening credit supply, which may in turn stifle growth. The key will be to find a balance where 'appropriate' levels of stability can be achieved that do not unduly curtail healthy levels of risk being taken such as lending to businesses which is a vital enabler of economic growth. It is for this reason that recognition of economic growth in the objective is so important.

It is worth adding that the concepts and tools of macro-prudential regulation – the mechanisms for improving financial stability – are largely new and untried. As it is currently proposed, the FPC will be using untested tools to achieve an undefined concept. Further research on macro-prudential regulation as well as a more definable objective would make the FPC's task more achievable and effective.

6. Should the FPC be limited in the actions it can take which might affect the growth of the financial sector?

Yes. The FPC must have regard to wider economic policy and growth. This can be achieved through an appropriately amended objective (see response to question 5 above), and a suitably clear remit set by the Chancellor, through which the FPC can develop, deliver, and be held accountable for, a working strategy.

With a greater focus on the potential impact of actions on growth, and a framework where the FPC is suitably held to account for its actions, we do not see the need to be overly prescriptive on what actions the FPC should not take. However, it would be inappropriate for the FPC to take action targeting any particular size of the UK financial services sector.

7. How will the interaction between macro-prudential and monetary policies be handled by the FPC and the MPC?

Given the current design of the framework, it is unclear how this important interaction will be handled. This is a question of both governance and remit.

However the Bank's financial stability objective is defined (see response to question 5 above), the FPC will primarily be dealing with the availability of credit whilst the MPC will be responsible for its price. These two functions are central elements of economic policy and are closely linked. In fact, there should be recognition of overlap as the FPC will also have an impact on credit pricing through influence on capital ratios and liquidity buffers. Greater thought should be given to how these economic policies can be appropriately handled to complement one another within the Bank. Shared membership of the committees is currently only through the Bank executives. It could be extended to ensure some independent, non-executive members were represented on both committees.

The Treasury should set a clear remit for the FPC as it does for the MPC (see response to question 8 below). This would ensure that both committees were operating with a remit based on the same economic policy context.

8. Has the right balance been struck between the powers of the FPC and the powers of the Treasury?

No. Whilst we support the strengthened responsibilities for the Bank, financial stability, particularly in a time of crisis, will ultimately be the responsibility of the Chancellor and the Government more broadly. The Treasury will obviously be responsible if public funds are needed, but it should be in a position of responsibility earlier if there is even a potential threat to public funds.

In particular, the powers set out in new section 9D of the Bank of England Act 1998 do not go far enough in applying a role for the Treasury to set the remit of the FPC. The wording (e.g., "*the Treasury may*") is too weak and the only compulsion for the FPC is to notify "whether or how far it accepts" and whether it proposes to take any action. This should be strengthened to bring it in line with the remit for the MPC (albeit accepting that a hard numerical target as with the inflation target is unlikely to be replicated).

9. Can Parliament take an informed decision about the proposals for the FPC without details of the macro-prudential tools at its disposal?

See the response to question 5. We support the principle of macro-prudential supervision, but given that it is an untried concept and the tools are untested, Parliament should be in a position to reserve judgement pending the sight of draft secondary legislation which sets out the tools.

There should be thorough research and analysis conducted on the potential effectiveness and impact of macro-prudential tools. This should then be followed by secondary legislation that receives adequate parliamentary scrutiny.

10. Does the draft Bill adequately deal with the risks posed by the shadow banking system?

This will depend partly on the vigilance of the FPC and the PRA and their willingness to tackle problems should they emerge. The regulators may then require further information and specific tools to be able to deal with the risks adequately.

There will be an important role for Parliament in ensuring that this issue receives the appropriate level of attention.

11. Are the PRA's objectives clear and appropriate?

Broadly, yes. We recognise that the Government intends that the UK regulatory system should have a lower risk tolerance than the FSA pre-crisis. However, insufficient risk tolerance may have unintended consequences on innovation and economic activity, just as there are risks to financial stability and consumer detriment with excessive risk tolerance. A careful balance is required.

With this in mind, we suggest that the PRA should have regard to the need for firms (authorised persons) to support economic growth in the UK. This should be part of its objective.

12. Are there any risks in the Government's proposed 'judgement-based' regulation?

Yes. We recognise the advantages that will come from the focus on judgement based regulation, including increased flexibility. However, this flexibility must not be obtained at the cost of consistency, legal certainty and due process, which are crucial elements of a strong legal and regulatory framework.

'Judgement' must not slip into arbitrary and inconsistent supervision. An appropriate framework of rules and guidance will be needed to ensure that firms receive rational and consistent supervision. For example, it will be essential that different firms are dealt with consistently and that firms regulated and supervised by the PRA and FCA are dealt with in a coordinated and consistent manner.

Regulators should be required to consult affected persons/firms before enacting new rules, guidance, and policy statements. Firms should also have the right to refer any disagreements to an independent tribunal for a review on the full merits of the case.

13. Is the Government's proposed approach to 'orderly' firm failure satisfactory?

We agree with the Government that it should not be a 'no failure regime'. Firms should be able to fail in an orderly manner without it being seen as a regulatory failure. This is particularly important as the PRA will be responsible for triggering the Special Resolution Regime ("SRR"), which will then be operated by the Bank. There should be no deterrent (even if only perceived) to triggering the SRR if it is required.

14. Given that the PRA and the FCA will inherit FSA staff does the draft Bill do enough to ensure a new regulatory culture and a more proactive approach to regulation? Will these two new bodies have staff with the appropriate skill and expertise?

Being able to recruit and retain the right quality of staff is of crucial importance, although obviously this is more of a management challenge than a legislative issue. We are aware that the FSA has already taken steps to address this issue. We welcome scrutiny from Parliament in this area to ensure that the right level of action is being taken. Also see response to question 2.

The Government has been clear about the type of culture it wants. As we mentioned above in response to question 11, it will be important that an inevitable shift to address the pre-

crisis risk tolerances does not lead to a culture of excessive risk intolerance in our regulators which could have seriously detrimental effects on the growth of the economy.

15. Are the FCA's primary objectives appropriate? Is significant emphasis given to the promotion of competition?

Broadly, yes, but the FCA's powers must reflect that it is a behavioural not an economic regulator.

16. Are the responsibilities of the FCA towards the regulation of markets appropriate?

Yes. However, as the Government recognises, it will be important not to apply a retail consumer protection lens to the regulation of sophisticated wholesale and investment markets.

17. Does the draft Bill strike the right balance between the responsibilities of consumers and firms? Are the FCA's new powers in the area of consumer protection appropriate?

First, the general principle that consumers should take responsibility for their decisions is very important, and we welcome the recognition that the Treasury have given to this principle. A more specific and narrower definition of "consumer" would be helpful. If this is not changed, the legislation should require the FCA to differentiate its approach between different categories of consumers. It can be argued that the most sophisticated market users, with equal access to market information and quality advice, do not require, nor should benefit from, the level of protection afforded to less sophisticated and/or well-resourced market users seeking to make similar investments. Importantly, more sophisticated market participants will not want to incur the added cost and burden associated with a higher level of regulatory protection and, if these costs are imposed, many will choose to deal with non-UK financial institutions able to offer products at a lower cost.

Product intervention powers need to be carefully thought through. Product intervention should not become routine or a pre-approval regime. It could have a potentially chilling effect on innovation that would be hard to reconcile with the FCA's operational objective to facilitate efficiency and choice.

18. Are the prudential regulatory responsibilities of the FCA towards FCA-only regulated firms given sufficient emphasis and detail?

No. Nor is the situation of groups that are regulated by the PRA, but which have individual subsidiaries that are prudentially regulated by the FCA. Prudential rules should be identical for activities whether conducted in a PRA or FCA prudentially regulated firm. Otherwise there is a serious risk of regulatory arbitrage.

It is worth noting that we do not know yet exactly which firms will be regulated by the PRA and FCA respectively.

19. Will the new regulatory arrangements reduce the risk and cost of dealing with mis-selling of financial products?

We recognise that a broadening focus of carefully applied regulation from point-of-sale to further up the retail product development chain, including product governance, is appropriate. However, we believe that the FSA already has sufficient powers to regulate sales practices. No regime can be designed to guarantee that in every instance the product

sold matches perfectly the needs of the consumer who bought it. In fact, attempting to put controls in place to verify if that is the case risks stifling the interest of product producers in innovating to meet emerging consumer needs and, therefore, the range of choice available for consumers. A market must retain an element of "caveat emptor" in order to function sustainably.

The challenge is ensuring that the consumer has all the appropriate information available to make an informed choice and that the design of the product is not inherently biased against consumer preference. We believe that the "Treating Customers Fairly" initiative has led to substantive progress in this area and should continue. Alongside this, it is essential that the new regulatory arrangements strike the right balance between accommodating the financial sector's need to be responsive and innovative while delivering appropriate and proactive challenge.

20. Are the proposals for co-ordination between the PRA and FCA clear and adequate? What would be the advantages and disadvantages of having a Single Point of Contact and/or a joint rule book for dual-regulated firms?

We believe there should be a statutory duty for the PRA and FCA to work jointly wherever possible. The operational manner in which such a duty can be delivered should be determined by the regulators themselves. Also see response to question 12.

We recognise that there will be two separate regulators, but a 'single point of contact' could be a useful evolution in the development of the new regime.

21. How do the proposals in the draft Bill fit within the new European regulatory regime? What freedoms and constraints will the UK have to operate within that regime?

This is an area of considerable concern. The proposals seem to largely ignore the evolution of a new EU regulatory regime. The PRA and FCA will need to be mindful of the European law and the powers of the newly created European regulators. For example, there are product intervention powers being consulted on as part of the Markets in Financial Instruments Directive ("MiFID"). It seems odd to be progressing with UK product intervention powers when a European equivalent is following shortly behind. We do not yet know whether this will be maximum or minimum harmonisation and hence the impact on any legislation the UK has put in place.

It will be important that the Bank, PRA and FCA all devote sufficient resources to ensure that the UK is able to maintain sufficient influence with the European Systemic Risk Board (the "ESRB") and the European Supervisory Authorities (the "ESAs").

22. Does the draft Bill contain any proposals or omissions, not covered by the questions above, which cause concern?

We have included further points of detail in our response to the Treasury's White Paper. We would be happy to share a copy of this response with the Committee if this would be useful.

September 2011

Barclays; HSBC and Royal Bank of Scotland – oral evidence (QQ 692-761)

TUESDAY 1 NOVEMBER 2011

Evidence heard in Public | Questions 692 – 761

Members present:

Mr Peter Lilley (Chair)
Mr Nicholas Brown
Baroness Drake
Mr David Laws
Lord Maples
Lord McFall of Alcluith
David Mowat
Mr George Mudie
Lord Newby
Mr David Ruffley
Lord Skidelsky
Baroness Wheatcroft

Examination of Witnesses

Witnesses: **Stuart Gulliver**, Chief Executive, HSBC, **Bob Diamond**, Chief Executive, Barclays, and **Stephen Hester**, Chief Executive, Royal Bank of Scotland, examined.

Q692 Chairman: Good afternoon, gentlemen. Welcome to this session of the Joint Committee on the Financial Services Bill. We are extremely grateful to you for coming, and conscious that Parliament has been making considerable demands on your time. We are all the more grateful as I know this has been quite difficult for a number of you to fit into your diaries. Thank you very much for coming. We think your evidence will be very helpful to us in helping the Government and Parliament to get the financial legislation right and improved. I have already given the Committee the apology we received earlier today from Mr Horta-Osório, who unfortunately, for personal reasons, is not able to be with us but will present his evidence in some other form or format.

I open the questioning by raising an issue that at least two of you have put in your written submissions to us, which is that the current objective of the Financial Policy Committee as laid out in the Bill to focus on financial stability is ill-defined and might be

better replaced by something on the lines of: "In relation to financial [stability] policy, the objectives of the Bank of England shall be (a) to maintain a sustainable supply of credit, and (b) subject to that, to support the economic policy of Her Majesty's Government, including its objectives for growth and employment", thereby, particularly in the latter respect, bringing it much more into line with the objectives of the Monetary Policy Committee.

That opens up a whole range of issues. Do you think there is any potential for conflict between the policies of the Financial Policy Committee and those of the Monetary Policy Committee, between one trying to affect stability and, in your view, the supply of credit, and the other affecting interest rates, inflation and the price of credit? Do you think they are ever potentially in conflict?

Stuart Gulliver: I guess that is our concern. The way we would see it is that the Monetary Policy Committee is clearly affecting the price of credit into the system—that is the price of money. Therefore, we were expecting that the Financial Policy Committee would be looking at the supply of credit into the system. You would have two mechanisms, one of which deals with inflation and setting interest rates, and the other with how you can ensure macro-prudential tools are used to cool the economy when it is overheating, and indeed support it when it is cooling down. Tools that are used regularly, for example, in Asia Pacific, are adjusting cash reserve ratios and loan-to-value ratios on mortgages—these types of fine-tuning tools.

The way the FPC has been set up is that it is focused entirely on stability. You could have a situation where the economy is stable, i.e. all the financial institutions are very conservatively capitalised and so on, but there is actually no lending going into the economy. You could see a situation where everything has been secured to such an extent that there is no risk of a failure but there is no credit going into the economy either. We had expected there almost to be a symmetry between these two—the left and the right arm, which is the MPC and FPC. One is going to the price and one is going to the supply. That is why we are a bit concerned about the definition, because there is not that symmetrical approach now, so one could contradict the other.

Q693 Chairman: Would that suggest that there might even be an advantage in simply merging the two committees?

Stuart Gulliver: I would not go as far as that, because I think they are different skill sets. You would want to have a situation where there was complementarity between the two. I don't think it is necessarily required to combine them, but the missing piece, if you like, has always been that there is an inability to deal with macro-prudential. You are left with one quite blunt instrument, which is moving your base rate around. It would, therefore, be important for the FPC to have the same goals that the MPC has, which is that the UK Treasury should be setting out what the Government's goals are for growth, employment and job creation and saying to the FPC, "Use your macro-prudential tools to ensure that you achieve the Treasury's goals." That needs to be brought out a bit more in this legislation because what it says is, "Create stability," when stability may not be consistent with the goals of the Government, to create economic growth and jobs. But I would not go as far as to suggest that they should be combined. They are different disciplines, although there will clearly be a common set of people at the umbrella level.

Q694 Chairman: Would others agree or disagree?

Bob Diamond: We support it. It was HSBC who first brought up the concept of sustainable credit into the market, and we supported that. Our take on it was similar. Stuart was eloquent, so I am not going to change a lot of what Stuart said; we support that. Our point of view was that in all regulation we have been looking to try and find a balance between safe and sound in jobs and economic growth. It is really no different in some ways from what we have been looking at. If the mandate is financial stability, we felt two things were important. The first is that what is meant by "financial stability" did not seem well defined. Second, if the only pursuit is financial stability, we can have a very stable financial system but no economy. Obviously, that is an extreme, but directionally that was our concern. We think the Government would want to see a balance between the responsibility for the economy and the responsibility for financial stability. That is really where we are coming from in support of the comments that HSBC made.

Stuart Gulliver: The other thing we would seek to see is almost a parallel structure in how the FPC seeks to change things, meaning that, if there is a departure from or an addition to the macro-prudential tools and they are going to be examined, it will be dealt with by a letter to the Chancellor, copied to the Chairman of the Treasury Select Committee, so that there is that kind of openness, just as there is about missing inflation targets and so on. You would, in essence, have a parallel structure for these two committees.

Q695 Chairman: Is the thinking particularly behind the concept of a sustainable supply of credit, if that is the phrase you use, that too rapid a growth of credit lay behind the crisis and helped create the conditions that caused it, and once you have a crisis, too little growth of credit makes it even worse?

Stuart Gulliver: It is; it is both. It is at both ends of the spectrum. When you have loans being put on with loan-to-values of 110, you clearly have an unsustainable credit bubble beginning to be created, and you need to cool that. Equally, where you have a situation where there is no credit going into the economy, you need to encourage that. Your FPC would be a contributor to counter-cyclical as opposed to pro-cyclicality, which obviously amplified a lot of the problems in the 2007-08 part of the financial crisis. That is exactly what you would be doing. It is part and parcel of the old Fed expression when you "take the punchbowl away at the party". The FPC would have a key role to play in that regard, because it would be using different levers than simply moving the base rate around in order to achieve that.

Q696 Lord Skidelsky: I want to follow up on those initial questions. How can credit growth be moderated in a boom and boosted in a recession? I am not talking about the tools here; I am talking about the judgment. After all, in the run-up to the crash of 2007-08 there were very few people who said that the flow of credit was in excessive supply. There were some who were worried, and one has the testimony of those, but on the whole, the banks were not. What are the indications that you would be looking for in the light of what has happened, and why were you not looking for those before?

Bob Diamond: First of all, it is fair to say that some countries and some regulators were looking at things that caused them concern and others were not. Some banks managed risk better than other banks. I don't think it was one size fits all. The poster child, if I can say

that, for the kind of thing we are looking for is probably the mortgage market in the US. I certainly think there were signs to Stuart's point of loan-to-value of the structure of the loans. I certainly think there were some things clearly, with hindsight, to which many people would point.

Q697 Lord Skidelsky: House prices were going up too fast.

Bob Diamond: That is a result of it; that is a fair point. We would all agree that a series of things that are being looked at can bring one to a decision. It is unlikely that there is any one measure that can be looked at. House prices were going up very quickly and it was probably for more reasons than just the sub-prime market. There was also the structure of mortgages or what was appropriate in terms of loan-to-value, down payment and things like that that changed. These were recognised. Many of them were enacted by Congress. The question is not whether Congress would understand it; it is whether the regulator would understand it.

Q698 Lord Skidelsky: Did you want to add something, Mr Hester?

Stephen Hester: It is a broad question, but I would add that one of the things that perhaps came out from the experience of a number of different countries of 2008 and the preceding period was that a series of Governments, for probably a whole series of political reasons, found it hard to have the independence to take the punchbowl away. Central banks were mostly stuck with a single weapon, which was interest rates. We have developed a more sophisticated understanding of the global and national economies, that interest rates can be quite distortive, and there may be other things that you want to do from a quasi-central bank independence that attack different dimensions of the heat that is in the economy. It seems to me that that is what we are, in a sense, trying to grapple with in this term "macro-prudential policy". I do think that the signals were in some senses widely commented upon of an overheating world, but the courage to take those signals and take the punchbowl away was one that eluded politicians and where central banks did not have the right tools. That is where I think we are fitting in here.

Q699 Lord Skidelsky: One thinks about boosting the supply of credit in a recession. On the one side, one is trying to moderate it to cut off a boom, and, on the other side, one is trying to boost it in order to get out of recession. Is that a sufficient tool? I am talking of the possibility that borrowers' risk may have gone up quite a bit. How much supply has to be provided? We are trying to do that at the moment.

Stephen Hester: That is absolutely right. My interpretation of the problem that is trying to be solved here is that it goes well beyond the supply of credit. Indeed, credit in some ways can be quite a bad causal indicator because you do not know whether it is supply or demand; you just know the amount. Conditions in the broader economy, business optimism and the extent to which businesses can productively deploy resources are all crucial aspects, but that is all part of giving the FPC a rounded ability to judge several different things rather than be limited to one indicator.

Q700 Lord Skidelsky: So the stability of supply of credit might be a necessary condition but not a sufficient one.

Stephen Hester: I would think that is correct, yes.

Stuart Gulliver: I would put it slightly differently. What you would be looking for is counter-cyclical measures, so the FPC would probably be recommending to the PRA that banks run down their capital buffers at this time; i.e. parts would be counter-intuitive but absolutely counter-cyclical so that they were not rushing to keep building liquidity up but putting it into the real economy. Of course, that lending would have to be risk-judged. One of the worst things you could possibly do is to set volume targets to lend without taking account of the risk and the likelihood of getting repaid. But you don't even get to the point of deciding, "Is it okay to lend and will this person repay me?" if your capital ratios keep going higher and higher, because in essence you are de-leveraging your banking system.

One of the things the FPC start looking at—and you would probably have seen this in the minutes of their meeting on 20 September or thereabouts—is whether they should be asking the FSA, as it now is, and the PRA, as it will be, to suggest to the banks that they can start to run down their buffers. They conclude, because the European situation is quite acute, that that would not be wise at this moment. But it is that type of directive that, to be honest, is practised by central banks in Hong Kong and Singapore and was practised after the Asian crisis. Prior to the Asian crisis they were not particularly advancing this either, but from the Asian crisis they have developed a series of counter-cyclical tools in quite an intrusive regulatory regime. I don't mean intrusive in the pejorative sense, but in the sense of being directly involved in their economies.

Bob Diamond: It is what is being done right now in China, where they are trying to slow down the increase in prices and supply of credit in both residential and commercial. It is worth staying on this, because you ask the right question, and this builds on what Stuart was saying. When one talks about a sustainable supply of credit, hopefully, they are talking about things that will allow that as opposed to mandating specific lending. On Stuart's point, one cannot force lending if the opportunities are not there and if there is not the demand with the appropriate ability to pay it back, but one can, by adjusting capital, create the opportunities for banks to increase or decrease the supply of credit either way. One of the things that is challenging today is that there is a tendency for regulators in a world with a lot of risk challenges—Europe is the best example today—to say, "Increase capital; increase capital; increase capital", and also call us up and say, "Increase lending; increase lending; increase lending." We can't do both.

Today I am getting signals from the Bank and the regulator in the UK both to increase my capital and to, please, increase lending. Obviously, those are in conflict. In a time with maybe less stress in the world, what we are talking about is creating the opportunity for banks to increase the sustainable supply of lending, and, in times when things are overheating, to do just the opposite.

Q701 Chairman: Would it be true to say, however, that capital adequacy requirements are not a very effective tool for slowing down growth in a boom because banks can always raise more capital? I can see that easing those requirements in the situation we are in now might make it easier for you to lend, but you were talking, Mr Gulliver and Mr Diamond, of the more interventionist controls that they have in the Pacific area. It is quite surprising in

some ways for this Committee to hear bankers saying, "Maybe there is room for us to be told in more detail how much and what kind of lending we ought to do."

Stuart Gulliver: It can't work off capital alone. As you say, in a boom time your ability to raise capital is reasonably straightforward. You can place capital into the market. That is again where your regulator—we term it the FPC here, but it is described in other ways in other parts of the world—would be looking to set other criteria to slow the pace of growth. That also has political consequences. In a place like Hong Kong, on LTVs on mortgages, the maximum you can lend is 70%. The buyer has to put a 30% deposit down. That has social, economic and political consequences. What Hong Kong did as its property market boomed was to restrict lending on properties over a certain amount to 50%. You were not allowed to lend more than 50%. It is the same thing on credit cards. You are not allowed to have more than X number of credit cards or cross-sell X number of credit cards.

It is a very granular direction. To your surprise about banks being happy with this, let us not forget that the banking industry is unusual in this sense. If we are running airlines and another airline gets into difficulty, we will benefit by picking up the traffic of that airline, either passenger or cargo. The banking industry is totally inter-related. That is how the payments system works. All three of us are running banks that are absolutely involved in the global payments system—CHIPS, CHAPS, how money moves around the world—so we have credit exposures to each other. When one of us gets into trouble, the others are immediately at risk. We, therefore, have a collective vested interest in a secure banking system.

Bob Diamond: Can I add to that again, because the discussion is good? As Stuart has mentioned, there is a political angle to this—he used Hong Kong as an example of the 70% loan-to-value—which can be both a positive and a negative. The Government and Parliament being involved in these kinds of views, from an accountability point of view, makes sense. I would like to look back at the bad example of the sub-prime market in the US, because it did have a political angle. It was an act of Congress and it had wonderful underpinning, which was, "Let's allow more people who can't afford a 30% loan-to-value own homes." No one was a bad person for trying to increase home ownership, but it went so far as to create an economic bubble. That is the kind of difficult to-ing and fro-ing where this is the truth of these things. The wisdom at the end of the day, the right governance structure and the right people are what is important.

Q702 Mr Brown: What would you do differently now from the way in which you behaved in the run-up to the crisis that we are trying to deal with here? Are the changes just a change in response to changed market circumstances, or is it permanent lessons learned and adjustment in the way in which you run your businesses?

Stephen Hester: As Bob said earlier on, the answer to that will be different for every institution.

Mr Brown: But just in general terms.

Stephen Hester: You would expect it to be more radically different at RBS than perhaps at some other banks. I would say there are some general systemic things which, to a greater or lesser extent, have come higher up the agenda. I would pick liquidity as one. Although liquidity has always been the most fundamental issue for a company or a bank, the incredible

expansion of global capital markets and the whole system of globalisation over the last 20 years made it hard to know how some of the prior lessons from prior downturns would apply in a much bigger and more interconnected market system. Across the system, we have all collectively had a harsh lesson in that. One of the areas of collective reform and tightening, although it will differ, will be on liquidity, on the way banks and countries fund themselves and the mismatches in those. Banks are, in the end, no more and no less than a mirror of the economies that they serve. That would be one, and then obviously in the detail of risk management some institutions will have had revolutions, as RBS has needed to have, and others got it reasonably right to start with.

Q703 Mr Brown: Would you say these were permanent "lessons learned" type changes?

Stephen Hester: I believe there are permanent aspects to it. Certainly, the attempt is to make everything permanent. We would be naïve to think that we can rule out any future economic cycles or any future unexpected happenings in the world. The world, by definition, delivers unexpected things to you, and so I am sure there will be some future moments when there will be future lessons to be learned—that will be just as applicable for economies as for banks—but it is our job to try and have a lasting increase in standards where standards have been found to fall short.

Q704 Mr Brown: Would you say the same?

Bob Diamond: "Permanent" is a tough word. Stephen said it right. Do I want to say yes, absolutely permanent? I will not be here permanently so I won't know, but there are serious changes. If you look at areas of liquidity or things about market structure with counterparty clearing and central clearing, I look back at what mistakes I made in terms of some of the assets on the balance sheet for spreads that were too narrow to be sustainable if you are really looking at the size of the balance sheet and other opportunities. I definitely think that there are long-term sustainable changes. An awful lot has changed, both on the regulatory side and on the banking side in terms of leverage, the size of the balance sheet, how much equity is carried, and liquidity and funding risk. I do feel that a lot has changed, but I don't believe that we can rest on our laurels and think that we cannot continue to keep learning and making the situation stronger.

One of the things that I think has gone frustratingly unnoticed during the period is that strong banks want strong regulation. Stephen was brought into RBS to fix a bad situation. I would say that in some ways Stuart's organisation and the organisation I am with suffered just as much as RBS. For the average person on the street, they are mad at their banks. They are not selective of which bank they are mad at. Stuart alluded to it earlier. To some extent we are all in this together, with regulators, banks and the Government, because it is about the economy and job growth. As the Chief Executive of a bank, I want strong regulators. I want strong regulation. I want the system to be protected. Sometimes there is a sense that banks want to get away with something, which is very different from the reality. Have they made mistakes? Certainly. Are they trying to get away with something? No, I don't believe that.

Stuart Gulliver: I would agree. To reiterate the point I made earlier, the institutions that are most exposed are other banks. By definition, we want the community to be as strong as possible. As Bob says, we all ended up with reputational damage, irrespective of whether our

own institutions were particularly at fault at any moment in time. The firm for which I have worked for 32 years has operated for most of its life in parts of the world where bank runs and volatile situations were much more common, so we came into the crisis with higher levels of liquidity and greater levels of capital than did our European or US counterparts. Nevertheless, today, we are holding even more than we were five years ago. I think that is a permanent change and there is a permanent structural change taking place in the industry.

As both Bob and Stephen said, that does not mean there could not be another financial crisis. Part of the reason for that is that financial crises each and every time have been different from the previous ones. When we go back into history, we have periods such as the recent financial crisis where Lehman Brothers was a reasonably small institution but massively globally connected and it had a terribly bad impact. Northern Rock was actually a very small institution, but it triggered a lot of problems here in the UK. In the 1980s the S&Ls were a lot like the ring-fenced banks in the UK will look. So are the Cajas in Spain. Architecture can only get you so far. You have to have a dynamic situation of interaction between the regulator and the industry.

Q705 Mr Brown: In the run-up to the crisis, one of the criticisms of the banking sector is that decision making was too short-termist. What would your response to that criticism be? People allege that that was exacerbated by the bonus system, which incentivised short-term trading and activities to the long-term detriment of stability.

Stephen Hester: In a sense, the short-termism accusation could be made to all players. There were many economies that were being run for short-term popular opinion as opposed to long-term reduction of deficits or trading balances or whatever. I guess there is always a tension between long and short term. I don't think the banking system is any more or less guilty of it than others.

On the very vexed subject of bonuses, it is appropriate that there has been very extensive reform put into place to try to ensure that inappropriate incentives that are contained in pay are dealt with. I believe that a massive amount of change and progress has happened there. But one should also say—and Stuart in effect said this—that, when you look at institutions that got into trouble, the list is longer of institutions that were not the big bonus payers. They were the Cajas in Spain or the Northern Rocks or whatever the S&Ls would be. You do need to reform the bonus system. A huge amount has been done, but you cannot look at that as the fount of all evil. The facts do not align with that.

Q706 Mr Brown: Would that be the same for you, Mr Diamond?

Bob Diamond: Yes.

Stuart Gulliver: Certainly I would agree with what has been said.

Q707 Lord Newby: Given that bonuses did play some part in terms of excessive risk-taking, would you think it appropriate that control of bonuses should be a macro-prudential tool that the FPC should have in its locker?

Stuart Gulliver: Control of distribution, be that dividend or bonuses, should be one of the tools that the FPC considers once a certain threshold point has been hit. If you are sitting with your Basel III core equity ratio at 10%, with all your other levers in place such as your leverage ratios, your equity ratios and your liquidity, I do not think that tool should be taken out, dusted off and used. If you have fallen towards a point where you have triggered some key point in terms of your capital ratio falling to too low a level, your leverage ratio is too high and your liquidity coverage ratio is too low, then clearly controlling the distributions, i.e. either the dividends to shareholders or compensation to your staff, is an absolutely reasonable thing for a regulator to take hold of because you would be wanting to conserve capital to prevent the institution in case going into a recovery or resolution point. I would see that as one of the tools at the recovery point of an institution that it would be absolutely legitimate for a regulator to use, but not at other times; otherwise you then put the regulator as a shadow director.

Q708 Mr Laws: If we re-ran the last decade with this policy architecture in the Bill in place, including the FPC and everything else, how does each of you think the last few years would have been different? In particular, are you at all optimistic that we would have had better policy outcomes?

Bob Diamond: You ask a very difficult question. I don't think any of us in hindsight could say clearly one way or the other. What I would say is that we are broadly supportive of this architecture. It raises issues around balance—in my mind, the issues around this are the balance of jobs, economic growth and making sure it is connected with Parliament and the Chancellor. The issues around this are balance in terms of the G20 and the EU: is it consistent with what goes on there? There are issues around governance. So much of this depends on the people and not the model. I hesitate to think that there is a model that is going to prevent something, for the reason that, under any model, it is really about the people, the culture and the governance.

Q709 Mr Laws: That is obviously an important point. When Sir John Gieve gave evidence to us the other day, he touched on the issue whether, if we had had the architecture, we would have made the right decisions. The Barclays evidence on this particular point, on the FPC, which is, I suppose, one of the crucial elements of the Bill that could have made a difference, sounds quite sceptical on whether this would really have made a difference. In particular, the evidence that you have given says: "It is worth adding that the concepts and tools of macro-prudential regulation are largely new and untried. As it is currently proposed, the FPC will be using untested tools to achieve an undefined concept." That sounds pretty sceptical, if I may say so, as to whether you really think the FPC would do a good job in the way that, as Mr Gulliver suggested, in a more ideal world it could have done a few years ago.

Bob Diamond: It is tough for me to remember exactly where that phrase was in all of the evidence we have given. If you will bear with me, I don't recall specifically how that was related. I think it was related to the issue of the definition of financial stability and whether it should be broader. If it was, we are giving suggestions. There is no question in our response that we are supportive, very broadly. There are questions that were raised that can be refined on governance. There are questions that could be refined on the other two issues that I mentioned, but I do not recall exactly where that phraseology fits in. I think it is on the definition of financial stability. Is it? Yes, it is. We are clearly supportive.

What we are trying to say as well is that there are some areas that can still be worked on. We are also saying that no system is perfect. There is no system anywhere in the world where we would say, "Go pick that one; that is perfect and infallible." When you are looking back and saying, "Would a better system prevent a crisis?", it is very hard to say that.

Q710 Mr Laws: Mr Gulliver's evidence sounded a little bit more optimistic about the FPC model based on some of the experiences.

Stuart Gulliver: In Asia, there is a tried and tested track record of these types of interventions. Yes, I would be more confident that this would have helped. The qualification I would put on it—and this is for you as the elected Government—is that there is a political dimension to this type of intervention. Once you say to someone, "I am sorry, you can't buy your house borrowing 110%; I am sorry, you can't withdraw the equity on your house to go and buy a car because I am not going to let the banks lend to you in this way," that has a political dimension. As I say, in Asia they have gone through the intellectual framework of getting comfortable with that and saying that the overall goal of financial stability is a lot more important than that. I do think the FPC will be a force for stability, not in the sense of the definition we were concerned about earlier but being able to manage down the type of extreme crisis that has taken place here. You would also be restricting exposure to commercial real estate. You would also be saying, as institutions, "We are not happy to see further lending going into the following inner-city areas for rejuvenation," etc. It becomes, as I said before, quite intrusive. That is also why you need the safeguards and so on against the FPC and the FCA to make sure there is a check and balance. But, yes, I think it would have helped.

Q711 Mr Laws: The political support for this type of thing is obviously very important.

Stuart Gulliver: It is critical, but that is for you rather than us as an industry.

Q712 Mr Laws: Leaving that aside for one moment, when we had Sir John Gieve here on this point the other day, he was very honest and open. He said that, even if they had all these policy tools, they would probably still have made a mistake because they had not spotted the problems. He also said that, if he had spotted the problems, he would probably have simply been in favour of running a tighter monetary policy through some of the measures that the FPC has but also in terms of interest rates, which would have required the inflation target to be undershot. Do you think there is going to be a policy co-ordination problem, coming back to the Chairman's opening question, between the MPC and FPC for that reason, or are you relatively optimistic, looking back a few years, that we could have controlled the financial risks through the macro-prudential tools even while the Bank trundles along running a reasonably easy money policy to meet the inflation targets?

Stuart Gulliver: I would be more confident that you could achieve the balance between the two. I would not want to put myself into Sir John Gieve's head to try and work out why he answered as he did, but I am sure it is probably because that is the only thing that was available to them. Once you have set these two avenues up—

Q713 Mr Laws: No. I think he was saying that, even with these new tools, he would have wanted a tighter money policy.

Stuart Gulliver: I think you can run these two, which is why I was saying earlier that they need to be complementary. One is going to supply and one is going to price, and you need the same reporting mechanisms to the Chancellor and the Chairman of the Treasury Select Committee to make sure there is a co-ordination aspect in place. I would be optimistic that you can do that.

Q714 Baroness Wheatcroft: I would like to take you along the lines of governance a little more, if I may, and in particular the governance of the Bank of England and its role in all of this. Several of the people who have given evidence to us have been concerned about the power that these changes give to the Bank. Alastair Darling, when he came to the Committee, talked about the Governor being a sun king whose position was, if anything, being enhanced by these changes. Are you comfortable with so much power being put in the hands of one individual and one organisation?

Stuart Gulliver: I guess we would have concerns. Let us be critically clear that my remarks are about the role of the Governor and not ad hominem comments about any individual who may be the Governor from time to time.

Baroness Wheatcroft: Absolutely.

Stuart Gulliver: If you compare this to a corporate structure, you have the equivalent of a CEO, who, for political reasons, is hired for five years and cannot be fired, and who has no real board that can check him or her. What I suggest we need to think about is that, if this was a corporate structure, if this was a listed company on a stock exchange, would we be comfortable with that? The honest answer is that we would be a bit uncomfortable with it. Therefore, our view would be that perhaps the Court should be strengthened in some way and a Chairman of the Court appointed. That would be the HSBC view on that.

Q715 Baroness Wheatcroft: I was intrigued, because your view is also that you were happy for the FPC to be a committee of the Court rather than of the Bank. That is quite an unusual stance.

Stuart Gulliver: There is a little inconsistency in a number of these things where the PRA, the FCA, the FPC and the MPC all report in at slightly different points in the structure, but ultimately they all end up under the Governor. I think that point is still correct. The read-across is that, if it was a listed company, and one of us could be hired for five years and we could not possibly be sacked—and it is clearly important to maintain that so that you have an independent central bank—we still need some kind of check and balance on it.

Bob Diamond: There are two things. I thought there would be a question on governance. I had the same thought in my mind that Stuart referred to and then a second one. What I said to myself was, would this Committee feel the same if it was a listed bank or a listed company in the UK? While that is not a perfect example, I think it helps us to think through what it teases out and some of the issues on governance. It could be enhanced with that thinking.

There is a second issue, though. There needs to be a democratic accountability to Parliament, to No. 10 and to the Chancellor. That is important for you and maybe to the Treasury Select Committee. That is a second issue that is separate.

Q716 Baroness Wheatcroft: Are you suggesting that should be for the Bank as a whole or for the FPC? There is a suggestion that the FPC should have a more defined remit agreed by Parliament and then be called back to explain it. What about the Bank being accountable rather than the FPC? How would that operate? At the moment it operates through the Treasury Select Committee.

Bob Diamond: So it has that accountability.

Baroness Wheatcroft: Yes.

Bob Diamond: It is similar. I would also step back and say, "What is the governance and the accountability that has worked in the MPC and why wouldn't that be similar here?" That is another way to look at it. How does the Monetary Policy Committee governance work?

Q717 Baroness Wheatcroft: Mr Hester, would you volunteer to be a director of the Bank of England?

Stephen Hester: I think I am conflicted, but, in short, I agree with what my colleagues have said. There is, I understand, imminently, in the coming weeks to be a report on the RBS. I am sure some chapters will be about governance. It is very important, as we deal with new structures after the crisis, that we learn lessons in all sorts of ways, and governance must be one of them, which should not apply exclusively to banks. Governance goes well beyond an individual or their reporting relationship or whatever. There is a whole series of things to do with transparency, how other aspects work and the democratic connection. We are in agreement.

Q718 Baroness Wheatcroft: A separate issue has been raised with governance. Whatever the structure of the Court, the structure of the FPC within that probably needs to have more independent members than are currently suggested. Is that something you would agree with?

Stuart Gulliver: I have seen in some of the evidence that has been given earlier some discomfort about the number of Bank of England executives, in essence, that occupy that. I would share that. The MPC has a mixture, and I think the FPC should have a mixture. Again, it is trying to get feedback from different parts, sectors and businesses in the economy as to what is actually happening on the high street. A mixture of business people together with Bank of England executives would be a better combination. The MPC already exists as a role model for that.

Q719 Baroness Wheatcroft: Again, on a governance issue, one of the things that Alistair Darling highlighted to us was that when the crunch came it was not clear who was in charge. Looking at the current arrangements, are you confident that that status would be avoided?

Stephen Hester: You cannot have it all ways. In a sense, if you only have one person in charge, then you have the risk that that person makes the wrong decision and you are all mopping up afterwards. Inevitably, there is some sacrifice involved in balancing the merits of decisiveness of action with that action being properly subject to checks and balances and accountability, whether tied into the democratic will of the people through Parliament and Government or through the governance of the institution. It would be dangerous to draw a conclusion that decisiveness of action is the same as only one person having all of it, or vice versa.

Q720 Baroness Drake: Staying with the governance issues and governance in another crisis, so to speak, under the Bill, the Bank of England has a duty to inform the Chancellor if a call on public funds is anticipated. Do you think the proposed arrangements for keeping the Chancellor informed of potential financial stability problems are sufficient, or is there a case for requiring the Bank to notify the Chancellor before the specialist resolution regime is triggered or some other trigger or some other event? Do you think the proposals are sufficient as they are posed?

Stephen Hester: Personally, I am less focused on this point in the sense that in real life I do not believe that there is not constant communication between the Bank of England and the Treasury; there would be. What we see are the formalities of letters that get published in the newspapers and so on, but my guess is that in real life there is not an issue here and I don't personally think there would be in its operation.

Q721 Baroness Drake: This was an issue on which Barclays expressed some reservation. Is that correct?

Bob Diamond: It comes back to my point on democratic accountability, that it is very clear. I think Stephen said it well. In practicality, it is hard to imagine a situation where the Governor of the Bank of England and the Chancellor are not going to be talking continuously at a time like this.

Q722 Baroness Drake: But the issue is how soon they do that. At what point is the Chancellor made aware by the Bank of an emerging problem? Do you think the Bill is sufficient in the provisions it makes for that?

Bob Diamond: I guess I am saying it a little bit differently. I would like to see stronger democratic accountability in the Bill, which is probably saying the same thing that you are saying, but also recognising that in real life, as Stephen expressed, it is unlikely to be an issue.

Q723 Baroness Drake: In terms of the parties working effectively during the crisis, do you think the arrangements spelt out in the Bill are sufficient for that? Is there a need for another COBRA committee? Should there be more specific provisions in the Bill for how the parties engage with each other during the actual crisis?

Bob Diamond: Other than the governance issue I don't really have anything to add.

Q724 Lord Skidelsky: Who is responsible for macro-economic stability? Until quite recently, the idea was that the macro-economy was fairly stable cyclically and all that macro-economic policy needed to do was to maintain price stability, and otherwise there would not be any large fluctuations. Now, that has been shown not to be correct. The Bank of England has been given extra instruments—macro-prudential tools—in order to ensure financial stability, but financial stability is partly a code for macro-economic stability. They are not identical, but they are very closely connected. Surely, it is the Government that are ultimately responsible for ensuring that the economy does not go into booms and slumps. Are you satisfied that the present restructuring of the macro-economic system is adequate to the challenges revealed by the crash? What has happened is that responsibility is still basically in the Bank, and the Government or the Treasury has no responsibility for macro-stability unless there is a crisis, and then it is obviously called in.

Stephen Hester: Would you not say that the point of a democratic system is that the Government are ultimately accountable for the stewardship of the economy under their watch?

Lord Skidelsky: Absolutely.

Stephen Hester: The Government cede certain aspects of that to other people. One of the problems that your point brings out is that, in a democracy, there are significant imperfections and limitations to a technocratic management of the economy. That is, among other things, effectively the consent of the people, directly or indirectly expressed through the institutions. One can see it very alive in the eurozone today, where some of these issues can collide and cause difficulties, but it is very hard to see how you can reach perfection on this subject because, in the end, you need to have the consent of the people, that being guidance that has worked, as well as some disciplines and pressures to try and organise that consent or work within it.

Q725 Lord Skidelsky: The consent is obviously there, but it is exercised fairly infrequently. Are you satisfied with the extent to which the macro-stability function has been outsourced?

Stuart Gulliver: That is why, in our remarks about the FPC, we said we did not think stability should be the focus; it should be a sustainable supply of credit. Then we went on to say that the FPC should be charged with executing the Government's policy for the economy. It is a sustainable supply of credit to create economic growth, job creation and whatever else the Government wish to set, which should be set through the Treasury. The FPC and MPC have to line up with whatever the Government's policy is to get economic growth and job creation. That is why we said the FPC should not just be stability, because you can have stability and absolutely no economic growth or job creation at all. That is why, in our remarks, we thought that the FPC should have a broadening out of simply this stability remit to be able to execute on your point.

Q726 Baroness Drake: I would like to come to the issue of consumers. The Bill imports the principle that consumers should take responsibility for their own actions, but recent scandals and the understood or perceived asymmetry of knowledge and understanding between customers and providers has led many consumer groups and academics to argue that the Bill does not take the opportunity to get the balance right between consumer

responsibility and consumer protection. Do you think that firms should have a fiduciary duty or some kind of duty of care to complement the consumer responsibility principle—that somehow with the consumer responsibility principle goes the firm responsibility principle? That is certainly an argument that is being put to us quite strongly.

Stephen Hester: Is that not a statement, in a sense, of the existing position? The FCA can only regulate the industry against a set of principles which forces the industry into the position of effectively having a duty of care. "Treating customers fairly" would be the language that would be more frequently used, but the whole point of the agency is to measure banks against that. Of course, banks themselves in any event ought to have those standards through doing business, and seek to do so, but it seems to me that they are already there. That is what the FCA exists to do. It is not obvious to me that you need anything additional to make that happen.

Q727 Baroness Drake: Consumer groups are arguing that they think there is a need for something extra and that there is not sufficient protection for the consumer, as evidenced by the events that have taken place. They say that simply treating customers fairly in the contractual relationship as it is currently understood is not sufficient and you need to import some concept of a duty of care. In terms of the new powers of the FCA—their product intervention, warning notices and financial promotion powers—do you think they are sufficient to strengthen consumer protection?

Stephen Hester: Certainly, as people who are on the receiving end of an agency that is only increasing in its power and intrusiveness, I think they have all the tools, and, if anything, one needs to worry about the motivation and where the pendulum goes. That is not the same as saying that the industry will never have imperfections or things that it does wrong. All of us seek earnestly to avoid that. The standards are going up against which that should be measured, and in many instances quite properly so. In that sense, this will be an intrusive and aggressive regulator. The evidence is currently there at the beginning of it, but, you could argue, entirely appropriately so.

Q728 Baroness Drake: The other issue that is often put is that the Bill contains too broad a definition of "consumer": that it can run from the individual mum going into her local bank to the professional customer. It is said that this will encourage a one-size-fits-all approach to regulation and that could prove detrimental, either in terms of the professional consumer or the retail consumer. Do you think that is an issue or do you think the definition of "consumer" posed in this Bill, when taken together with the FCA's objectives, does not pose a problem?

Stuart Gulliver: The broad definition is almost inevitably going to result in a sub-optimal position for both ends of the spectrum. If the burden is identical to a highly sophisticated investor as it is to your example of the mum going into their bank, then, by definition, the choice for the highly sophisticated investor is considerably less than it might be in another environment. That is a decision and obviously a choice that society has clearly taken here by drafting it that way.

Q729 Baroness Drake: In your view would it be appropriate to make amendments to the current provisions in the Bill to address the need to disaggregate that concept of a consumer?

Stuart Gulliver: In other countries in which we operate, there is absolutely a classification of a sophisticated investor, which tends to be defined by how much liquid investable assets they have with you. There is, therefore, still, to use your words, a duty of care towards them, but the sophistication of that client enables you to be able to be more certain that they know what they have bought and the risks that they are consciously taking by having bought it. The prerogative here is on transparency and education. It is your point about asymmetry of information. That asymmetry should be less, the more sophisticated the investor is.

Frankly, as cumbersome as it sounds, the only way to decide that is the amount of money they have with you, as opposed to necessarily a test of their sophistication, although again, in Asia, we are now required by the regulator to have our clients fill out a quite detailed risk appetite statement which sets out quite clearly what type of products they understand. We do not test whether they do understand them, but if they say, "We have invested in equities and in bonds, and we have traded in foreign exchange," then clearly you are discharging part of your duty of care, because they are clearly saying to you, "I am pretty sophisticated." Then we put a second criterion in, which is, "You have to have investable funds of more than X with us." Then my duty of care is very different from the mum who has just walked in off the street. It is worth looking at that, because what you are going to do, otherwise, is significantly impact the type of investment vehicle available for a certain part of the community here.

Bob Diamond: I was going to say, "Why do we care?" Why we care is because we want a good supply of good products. We want strong regulation in the consumer area. Stephen's point was that we are committed to treating customers fairly. But, if you ask the narrow question, "Do we need a clearer and narrower definition of the consumer?", I think we do. The unintended consequences of this could potentially be inadequate provision of product because of fear of providing the product. We have to be able to have sophisticated retail users that are allowed to be disappointed with their investment returns. Sometimes investments don't work, when everything has been done correctly. I do not think you will find any of the three of us pushed back on the need for strong regulation and consumer protection. On the narrow question of whether we would recommend a more narrow definition, we would.

Chairman: I will now ask Lord Newby to come in, and, from now on, since time is flying, can questions be pithy to encourage more direct answers, and we will get home for our tea?

Q730 Lord Newby: I will do my best, Chairman. Moving on to the objectives of the PRA and whether it should have more than one objective, I will ask a multiple question. Mr Diamond, I know that Barclays suggested that the PRA should have regard to economic growth as one of its formal requirements to balance the stability requirement. Mr Hester, you have suggested that they should have competitiveness and innovation as a complementary objective. The consumer groups, and to a certain extent Sir John Vickers, have suggested that competition on consumers should be considered as part of their

Stephen Hester: On the competition point, we would not agree with putting that in, but the simple reason is that you have an agency whose job that is; they are called the OFT. It is not that competition is not important; it is just simply a choice of having one or the other. Abolish the OFT and give it to the PRA, or leave it with the OFT and don't give it to the PRA. That would be our rationale there.

I would not personally get too hung up on the specific words we are using. I am sure Bob for Barclays will clarify for himself. What we were getting at in the first part of your question is what we have talked about in a different context earlier on in the context of the FPC. If the PRA's mandate is simply, "Make sure nothing goes wrong on your watch", the way you can do that is to make sure you effectively do not have a banking system because it is managed with so few opportunities for risk or anything to go wrong that the country cannot function. Almost every day we see tendencies that go in that direction, very understandably, given the pressures that regulators are under. In that sense we feel that, while the primary responsibility of the regulator is prudence of the institutions they regulate, if you have no balance to that, you are introducing a danger to the economy which may have unintended consequences.

Bob Diamond: I agree.

Chairman: Everybody is agreed. You managed to combine your three pithy questions into one. That is excellent. We will move on to Lord Maples.

Q731 Lord Maples: A lot of this discussion, both here today and outside, takes place in the context of what went wrong with the regulatory system. But, actually, the crisis blew up because individual banks, and collectively, made some very bad decisions. Every business makes bad decisions from time to time, and, as you have often pointed out in your testimony, risk is implicit in that. I would suggest to you that some of the things that went wrong were the result of a failure of any sort of system of ethics within your institutions. I would like to give you a couple of examples and then ask you whether you think this is a problem and what, if anything, you are doing to address it.

One is that accounting policies were skewed, I am sure with the sign-off of your auditors, to bring profits forward, which no doubt triggered bonuses to people. There was the discounting of forward cash flows and the accounting of commitment fees in year one rather than spreading them out over the life of a loan. Secondly, particularly within investment banking, there seems to be a disregard for the interests of the customer, where you had proprietary trading desks betting against bundles of securities which had been sold to customers. There is a wonderful example given in one of the many books about this regarding Goldman Sachs. We can all be rude about them today, but I suspect you were all doing it. In that context it seems to me that this is a failure of ethics. Almost every successful business has a very strong ethic about customer service or quality, but, particularly within investment banking, it seems that you and your predecessors have created structures where, in the employees' interests, often completely rational, you do something today which maximises their interests but it is not only bad for the shareholders but contrary to the interests of the customer. If this failure of ethics is not addressed, it seems to me that you are storing up a similar problem for the future.

Do you recognise that as a valid criticism, and are you doing anything about it? I suppose, if the answer to the first question is no, the answer to the second question will be no too.

Bob Diamond: It is tough to give that many generalisations. I am supportive of many of the conclusions you come to. I certainly bristle when I hear people refer to what we do for customers as "casino banking", without the courtesy to come in and look and show me where the casino is, and watch our operation. There are a lot of generalisations made about specific firms that are then applied to the industry. That is not necessarily helpful.

In answer to your broader question as to whether ethics and integrity are important, the way I phrase it is that we need to be better citizens. We need to show we can be better citizens. Citizenship, to me, is how we behave, and particularly how we behave in putting our customers and clients at the very centre of every decision we make. It is how we behave in terms of integrity and trust, not only in the minds of our clients but also in the minds of our colleagues. It is not allowable to be a part of our organisation if people cannot operate in that culture, where clients and customers are the lens upon which we make decisions and where there is integrity and trust in our behaviour with colleagues. It is also about how we help our customers and clients to create value for the community. It is what we do to give back.

In conclusion, do I think you are right? It is broader than investment banks. It is banking; it is business.

Q732 Lord Maples: Have you found the need to make any changes within your organisation about how people see these responsibilities?

Bob Diamond: I feel there are a lot of lessons learned over the last three or four years. It is beyond banking; it is across society. One of the lessons I learned was about citizenship. When I became Chief Executive on 1 January 2011 I set out four key strategic priorities, one of which was citizenship. If I had been named CEO five years ago, if I am being perfectly frank, do I think citizenship would have been one of the four points in my strategy? I do not. I think it is a function of lessons learned in the last few years.

Stuart Gulliver: I would make two points. I am not sure I recognise for HSBC a lot of what you described about investment banking,, but that is possibly because we are a universal bank and not a bulge bracket investment bank. But, in May this year, we rolled out a programme on values, specifically with an overarching requirement of our staff to act with courageous integrity, specifically talking about being open, dependable and connected. It is a specific piece of our ethics and values. For the senior team, they need to demonstrate a certain set of behaviours before they even get into their balance scorecard. So I don't recognise what you have just described, which is a selection of the worst possible behaviour from books about Goldman Sachs and so on. That was Bob's point. I do recognise the importance of ethics, moral fibre and standards in conducting business whatever industry or sector you are in. I don't think it is banking-specific.

Q733 Lord Maples: You came in off the back of somebody else's mistakes.

Stephen Hester: In essence, I echo my colleagues. There is no doubt that ethics and citizenship—there are a series of different words that have overlapping meanings—are vital aspects of any business. Culture was one of the things that I sought and needed to prioritise for reconnection with the community when I arrived three years ago. That said, I would remind you that in the case of RBS, and it is true for the system as a whole, we lost far more money lending than we did in the investment banking area. We get castigated in both directions every day for some of the dilemmas. When we have a loan officer with a small business asking for a loan, that loan officer is incentivised to give the loan, broadly because doing more business is considered a good thing to do. On the other hand, there is a great deal of pressure on society to give it. If you walk into a shop and buy a TV or you walk into Tesco and buy some doughnuts, businesses have incentives, and those incentives, viewed narrowly, can sometimes go in the wrong direction. But, equally, you have to have a society that operates, and the need for a moral and cultural structure to business in order for the business to be successful and acceptable is vital. Some notion that banking is peculiar, inhabited by scandals and with unique and distortive incentives different from the rest of society is, I think, simply not true.

Q734 Lord Maples: I am interested in what you all say but I am amazed that you do not recognise what I am saying. I must have read a dozen books about this, and those behaviours seems to me to be absolutely endemic within the industry. I can quite understand how they occur, because of the motivation.

Bob Diamond: Let us step back and look at it. Stephen has said that at RBS, when he came in, the problems that created the crisis were in the lending book and not in the investment bank. The other institutions that failed in this country were the Bank of Scotland and Halifax. Neither was in investment banking; both did straight, traditional, commercial and retail lending. There was Northern Rock, Bradford & Bingley and Lloyds. I would look at the reality. In the United Kingdom, the crisis here was a function of traditional banking, lending to commercial and residential real estate. There are other issues around capital markets borrowing and leverage, but it was not an issue that you just described. I would say that does not describe our institution. You may have read your books, but that was not an issue for the United Kingdom during this crisis.

Q735 Lord Maples: We do not have time to go into this in an awful lot more detail, but it was an issue at Bear Stearns, Merrill Lynch and a great many American investment banks which triggered this crisis in the first place. It would be interesting to know how loan officers in the Halifax and other banks that got their commercial lending books wrong were motivated. I suspect they were doing things that made a lot of sense for them but did not make a lot of sense for the banks' shareholders or for the wider public.

Stephen Hester: I think you are trying to create a disagreement where there isn't one. We have all said to you that we think ethics, citizenship and culture—a series of overlapping terms—are vital parts of a successful business and a successful society. I believe we are agreeing with each other on that. We have all said to you that we have sought to move the dial further from where the industry had got. We would all readily agree that there are examples of where our industry, and indeed our individual firms, fall down and do not reach the standards we would set. There is no disagreement on that. What you are getting is some push back on some broader aspects of the generalisations that were being made.

Stuart Gulliver: Nobody here is in any way defending the types of behaviour you outlined and saying, "Oh no, they are good things." It is quite the contrary. We are saying that, equally, we would agree with you, but we are saying it does not apply to the problems that the UK suffered and it certainly does not apply to the banks that we are running. I am agreeing that what you found in those books is totally appalling. Referring to my earlier point, banks are completely exposed to one another. It is not satisfactory for us to find those kinds of practices in other institutions, but they do not exist within our firms and they were not the cause of what happened here in the UK. That is the clear point. I am not condoning it in any way, shape or form. I am just saying that it did not happen here.

Q736 Mr Brown: Mr Diamond, do you have a briefing note on your ideas of good corporate citizenship that you could share with the Committee—not now, but that you could send to us?

Bob Diamond: I don't want to get ahead of myself, because I stand here quite nervous when I am giving the BBC inaugural business lecture on Thursday. I will be happy to send you a copy after that.

Q737 David Mowat: I would like to turn to the ICB report specifically on ring-fencing. Is it your judgment that they have it about right in their proposals?

Stuart Gulliver: It remains to be seen. As has been said at previous Committees, it is obviously a "done deal". The Government wish to introduce this. It would not be our most preferred way of doing it. To my earlier point, there have been several examples in history of narrow ring-fenced institutions also failing. They are happening in Spain at this moment in time. This is what the UK wishes to do; therefore we will implement it.

Q738 David Mowat: That sounds like a no.

Stuart Gulliver: No. We don't really know what the end impact of this is at this moment in time. For example, the number that is in the ICB report does not contain the cost of moving a pension fund from within your ring-fenced bank into your non-ring-fenced bank and having to crystallise all of the catch-up required for your defined benefits scheme. Those kinds of technical details are not covered and are often not in that cost-benefit analysis, for example. Also, when the cost-benefit analysis was applied across all assets in the banking system, it of course includes our global balance sheet at £2.7 trillion, of which 70% is outside the UK so it has a bit of a dilutive effect on the basis point cost of the whole thing. It will absolutely help solve the issue that the ICB has been asked to solve. It will absolutely be implemented and absolutely we will all implement it, but all I am saying is that it is not as crystal clear cut, and nor will it be, until we see what implementation takes place.

Bob Diamond: We have been in a bit of a tough position recently. To be perfectly frank, we are trying to be supportive and implement a decision that has already been made. We keep being asked if it was the right decision. One of the many good things about the Independent Commission on Banking is that they were very open and straightforward. They gave us plenty of time to give our opinion. Nothing was left unsaid. I do not feel that I did not say everything, but what I have said is that it would not have been my choice. It certainly would not have been my first choice. It will add costs to banking and, therefore, it will increase the

cost of borrowing, but we can live with it and we are going to implement it. The decision has been made and so I want to be as positive as I can and run the best ring-fenced bank that I can. There are a lot of positives. There is flexibility. As banks, we certainly would have liked to have said there is one model of ring fence that fits all of us, so let's implement that, but there is not. The Independent Commission and the Chancellor have given flexibility. They have given a time frame that is supportive of not overreacting in the UK. There are a lot of positives to this and we are going to make it work, but it would not have been my first choice.

Q739 David Mowat: Are you comfortable as Chief Executives that having a ring-fenced retail bank with the sort of onerous requirements that the ICB report talked about is good for shareholder value? Is it a worthwhile thing to do if the ring fence is really effective?

Bob Diamond: It would not have been my first choice, but we can make it work. I would say the other thing is that, to the extent that every retail operation in the UK will be operating with broadly the same rules, it will be a level playing field, which is another aspect of it that we can live with.

Q740 David Mowat: Yes, but what I am getting to is this. If the ring fence is really effective in terms of solvency and liquidity, does it give shareholder value to a composite bank to have a retail operation in that instance?

Bob Diamond: If you are asking whether a sound financial system makes the whole world better, I would agree with that. What I was saying is that I still have the same objective of safe and sound. I just felt there was a less onerous and costly way to get here, but again we can live with it—the decision is made and we are going to implement it. I don't think it adds to shareholder value versus other decisions.

Q741 David Mowat: It seems to me that implicit in the structure of the ring fence is the concept that the non-ring-fenced part can be allowed to fail.

Bob Diamond: I think both can be allowed to fail.

Q742 David Mowat: Do you think that is feasible? Do you think that that could really happen?

Bob Diamond: I am sorry; I keep jumping in on you. I apologise. I am so excited to answer. The reason I am excited to answer is very simple. If we could get that noise away, if I could ever do away with the phrase "too big to fail", if people really believed that, if there were a problem in any bank it could be managed by the regulators through resolution and recovery—which I do, and I am a proponent of it—a lot of the anger, steam and emotion would go out and we could get back to business. The Independent Commission were very clear that they want both the ring-fenced portion and the non-ring-fenced portion to be able to fail, and we support that completely.

Q743 Chairman: I am sorry, but there is a Division in the Lords. I will have to adjourn the Committee to allow their lordships to disappear, and I hope they will return with immense speed. *[Interruption.]* It seems that they don't have to go.

Bob Diamond: Can I say that this is the first time I have seen people willingly stay for three bankers? That is really something.

Chairman: See what a hit you have made. We have paired them off, both sides. We have restored pairing to the mother of Parliaments, which is unprecedented, and we can now continue with Mr Mowat's question.

Q744 David Mowat: I want to follow up on your answer. My specific question is whether or not it is feasible for a non-ring-fenced bank of the sort of size that your banks are to be allowed to fail—could you imagine a scenario of that happening and the world carrying on?

Bob Diamond: Yes. It is very important to us. We have asked the FSA to put us right at the front of the queue in terms of a test case, if you will—I don't think it is formally that. We are implementing operational subsidiarisation. We have spent £30 million this year, and we will probably spend half of that again next year, in the hope that, by early next year, at the end of the first quarter, we will have everything in place so that, if there were an issue in some area of the bank, the regulators would be able to provide all that is necessary to allow that to be cauterised and the rest of the bank to operate. There are a lot of moves being implemented around resolution and recovery, bail-in bonds and potential contingent capital which, at the end of the day, we hope very much support that banks can be allowed to fail. So I am saying, yes, I can conceive that.

Stuart Gulliver: I would also say yes. The recovery and resolution work that has taken place with the FSA and the international work that has taken place with the Financial Stability Board is all aligned to reach a situation where an institution such as HSBC, if it were to get into difficulty, could fail in a way that inflicted losses on its equity holders and bond holders but not taxpayers. That would absolutely be the aim.

To your earlier point, which was your question about the ring-fenced bank and whether it will have a return on equity above its cost of equity, it remains to be seen. As I say, the devil is in the detail and one will not know whether that is the case. Just as a general point, this sounds rather an odd thing to say, but it is generally helpful to have a banking system that is profitable, because a banking system that is profitable retains earnings and creates capital, and it can leverage that capital into lending into the real economy to create jobs. It would probably be unhelpful if the ring-fenced bank—we don't know whether it will or it won't—does not generate any retained earnings because its cost of equity and its return on equity are the same or the ROE is lower, but it remains to be seen.

On the wider point, we would absolutely expect to be in a situation where nobody is too big to fail. As Bob says, we want to be in a position where we are not beholden to taxpayers in any way, shape or form. We want to be in a situation where our investors carry the losses and we must be resolvable completely.

Q745 David Mowat: You have said it may not be your first choice but you are ready to implement it. I know the time scales are not clear year. Do you have a view as to cost and what the main implementation challenges are?

Stuart Gulliver: No, we don't. There is a logical further step on this, which is that you will probably want to create bankruptcy-remote operational companies that are separate from your ring-fenced bank and your non-ring-fenced bank where all of your settlement processes are. They would be quite expensive to set up. We could not really size that at the moment. Clearly, we are working on the implementation. As Bob says, this is a decision that has been made.

Q746 Mr Laws: Following up on that question, is it right that none of you have so far got an annual cost range for the ring fence?

Stuart Gulliver: We do not have an annual cost range for the ring fence itself.

Q747 Mr Laws: Is it the same for the others?

Bob Diamond: It is—but I don't want to be evasive. When we heard in the report that the range for the industry was £4 billion to £7 billion, our estimate today—and we don't know enough—would be that the low end of that is probably right for the industry. We are not sure because there is a lot of devil in the detail, but I want to give you an indication of our early thinking on that.

Stephen Hester: We would be at the opposite end of the spectrum. Our view is that the costs have been underestimated.

Q748 Mr Laws: That reflects your institutional perspective as well.

Stephen Hester: It is our system-wide view in addition to our view of RBS. I would echo my colleagues' remarks. We consider it a "done deal". That was my phrase. We have to get on with life and do what we are told to do, and that is what we are all doing.

Q749 Lord McFall: Is Vickers prompting any of you to review your business models for retail banking?

Bob Diamond: Yes and no. The whole process of ring-fencing will create changes. Most of them are more internal and in the management, the governance and the funding than in terms of the customer walking into the branch and seeing a difference, if that is what you are asking. There are definitely changes. If you are asking whether the model of retail banking will look particularly different, I do not think so. How we operate that from a funding point of view or a capital or cost point of view will be different

Q750 Mr Ruffley: Could I ask each of you whether you think prudential requirements based on risk-weighted assets are going to be successful in making risk more transparent? Perhaps I could start with you, Mr Hester.

Stephen Hester: My view is that that is an important and valuable ingredient, and that a huge amount of work has gone in, and will go in, over decades. Basel III is the most recent version to try and get that to be as good a tool as you can have, given the imperfections of a global tool and all the complexity. I certainly believe that it is a useful tool and a tool that has improved with experience and with changes. However, the subject of risk teaches us all repeatedly that you can be as clever and sophisticated as you like, but you never know for certain what is in the future. You always need to have, as a complement to your sophisticated measurements, some fail-safes that are less sophisticated and that seek to avoid undue concentrations even if your models tell you that the concentration is not dangerous. All of risk management—this does not just apply to banks, by the way—has to be some triangulation of judgment, clever models and crude controls.

Q751 Mr Ruffley: Apart from a crude control like leverage ratio, what else would you have in mind that regulators should be looking at?

Stephen Hester: Certainly, our experience, and not just here in the UK but with regulators all around the world, is that regulators now look at everything you could possibly imagine them looking at and then some more. The danger, if anything, is a "wood for the trees" issue. Indeed, some of that may have been a problem before; people were too much in the weeds and therefore not staring at the big things that were looking at them in the face. If anything—certainly the Bank of England has stated this as their intent, and we very much hope they carry it out in practice—the regulators need to create a regulatory system that looks at a small number of really big important things as they relate to risk rather than the big number of in-the-weed things that allow you to miss it. Certainly, I would say concentrations are where it hurts you. A small amount of misjudgment is impossible to avoid and not even desirable to avoid. What you need to avoid on a systemic or individual company basis are dangerous concentrations.

Bob Diamond: There are a couple of ways to answer it. If I am not answering the correct question, please push back. On Stephen's point, no one should ever look at one measure of risk. The key measure of risk through the Basel Committee and for the G20 is RWAs, and having a balance, so that no country is super-equivalent or less equivalent. We worry that the US has not adopted Basel II yet, never mind Basel III. They are not going to implement Basel II-and-a-half. As Stuart said, 70% of his business is outside the UK. We have been here for 320 years, but we have very strong operations that compete in Africa with Deutsche Bank, JP Morgan and African banks, and if they are on a different measure of capital than we are, it will create inefficiencies. I hope very much that the G20 can get consensus.

There is also the issue that the US feels that some of the European countries are not as rigorous in their application of RWAs. There are a lot of issues being discussed within the G20, but I am broadly supportive of Basel for the G20. I agree with what Stephen has said. Our regulators look at a host of things—from value at risk in our trading books to balance sheet leverage, concentrations and loan books—that are in addition to RWAs.

Stuart Gulliver: I have nothing in detail to add. I completely support what Bob and Stephen have said, but I would throw a little bit of a curved ball in here. One of the things that has underpinned the RWA regime under Basel II and Basel III is the notion of sovereigns being zero-risk weighted. Obviously, lessons in Europe right now indicate that, if your sovereign is

not zero-risk weighted, the whole mathematical basis on which you have built your bank capital clearly falls.

Q752 Chairman: Clearly, it is not going to happen because everybody is moving down this RWA system. But is there not a strong case for just having a tight gross leverage ratio—X times your equity capital—and leaving you to sort out what the risk balance within it is, subject to prudential supervision and the Governor coming along with raised eyebrows and saying, as he should have done with BICC, for example, that there is too much exposure to one customer or too much exposure to one type of asset, rather than trying to do it by formulae?

Stuart Gulliver: You will probably find that in all of our firms we do exactly what you have just described on top of the more mathematical stuff. We have gross limits and concentration limits for absolutely everything which are expressed in simple numbers, quite honestly. We all know that, in a way, even value at risk RWAs are all driving looking in the rear-view mirror because they are all based on historical volatility as opposed to suddenly step-jump events that happen. Hey, look, a sovereign is zero-risk weighted so it does not attract any capital at all, until of course it is suddenly looking at a default. You are right, but to a great extent we are already doing some of this because we recognise the flaw in the system.

Q753 Mr Mudie: Going back to the ring-fencing, you have all accepted it, but is that a conditional acceptance? If it was as hard as I would wish, would you go for separation or emigration?

Stuart Gulliver: That is a very hypothetical question to which I prefer not to give a hypothetical answer. I think separation is completely different—that is different legal entities. What you would then need to think about if you are an international company like us is whether that would be an attractive asset to own for your parent company, or you would simply devolve yourself of that. Given that we have not got anywhere near that, I prefer not to comment.

Bob Diamond: Separation would not be something we would want to look at. I think you know this from previous conversations. I often like the example of Africa. We have businesses in 12 different countries in Africa. They tend to be smaller economies than the United Kingdom and less sophisticated economies at this point. They are all based on historic retail banking operations. We have been in Nairobi for 85 years. When I visit with a central bank Governor or the Head of State in Kenya, they want more of Barclays. It is, "Why are you only a retail bank? We need your credit card technology. We need the risk management that Barclays Capital can bring, because the Chinese companies are outperforming our domestic companies. How do you help them hedge out the risks in diamond mines? How do you help them hedge out the risks and raise capital against other commodities? How can you bring your global corporate bankers who are covering the Chinese companies down to introduce them to ours?"

Interestingly, I find that the dynamic growing economies are asking us—and I think Stuart would say the same about the economies in Asia—"Bob, can you bring the full power of Barclays, because an integrated Barclays is so much help to our economy and our job

growth?" I then go to the Qataris or to Abu Dhabi. They don't want the retail bank. They want the power of Barclays and the wave and pay technology.

If I look at the United Kingdom and the benefit in our branch system of the fact that Barclaycard has scale and technology and was able to take on the Egg portfolio that failed so that people continue, it is the integration of this business that has made it so powerful. As we implement the ring fence I do not want to separate it.

Q754 Mr Mudie: I know you do not want to separate it, but then you would accept a ring fence however hard. It is up for negotiation.

Bob Diamond: I am being very straight. This would not be our conclusion. It will add cost, but we can live with it and we are going to implement it.

Q755 Mr Mudie: Do you have any agreement with Vickers in his expressed wish in the report that the ring fence should be implemented at the maximum when Basel comes in but, otherwise, as soon as possible? Are you in your minds thinking that it is necessary to go to 2019, or are you thinking in your minds, "The sooner we get the legislation in and we get ourselves sorted out, the better"?

Stephen Hester: We would certainly like the detail to be worked out as soon as possible, subject to not making mistakes. I suspect that is going to be a ferociously complex and long process, even with a following wind. The way we would then think of the implementation, once that has worked through, is in two bits. What I call the plumbing— putting things in different legal entities and making sure they all work—is going to cost billions across the industry and will probably involve huge movements of customers and contracts across legal entities and so on. That will probably take the full period to complete.

There is what I would call the business adjustments as opposed to the plumbing. That will probably be implemented rather more quickly. That will not be on a single day flick of the switch but as banks seek to get to their end position to give their customers and all their other stakeholders high levels of business certainty. You will probably have a quicker adjustment of businesses but, inevitably, a long and very expensive and complex adjustment of the plumbing, which will take all of that time.

Bob Diamond: I had the pleasure, I think, of being invited by the President to the signing of Dodd-Frank in Washington. That was over a year and a half ago and none of that is enacted now. The amount of time it takes to turn this into code and legislation is more than we expect on the day of the signing. There is a lot of work ahead of us.

Chair: We are into injury time, so could you be very quick, Lord Skidelsky?

Q756 Lord Skidelsky: Do you think there is a danger, going back to RWA, of maths crowding out other criteria here? One of the things that was said was that people did not understand many of the mathematical forecasting models that were used. Do you understand them? Do you need a board that understands them? Do they give you too much faith in the model against which criticism runs the risk of sounding simply ignorant or based on intuition of some kind?

Stuart Gulliver: Those are very good questions. The audit committee and the risk committee of the board do need to have a mathematical background. Ours does. However, we have always had any mathematical model overlaid with various stress testing and various common-sense approaches. It is my earlier point. Models tend to be based on what has happened in the past, which is sometimes not a very good guide to what is about to happen in the future. You would not want to just depend on a model at any point in time. That is not a new learning from this crisis. That is the way things have always been in HSBC, in part because we have tended to operate a reasonably simple business model but in parts of the world that are quite volatile and, therefore, political macro-risk has been more present in our business model than in some other companies.

In answer to your point, your audit and risk committee do need to be financially sophisticated; they absolutely do. On your point, they also need to have the self-confidence to ask the question that suggests they are going to challenge the PhD who has written the model and not feel embarrassed about doing it. That is more about a self-confidence issue than it is about anything in particular. The two most important committees on the holdings board, for example, are the risk and audit committees.

Q757 Baroness Wheatcroft: There has been some criticism of auditors and their performance over the financial crisis, and the fact that none of the banks' accounts showed any concern on behalf of auditors. There is a suggestion that perhaps they might look at adding some sort of narrative that did highlight risks. Do you see that as being something that would be potentially useful or potentially damaging, or something that auditors would fight shy of doing anyhow?

Stuart Gulliver: The cute answer would be that you would have to ask an auditor, but I think they would fight shy of doing it.

Q758 Baroness Wheatcroft: Do you think they acquitted themselves well, because some of them are quite embarrassed?

Stuart Gulliver: To be fair, I can only talk in the context of the auditors that have looked after HSBC, which is KPMG. I think they have done a good job. I would highlight that we have had a particular problem with Household in the United States, as you know. KPMG have worked diligently to surface the issues and the problems with Household and in no way, shape or form were involved in lessening the risk issues that we had with Household. In our specific experience with our main auditor, no, I would not recognise what you are saying.

Stephen Hester: The risk, perhaps, is that there is confusion and maybe not even agreement over what we expect from auditors. Clearly, if you expect from auditors that they are risk managers and they are to be held accountable for, if you like, controlling general risk management, then one could point out some flaws. Perhaps entirely wrongly, my own view is that auditors are largely there to make sure that the numbers are correctly stated and it is the job of other people to make an assessment based on correctly stated numbers. In that sense, I think that the auditing profession fell down on the job by less, or perhaps not at all, but you have to define what you expect of them in order to get back the answer.

Q759 Baroness Wheatcroft: Would a narrative necessarily be useful?

Stephen Hester: My own view, again, is that there is no shortage of narratives. What everyone has tried to move forward on is greater disclosure, giving more information to allow external narratives to be arrived at. Auditors have encouraged that and all of us have substantially developed in that respect. To me, that would be the place to look to make sure that information is made available for outside people to reach their judgments on, rather than an excess reliance on somebody who may get it wrong.

Bob Diamond: I don't think I have anything to add.

Q760 Chairman: I will end with a question which is partly clarification. When you talked about the costs of ring-fencing, were you including there the costs of the 17% to 20% capital buffers about which Vickers is talking? Could you comment on those, how you see them, how they are defined and how they would affect your groups, both UK and worldwide? While on that subject, you mentioned that you did not want British-based banks to be disadvantaged relative to others by super whatever it is.

Bob Diamond: Super-equivalence. Sorry.

Q761 Chairman: No, I am not very good at jargon—I am learning but I forget as many bits of jargon as I learn each day. How do you feel about the attempts by the European banking supervisors to impose a maximum on capital adequacy requirements? Do you welcome that because it would prevent Britain being a super-equivalent?

Bob Diamond: I will start first and share the spoils here. In terms of ring-fencing we have tried to be open that we do not fully know the costs. One of those is the 17% versus 10%. It is not the extreme of the "Swiss finish", which some people feared, which was an additional mandatory convertible equity. This is loss-absorbing capital, so it is something where there is a broader investor base. It would be similar to the EU, the US or G20 going to bail-inable senior debt. It somewhat depends on what happens across the G20, but it is one of the reasons that all of us are telling you that we only have a range of costs at this point. It is very hard to tell.

In our case, in addition to our core equity capital, we do carry Tier 1 and Tier 2, which can be converted over time into the definition of loss-absorbing, so we don't think the 17% will be materially different if we can convert some of our existing Tier 1 and Tier 2, but it is a little bit different for every bank, and I would say it is an added cost. That is another part of the reason why it is difficult to define exactly.

Lastly, it could potentially be super-equivalent, which is not good, for the reasons I have described.

Stuart Gulliver: For HSBC, it would appear, on first reading, to present a significant cost to us. This is because HSBC has an advance deposit ratio of 78, meaning we have 100 deposits for every 78 loans. We are retail funded. Therefore, we do not have the bonds in existence that can simply be converted. We would have to go and issue about US$55 billion of bonds we don't want in order to buy US$55 billion of assets we don't want. The carrying cost of

that—this is in a piece of research that UBS has done—would cost us in the region of US$3.5 billion a year. For us, that does create a very explicit cost of being UK headquartered. The proposal is that that is applied to the group and not just to the UK bank. As I say, because we are retail funded, which is actually the most conservative way you can be funded, we do not have bonds because we have never needed to issue them. We are going to have to go and issue US$55 billion of bonds we don't need to buy US$55 billion of assets we don't want. Those bonds, because of depositor preference, will be sub-investment grade by any rating agency; so they will probably cost us 300 or 400 basis points over where we would currently issue. We will go and buy gilts with them, which yield about 100 under, and the cost on that amounts to about US$3 billion a year. If you allow for tax deductibility, it is about US$2.1 billion a year. That is not in our cost assumption for the ring-fenced bank. So there is a very specific issue around this and obviously we are in discussions with the Treasury about this.

Chairman: Do any of you want to add anything on that and on the European maximum CRD IV issue? If not, thank you very much indeed, I think the Committee will agree, for your very constructive, helpful and straightforward answers to our questions. I fear they won't earn you the publicity you are perhaps used to on these occasions, but I hope you are not too disappointed by that. They have been very useful for us in our work ahead. We are very grateful to you indeed. Thank you very much for coming.

Barclays – supplementary written evidence

Thank you for your letter of 30 November regarding my evidence to the Joint Committee on the Draft Financial Services Bill on 1 November.

In your letter, you specifically asked me to clarify a response that I provided during my testimony to three matters which were raised by Lord Maples.

I confirm that the practices referred to in those three matters are not used at Barclays.

In the hope that it helps the Committee in drawing up its report, I have set out below a little more context on each of those matters.

I should start by emphasising that our financial statements are prepared in accordance with International Financial Reporting Standards (IFRS), and our accounting policies are disclosed in our 2010 Annual Report (which can be found on our website). The accounting policies that cover the practices comply with the requirements of the relevant accounting standards.

The first matter referred to in your letter relates to the fair valuation of investments. Our accounting policy on determining fair value is disclosed on page 197 of our 2010 Annual report, with further detail on valuation techniques provided on pages 256 to 260. Fair value is determined by reference to industry standard valuation and discounting techniques, making the maximum possible use of inputs that are directly observable in the market. In addition to discounting, valuations include reserves to cover items such as market and credit risk hedging costs. Gains that might arise when new investments are acquired are recognised as profits only if all material valuation inputs are directly observable in the market. Where that is not the case, such up-front gains are instead recognised over time, generally on a straight line basis.

Importantly, all assumptions used in valuations must be reviewed and signed off by our independent auditors before they're used in published accounts. The second matter relates to the booking of commitment fees on loans. Our accounting policy in this regard is explained on page 196 of our 2010 Annual report. Commitment fees are spread over the term of the loan or facility and, therefore, recognised over the period to which the commitment relates, rather than recognised up front. There are no exceptions.

Finally, the third matter raised in your letter relates to proprietary trading.

Proprietary trading does not form a part of Barclays Capital's business model. The very limited amount of such trading that we do undertake is conducted by a distinct set of individuals disengaged from client-related market making activities. Controls put in place ensure that these individuals act as independent market participants, and, as such, the scenarios mentioned in the letter do not arise. Note that the size and mandate of these activities is heavily restricted and revenues generated historically have been an insignificant part of our business.

I hope this response provides you with the clarity you sought.

9 December 2011

Berwin Leighton Paisner LLP – written evidence

Early publication of disciplinary action

1. **Background**

Berwin Leighton Paisner LLP is a leading City law firm with a large financial services practice that advises financial institutions and individuals on their regulatory obligations, including advising institutions and individuals that are involved in investigations and enforcement procedures.

We have followed with great interest the publication of the White Paper and the subsequent Draft Bill and we have very serious concerns over one aspect of the proposed reforms, namely the early publication of disciplinary action (the "**Proposal**").

We note that formal consultation closed in September but that the Committee has expressed an interest in hearing views on the Proposal before it concludes its scrutiny of the draft bill.

2. **Proposal**

As we understand it, the Proposal is to permit the Financial Conduct Authority and the Prudential Regulation Authority (the "**regulators**") to publish certain details of a Warning Notice which has been issued, following consultation with the subject of the Warning Notice.

We have considered the Proposal as set out in paragraphs 2.106-2.110 of the White Paper and the associated draft legislation and explanatory notes. We are also aware that the Proposal has received widespread support from consumer groups but been the subject of significant industry criticism. We also note that the Proposal sits within the Government's current transparency agenda and we would agree that the new regulatory regime should operate in an open and transparent manner where appropriate. However, it is our firm belief that, in this instance, transparency is far more likely to cause more harm than good.

3. **Comment**

In our opinion, the Proposal provides a wholly disproportionate power to the regulators and is bound to lead to significant unfairness for many authorised firms and approved persons. Further, we do not believe that the safeguards suggested in the White Paper provide adequate protection and counterbalance to the proposed power.

The FSA claim that the Proposal is a "small change". In reality, for those affected it is a very significant departure from the current position. It appears to us that the Proposal, if enacted, would give the regulators the ability to cause very significant prejudice indeed to both firms and individuals in circumstances where there is no overriding public interest.

We have set out our principal concerns below and have sought to address the arguments that have been raised in support of the Proposal:

A. **Aligns the position with criminal process**

Some have attempted to justify the Proposal by drawing comparisons with the process followed in criminal proceedings. However, this is a false analogy. The Warning Notice is quite different from the charging of a suspect in a criminal prosecution. The Warning Notice and the procedure leading up to it is wholly controlled by the regulators. In contrast, criminal proceedings are generally initiated by the Crown Prosecution Service (the "**CPS**") following an independent review of the evidence

obtained during a police investigation. Moreover, the CPS is bound by the Code for Crown Prosecutors which does not apply to regulators in disciplinary cases. This Code imposes a far higher standard of proof than exists for the regulators. Under the Code, a prosecutor must be satisfied that a prosecution will be in the public interest and will have a realistic prospect of conviction. In this regard, the prosecutor must consider the significantly more onerous criminal evidential standard ("beyond reasonable doubt") rather than the civil and regulatory standard ("on the balance of probabilities").

Furthermore, a criminal charge is the commencement of a public process that involves an active prosecution and defence of the issues which culminates in a public court hearing. It is therefore appropriate that this process begins in public. The FSA's disciplinary process before the Regulatory Decisions Committee ("**RDC**") on the other hand, is not a public process and there is no proposal that it should become one. Indeed, the FSA accepts that the RDC process should be conducted in private[26]. However, the Proposal would permit the regulators to publicise the beginning of a process that is private (and that the regulators themselves want to remain private). This cannot be consistent with the overall objective of a private process.

Under the existing disciplinary process, the regulator's decision to "charge" a firm or individual is in fact only taken once the Decision Notice is issued. It is in response to this Notice that the defendant is given the choice to either plead guilty (by accepting the Decision Notice) or not guilty (by referring the matter to the independent Upper Tribunal). This is the correct comparison to a judicial procedure. A Warning Notice is simply part of the FSA's internal, administrative decision-making process whereby the subject is afforded an opportunity to make representations in private before the regulator decides whether or not to bring "charges".

B. **There would be an obligation to consult with the subject of the Warning Notice and regulators will use their discretion**

The White Paper suggests that the Government expects this power to be used infrequently and only where appropriate. Further, the draft legislation contains some supposed safeguards (the proposed s.391(6),(6A)) that the regulators must consider before deciding to publish information.[27]

In our view, it should be assumed that the regulators will use all the powers available to them in support of their "credible deterrence" agenda. Despite the Proposal being framed as a right rather than a duty, it seems to us likely that publication of details of Warning Notices will become standard, as the regulators will want to demonstrate their tough stance in disciplinary cases. Moreover, there is a significant risk that it will be used by the regulators as a means of forcing the party under investigation to settle at an earlier stage than they would otherwise in order to avoid repeated publicity.

The obligation to consult with the subject of the Warning Notice may ultimately be ineffective as, at this stage, the subject is unlikely to have full knowledge of all the information that the regulators possess and the regulators may be unaware of any defence that the subject may have. Such consultation is likely to result in costly satellite litigation to compel the regulators to disclose the information they hold, thereby increasing both the cost and duration of the process. Such an outcome is not consistent with effective regulation.

C. **The subject of the Warning Notice is still bound by statutory confidentiality**

[26] See Margaret Cole's evidence to the Committee on 10 November 2011.

[27] We are aware that the FSA has requested that the requirement to consult with the subject be removed.

The Proposal provides no right for the subject of the disciplinary action to answer the regulators' criticisms as the subject sees fit. Instead, the subject is prohibited from commenting on the Warning Notice by virtue of s.391 Financial Services and Markets Act 2000 which prohibits the provision of any details concerning the Warning Notice. In conjunction with the subject's lack of knowledge of the full case against it (as outlined above), the prejudice suffered by the subject will be significant. This prejudice will be magnified in the case of an individual whose very livelihood could be put in jeopardy.

D. **Greater transparency in regulation and consumer protection**

The FSA already has the power to publish Decision Notices, which is the proper stage for making the matter public. Publication at the Warning Notice stage would be:

(i) **overly premature -** in our experience, there are often quite significant differences between the contents of a Warning Notice stage and the actual outcome at the Final Notice stage. Whilst a significant number of Warning Notices do result in a Final Notice, the Final Notices can sometimes concern far less serious breaches than those alleged in the Warning Notice. The FSA claims that some 95% of cases result in the imposition of a substantial financial penalty. This certainly does not accord with our experience or the evidence collected by the British Bankers Association. Even if true, the FSA is effectively saying that Parliament should not be concerned with the rights of the minority of persons against whom there is ultimately no finding of wrongdoing. This cannot be correct.

(ii) **confusing for the public as to what it actually means -** consumers will probably only see the media reporting and there will be no effective method of controlling this sort of reporting. The inevitable conclusion that will be drawn will be that the individual or institution is guilty of something, and it will not be clear that the FSA's case has not been properly tested at this stage; and

(iii) **unnecessary -** there exist significant powers to protect consumers that permit the FSA (and its successor regulators) to vary a firm's permissions where appropriate. The regulators should not be able to damage a firm's brand in circumstances where it has not yet proved its case or where there are no grounds for exercising its "Own Initiative Variation of Permission" powers in order to protect consumers.

E. **International Comparisons**

We understand that regulators in the United States, widely recognised to be a highly aggressive regulatory environment that provides its regulators with significant powers, have no equivalent power to the Proposal. There are certain regulatory filing requirements that may mean that the fact of an investigation becomes public, but that is not the same as a regulator actively publicising that an internal, private disciplinary process is underway.

4. **Conclusion**

We hope that the Committee will find these observations useful.

14 November 2011

T R G Bingham[28] - written evidence

KEY RECOMMENDATIONS

- **Ensure that the arrangements give adequate attention to securing the continuity, depth and efficiency of core financial markets.** In a twin peaks' approach there is a risk that this will fall between two stools. The Financial Conduct Authority is responsible for market conduct regulation, but its focus is consumer protection. The Bank of England Group will pay attention to systemic stability, but does not have an explicit mandate for the systemic integrity of short-term money markets. The risk can be reduced by giving the central bank explicit responsibility for oversight of key short term markets – as in Mexico – or ensuring that the Financial Policy Committee has and uses powers of direction over the market conduct authority and that the Bank has the legal, financial and operational capacity to act as market maker of last resort in critical short-term markets.
- **Make sure that the Bank of England has the financial capacity to perform its financial stability functions.** The crisis demonstrated the potential risks to central bank balance sheets. The Bank needs adequate resources to perform its financial stability functions, and clear procedures are needed to provide it with continued financial integrity.
- **Clarify responsibilities for crisis management.** At present, the proposals contain a placeholder – a call for a memorandum of understanding between the Treasury and the Bank. Responsibilities, decision making procedures and triggers for activating them need to be specified in a manner that permits rapid action and clear accountability.
- **Ensure the FPC and/or the Bank has a legal right to be consulted on legislation relating to financial stability and to obtain all information needed to discharge its duties.** In the EU, there is a statutory obligation to consult the ECB about legislation on matters in its field of competence. The Bank of England should be consulted on such legislation in the UK. In addition, it needs the statutory right to obtain information that is material to the discharge of its functions.
- **Strengthen the proposed accountability arrangements for the Bank.** Oversight of policy decisions by Parliament and its committees, effective reviews of processes and operational capacity by a professional and impartial Court, and double-key decision making procedures (including giving the Treasury secondary legislation powers subject to Parliament override) are needed to make a more powerful institution more accountable. The Bank should be shielded from influence by vested interests, irrespective of whether they are political or commercial.
- **Recast the proposals so that the legislation is simpler and clearer and permits flexibility.** The proposals as presented to Parliament are lengthy, complex and lacking in logical order. Some fairly minor matters are addressed in great detail in primary legislation, while others of potentially great significance for financial stability are not addressed at all. The primary legislation should set out the broad objectives and the basic structure of regulatory arrangements; secondary legislation should give effect to primary legislation and oversight bodies should have clear authority to establish bylaws, rules of procedure and codes of conduct.

[28] Secretary General, Central Bank Governance Forum (2005-2011). The views expressed do not necessarily reflect those of any of the institutions, bodies or fora with which I am or have been associated.

INTRODUCTION

This note responds to the request for comment by the joint Committee conducting pre-legislative scrutiny of draft Financial Services Bill. It addresses the issues of interest to the Committee thematically, instead of replying to the 22 questions posed by the Committee. In so doing it provides implicit or explicit answers to some, though not all of the questions. The note draws on an extensive body of evidence covering more than 50 central banks published by the BIS.[29]

OVERALL ASSESSMENT

The proposals being considered by Parliament provide a practicable framework for preventing, managing and resolving financial crises.[30] They allocate responsibility with more clarity than in many other countries.[31] They establish a well-articulated framework for macroprudential policy at a time when few countries have such a framework. They provide an effective means for setting objectives in the financial stability area, where objectives are - unlike in the monetary policy arena - not amenable to quantification.[32] They introduce checks and balances into the regulatory system, and they supplement the already strong accountability arrangements for the Bank of England with new ones. Nonetheless there are a few areas where improvements merit consideration.

One of the lessons of the financial crisis of 2007 to 2009 is the importance of focusing on the stability of the financial system as a whole. There is, however, no consensus in the international community on just what this means in practice.[33] At one end of the spectrum, there is the view that it suffices to use prudential instruments and other administrative measures. In the middle is the view that such tools need to be accompanied with changes in the way monetary and fiscal policies are conducted. At the far end of the spectrum is the view that these two approaches need to be supplemented by significant changes in the structure and operation of the financial system.

In part because there is no consensus on what needs to be done, there is no consensus on how the responsibility for the function should be allocated across public authorities. Each jurisdiction takes an approach suitable for its institutional, political and historical circumstances. At least two common features can be identified in the approaches that have been adopted. One is that the central bank plays an important, although varying, role. The

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[29] See *Central Bank Governance and Financial Stability* and *Issues in Central Bank Governance* .Both reports can be found at http://www.bis.org/publ/other.htm.

[30] These proposals were prepared at the same time that serious reflection about the structure of the financial services industry in the United Kingdom was undertaken by the Vickers Commission. This could lead to changes in legislation governing the financial industry and the regulatory framework. The implications of these changes for the design of financial regulation are not taken into account it this note.

[31] There is primacy for the financial stability objective in the proposals, together with suitable "have regards" relating to the promotion of efficiency and fostering competition in the financial services industry. One of the consultation questions was whether it would be reasonable to limit the FPC's actions if they were to affect growth. Given the "have regards" in the proposals, this does not seem necessary. Indeed, it is possible turn the question on its head and to argue that the FPC should be ***required*** to consider taking action if the growth of the financial sector were too fast or if it threatened to become "Icelandic" in size – "too big to save".

[32] The proposed language is "*An objective of the Bank shall be to protect and enhance the stability of the financial system of the United Kingdom".* Since events elsewhere could affect financial stability in the United Kingdom, the Bank could be said to have an implicit mandate to cooperate with authorities abroad. However, there are circumstances where the current language could create an impediment to international cooperation. It could also be contrary to requirements set out by the Financial Stability Board that call on authorities to consider the potential impact of action on financial stability in other jurisdictions (see FSB Recommendations on reducing the moral hazard posed by systemically important financial institutions, October 2010; FSB consultation document on effective resolution framework for financial institutions, July 2011. I

[33] See *Central Bank Governance and Financial Stability* op. cit.

second is that the government is responsible for the use of taxpayers' money to salvage financial institutions and the financial industry.
The proposals being considered by the Committee deal with the ambiguity about the nature of the systemic stability function. They allot the Bank an important, but constrained role, while ensuring that the government is responsible for the use of taxpayers' funds. The financial stability objective of the Bank of England is broad; reasonable procedures have been put in place to flesh it out, and the powers given to the Bank and the FPC are general enough to accommodate different interpretations of the financial stability mandate.
However, there are six issues that merit reconsideration. The first relates to the risk that the proposed arrangements will not ensure the stability of critical short term markets essential for the provision of liquidity. The second relates to specification of responsibilities in a crisis. The third to the financial capacity of the Bank of England to perform its financial stability functions. The fourth concerns the powers needed to perform a financial stability function. The fifth one relates to accountability and ensuring the effective performance of the financial stability function. There is a final question about whether the proposed legislative process is consistent, comprehensive and flexible.

SIX ISSUES

Risks arising from the use of a "twin peaks" approach
One of the weaknesses of the "twin peaks" approach is the risk that inadequate attention will be given to securing the continuity, depth and efficiency of core financial markets. This is a serious shortcoming because both the Lehman episode and the current European debt crisis demonstrated that the repo, commercial paper and other short-term funding markets can become dysfunctional in periods of stress. According to the proposals, the FCA will have primary responsibility for regulating these markets. Its focus is, however, primarily on the prevention of market abuse, and consumer protection more generally. The language in the proposal cites market integrity as one of its responsibilities, but this term admits of a variety of interpretations. The one most likely to be adopted by an authority focused on consumer protection is in terms of deterring fraudulent activity and other types of behaviour that cast doubt on the integrity of the transactions that take place in the market. An authority with a systemic stability mandate such as the Bank of England will be inclined to view market integrity from a systemic perspective and seek to ensure the continuity, depth and liquidity of the market in all circumstances.
There are at least two potential solutions to this problem. One is to give the central bank oversight of key markets in which liquidity in managed. Such markets are critical for the implementation of monetary policy. Mexico is an example of a country that has adopted such an approach.
A second approach is to allocate responsibility for market oversight to the market conduct authorities, but give the FPC an explicit mandate to monitor the continuity, depth and liquidity of key short-term markets and to use its powers of direction to ensure that the FCA takes systemic considerations into account. Alternatively, the FCA could be given an explicit mandate to do so. The problem with this is that it risks conflating the systemic and consumer protection objectives, which is one of the main reasons for segregating market conduct regulation from prudential regulation.
In addition, the Bank of England needs the legal and financial capacity to act as market maker of last resort in core short-term money markets.
Financial strength of the Bank of England
There is one important area where the proposals are silent. This is how to ensure that the Bank of England has the financial strength to perform its policy functions, especially when they include financial stability. As a consequence of the crisis, the size and risk characteristics

of the balance sheets of many central banks, including the Bank of England, have increased massively.

The proposals are clear that the Chancellor should be in charge when taxpayers' money is put at risk. This is consistent with the approaches applied in other countries, as well as with general principles relating the use of fiscal resources. The Bank will have the independent authority to provide liquidity to the financial system. This is appropriate but it can expose the Bank to financial risk.

Around the world there are three main ways central banks are given the financial strength they need to perform their policy functions. The one used in the United Kingdom is to rely on strong collateralisation procedures and to provide the central bank with indemnification for the losses it could incur in performing financial stability operations. This was the approach used in the crisis, and it permitted the central bank to undertake substantial financial stability operations. A second approach is to ensure that the central bank has sufficient capital. This is the approach used in many European countries such as the Netherlands, Sweden, and Switzerland. It has also been adopted by the ECB. A third approach is to give the central bank a prior claim on seigniorage[34] income to make good financial shortfalls encountered in its operations even if it has no or little capital. As long as seigniorage income is sufficient, such an arrangement will permit the central bank to make up losses incurred in its operations without impairing its capacity to perform its policy tasks. This is the approach followed in the United States as well as a large number of other countries.

Given the increase in financial risk, it is appropriate to consider how to provide the Bank of England with the financial strength it needs. Any of the three methods – or some combination of them - could be envisaged. The one most compatible with the traditions of central banking in the United Kingdom is to establish robust "double key" procedures for financial indemnification of losses incurred in the conduct of policy. The Bank should not be constrained by inadequate financial strength from acting decisively and quickly. At the same time, it is important that the central bank be shielded from pressure to undertake tasks that are the responsibility of the government.

At present, Court must approve operations that put the Bank's balance sheet at risk. As long as Court is properly constituted and has an explicit mandate to safeguard the central bank's capacity to perform its statutory responsibilities (see below), such arrangements provide an effective check on the use of the central bank for quasi-fiscal ends.

Allocation of responsibility and decision making in a crisis

The proposed framework provides for a broad allocation of responsibility in a crisis, with the Treasury responsible for decisions relating to the use of taxpayers' money, and the Bank responsible for providing emergency liquidity assistance and operating the special resolution regime.[35] The Governor will be required to update the Chancellor on financial stability matters semi-annually and to notify the Chancellor whenever there is a risk to public funds.[36] This allocation of responsibility is based on the distinction between liquidity and solvency. While this distinction is useful conceptually, it is difficult to apply in practice, particularly in a

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[34] Historically, seigniorage was the difference between the face value of a coin and the cost of the metal used to mint it. Over time it has come to refer to the revenue that arises from the issuance of money (banknotes). Economically, it can be considered the discounted present value to the income on assets funded with monetary liabilities issued by the central bank.

[35] The SRR gives the Bank powers needed for the resolution of a UK based financial institution. How such powers would be used in a cross border question has not been addressed in the legislation. (*Question 13*)

[36] The draft is unclear about what this means in practice. It could mean that the central bank would need to inform the Chancellor whenever there was a risk that the government's tax revenue would need to be used to provide solvency support. It could mean that the Governor should inform the Chancellor whenever there is a risk that the central bank would incur a loss since the government is the owner of the Bank of England and its equity stake in the Bank can be considered to be "public funds", i.e. an asset of the government.

crisis. In such circumstances institutions that are solvent one day – and therefore eligible for liquidity support – can become insolvent overnight. In fact in the crisis, the institutions that failed were on average slightly better capitalised at the time they first received official assistance than other institutions, but this did not prevent them from requiring public funds to survive.

The proposals call for a memorandum of understanding between the Bank and the Treasury. Procedurally this is adequate, but crafting such a memorandum should be a high priority. The memorandum should specify the procedures that will be used to make decisions in a crisis. In particular they should set out credible and effective procedures for making decisions on the use of taxpayers' money in a manner that preserves the Bank's policy capacity both in the crisis and in "peace time". In addition the memorandum should indicate the criteria to be applied in determining when crisis management procedures will be activated. The draft should be reviewed by Parliament and Court (see above and below regarding the role of Court).

Bank of England's powers

By and large, the Bank of England Group will have adequate powers to perform its financial stability functions. Moreover, the Treasury will be able to use secondary legislation to amend the FPC's toolkit immediately, subject to approval by Parliament within 28 days. However, there are two areas where the Bank of England's proposed powers are deficient. First the Bank does not have the statutory right to obtain the information it needs to perform its financial stability function. It is difficult to see how the FPC can carry out its objective of identifying, monitoring and taking action to remove or reduce systemic risks without assured access to relevant information. Central banks in other countries have such powers, even when they are not supervisors. For example in Sweden the central bank, which is not responsible for bank supervision, has the legal right to obtain the information it needs in the discharge of its duties. It has found it necessary on occasion to invoke this right.

Secondly, there should be a statutory provision to ensure that the Bank is consulted on legislation that has the potential to influence financial stability. The EC Treaty gives the ECB, as part of the European System of Central Banks, such a right and the ECB has used it actively.[37] In the EC this right is "double edged": lawmakers at both the EU level and national level have an obligation to consult the ECB on matters in its field of competence, and the ECB has the right to issue opinions on its own initiative on these matters.[38] Creating such rights and obligations with respect to the Bank of England would be an effective way to address the risks posed by the shadow banking system, since the Bank could, in addition to using its current powers of direction, suggest legislative changes to address such risks *(Question 10)*.

Autonomy and accountability and the role of Court[39]

There is as yet no widely accepted consensus on the amount and nature of the autonomy needed by a public policy institution with a mandate to foster financial stability or on how the corresponding accountability mechanisms should be designed. In some respects the need for autonomy is greater in this area than in the area of monetary policy because financial stability decisions are inherently more political. At the same, it is more difficult to provide autonomy because financial stability actions require collaboration with governments, other regulatory authorities and competition authorities.

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[37] See http://www.ecb.int/pub/pdf/scplps/ecblwp9.pdf Article 105(4) states ECB shall be consulted on draft legislation, either at the Community level ('EU consultations') or at the national level ('national consultations'), in its fields of competence.

[38] NB There is a carve-out for the UK in the EC Treaty with respect to this provision.

[39] Cross country evidence on accountability arrangements for central banks can be found in written and oral evidence presented to the House of Commons Treasury Committee (see http://www.publications.parliament.uk/pa/cm201012/cmselect/cmtreasy/uc874-iv/uc87401.htm) .-

The proposals contain effective means to hold a more powerful Bank to account. Current arrangements already provide for strong accountability, particularly in view of the fact that the Bank of England's scope for independent decision making is more limited than that of many other central banks.[40] The Bank's transparency practices with respect to monetary policy are among the strongest in the world. Regular and ad hoc reviews by Parliament of the Bank's actions are undertaken in a manner that probes the rationale for the policy decisions. In the operation of the interim FPC, the Bank has demonstrated similar forms of transparency.

The proposals provide for additional reviews in the event of a regulatory failure. Moreover, the Chancellor will retain the power to give instructions to the central bank in areas other than monetary policy. And the Court of Directors will be able to exercise oversight of process and the stewardship of resources.

Review is an important complement to transparency in the field of financial stability. This is because financial stability objectives cannot be given the same quantifiable precision as monetary policy ones. Reviews of performance are generally conducted or commissioned by parliamentary committees, government ministries, oversight boards, external auditors, international organisations and panels of experts. By and large, parliamentary committees and government ministries are responsible for the review of policies, whereas oversight boards are responsible for establishing procedures, monitoring processes and overseeing the use of resources. The two forms of review are complementary.[41]

The role of Court

Court should have a well-defined role in ensuring the Bank is accountable and independent. It should review the Bank's performance on behalf of the ultimate beneficiaries - the public at large. At the same time, it should have a statutory duty to shield the bank from pressure from vested interests, irrespective of whether they are commercial, financial or political. Its oversight should cover the effectiveness and efficiency of the Bank in the performance of its public policy objectives. In performing this role, it needs to be independent, impartial and professional. It should evaluate the processes the Bank uses to make decisions, the actions to implement these decisions and the use of resources needed to perform public policy functions.

The specific functions performed by oversight boards vary from central bank to central bank, but they can be placed in four clusters. The first involves establishing bylaws, rules of procedure and codes of conduct, and allocating tasks across management. The second cluster is financial and involves approving budgets, determining accounting policies, deciding on risk management practices, determining the retention or distribution of profits and safeguarding the financial integrity of the institution. The third consists of audit, compliance and other actions to ensure observance of laws, secondary legislation and rules established by the board itself. The final cluster consists of personnel actions, including the appointment and dismissal of senior officials. Court should have a clearly specified role in all four areas, with double key decision making being used to forestall the abuse of power and to provide for checks and balances.

For example, primary legislation could set out the functions of the FPC and the PRA Board, determine their maximum and minimum size, itemise the qualifications of the members (professional expertise, independence) and specify a small number of ex officio members, to

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[40] For example, many central banks such as the ECB and the Fed have the discretion to determine what their statutory mandates mean. By contrast, in the United Kingdom the Chancellor performs this task by setting an inflation target for the central bank.

[41] Legal provisions are often framed to ensure that the board oversight will be complementary to that of Parliament and government, for example, by excluding members of Parliament and government from central bank boards, as in France, Ireland, Sweden, the United States and a number of other countries.

be appointed in the manner suggested in the proposals. Within the clear limits set by primary legislation, secondary legislation could be used to determine the precise composition of the committees (e.g., whether insiders or outsiders were in a majority), using a double key method involving the Treasury and Court. The proposals for changes would be made by Court in light of its evaluation of process. For example, if it determined that there was a risk of groupthink, it could propose changing the balance between insiders and outsiders. By contrast, if it felt that greater cross-committee coordination was needed, it could decide that there should be more cross membership. In deciding on rules of procedure, it could call for occasional or regular joint meetings of the policy committees.

Similarly in overseeing the financial integrity of the Bank, Court would need to approve operations that put the balance sheet at risk and make sure that appropriate risk mitigation, indemnification and/or capacity to absorb losses were in place. In short, Court would be responsible for overseeing the Bank's capacity to perform its public policy functions. It would not, however, evaluate the appropriateness of policy. This task would fall to Parliament.

In order for Court to perform these tasks, considerable attention would need to be given to the professional qualifications of the members, their independence and their impartiality. They would need expertise in the four clusters of responsibility, and knowledge of the public policy function of central banks. They would be selected in the manner now used, which is open and transparent.

Consistency in the legislative framework

The proposals being considered by the committee foresee a fundamental change in the way financial services are regulated in the United Kingdom. However, instead of starting from first principles, they take existing practices, institutions and legislation as a point of departure. This results in legislation that is far longer and complex than in other countries. As a result a number of minor institutional details are fixed in primary legislation (such as the frequency of meetings of the FPC) rather than being determined in secondary legislation or rules of procedure. In most countries, a legislative reform of this significance would lead to a framework where primary legislation would set out the primary purposes, structures and powers; secondary legislation would give them greater precision, and bylaws and similar instruments would be used to determine procedures and processes. For example, rather than specifying the exact nature of the consultation process in primary legislation, the purpose of consultation could be laid down, with the modalities for consultation being set out in secondary legislation and the procedures being determined by Court.

It would be useful to review the proposals to see whether some adjustments could be made that would make the framework more logically consistent and to provide for needed flexibility in the future. If this can be achieved, it will not be necessary to reform legislation so frequently.[42]

21 October 2011

[42] The last legislative reform in this area took place just two years ago, in 2009.

Professor Julia Black, London School of Economics and Political Science – written evidence

I am writing to you to voice some concerns with respect to the draft Financial Services Bill. The issues I raise here relate specifically to the FPC, the Bank's regulatory responsibilities for payments, clearing and settlement, and some aspects of the PRA's powers and complaints procedures.

I have researched and written on UK financial services regulation for over twenty years, and have also written on investor protection and banking supervisory practices in Canada and Australia. I also worked for the Department of Justice on the current structure of legal services regulation, and have acted as advisor to a number of UK and overseas regulators. My comments come as those of a disinterested observer who is keen to ensure that the system works and is as transparent, accountable and flexible as possible. I have put my points in summary form below but would be happy to discuss any of them with members of the committee if that would be of assistance.

1. Financial Policy Committee (FPC)

1.1. The FPC is a potentially valuable creation but its remit should be expanded. In particular, it should be required to comment on, and possibly approve, all policies that will affect the financial services industry with respect to their implications for financial stability, including reports such as that of the Independent Banking Commission, decisions by any competent competition authority, and proposals such as a financial transactions tax.

1.2. The interface of the FPC with the EU authorities is not satisfactory and needs to be addressed in the legislation: at present the European Systemic Risk Board can direct the Prudential Regulation Authority (PRA) to act, and the FPC has no voice in that decision nor in the decision as to whether or not to exercise the 'fiscal defence' option under EU rules. The PRA should be required to refer the matter to the FPC for determination, not least to protect the PRA from infringement proceedings and / or any action in judicial review.

1.3. The FPC and the MPC should be required by statute to meet at least twice a year and take joint decisions if necessary. Minutes of their meetings should be published. The line between monetary policy and financial stability is becoming increasingly blurred and it is not enough to argue that the Bank has representatives on both committees to ensure their coordination – the constitution of each is different and there is no overlap in the independent members of each committee. Independent members should also have the right to put topics for discussion on the agenda even if the Governor does not agree. Having joint meetings would (i) recognise the dual monetary and financial stability effects of a number of policies or 'tools' that the Bank can use, including some which no one has yet thought of; (ii) avoid artificial and unhelpful distinctions having to be made on procedural grounds when critical matters of substance are at stake; (iii) recognise the important role of the independent members on each committee: at present the power of the Governor to control the agenda of both and to 'divide and rule' is too great.

1.4. The FPC should required to set out a policy statement saying how its powers of recommendation or direction will be used with respect to the PRA, the FCA and the exercise of the Bank's regulatory powers with respect to critical market

infrastructure. Further, there is no requirement for the FCA, the PRA or the Bank to publish a statement saying whether or not they have complied – this should be made a statutory requirement. Both amendments would improve the transparency of the regulatory system.

1.5. The remit of the FPC should be extended to cover other market actors whose activities could have financial stability consequences, at least to monitor them - for example decisions by ISDA's determinations committee on matters that would have systemic financial stability implications, such as the determination of a credit event.

2. **Bank of England's role as regulator of critical market infrastructure**

2.1. The Bank's role as regulator of critical market infrastructure (payments, exchanges, clearing and settlement systems) is critical for financial stability but has received insufficient attention in the draft legislation.

2.2. The legislation should be amended to give the Bank a consistent set of powers with respect to the critical market infrastructure (CMI) institutions, and to strengthen those powers. For example, the rulemaking processes with respect to payments are different to those with respect to clearing houses. The disciplinary powers are also different. At present there are too many inadequacies and inconsistencies for the regulation of CMIs to work effectively or to cope with changes in market structure or practices.

2.3. To clarify the role and responsibilities of the Bank with respect to CMIs the legislation should require the Bank to create either a separate unit to regulate CMI institutions which reports to the Governor / new Board and to the FPC, and whose reports are published, or (preferably) to create a new subsidiary that sits parallel to the PRA with the same accountability structures attending it. Alternatively, the PRA should be given the powers to regulate CMI institutions.

2.4. The resolution powers should be extended to cope with the failure of a CMI institution.

2.5. A complaints scheme akin to that for the FCA should be established with respect to that proposed below for the PRA (para 3.3) for the Bank's regulatory activities with respect to CMI.

3. **Prudential Regulation Authority**

3.1. Insurance objective – extending the PRA's objective to require them to protect the interests of 'future' policy holders as well as existing is unclear (how far into the future does the PRA have to look) and potentially overlaps with the FCA's responsibilities with regards to sales of insurance products. It also raises the question of why no parallel obligation is imposed on the PRA to protect the interests of depositors, current or future.

3.2. With profits policies – it is suggested that the question of whether with-profits policy holders 'reasonable expectations are met' should be joint between the FCA and PRA, as there are a number of reasons why such expectations may not be met other than financial soundness.

3.3. Complaints against the PRA should be brought in line with those of the FCA. Any complaint against the PRA will inevitably reflect on the Bank and it is not appropriate that the Bank should investigate. There is clearly a conflict of interest, or at the very least an appearance of one. Instead, the Treasury, not the Bank, should approve the complaints scheme, and the Treasury, not the Bank should appoint the independent investigator. However, the PRA should have to report to the Bank as well as the Treasury on its response to the complaints.

3.4. Finally, it is recommended that the legislation should be amended to provide the PRA to issue formal guidance. At present I understand that the Bank does not want this power as it assumes it will be able to regulate firms by published rules and informal guidance given on an individualised basis. This may be true for the large banks, but the Bank's remit is not the same as in 1997. It will have a large number of small credit unions and other firms to regulate as well. Published guidance is not only more practical but more transparent than individualised guidance or the equivalent of a series of Dear CEO letters.

October 2011

Brewin Dolphin, Cazenove Capital Management and Rathbone Brothers – written evidence

We are the three leading firms providing complete wealth management services in the UK. As such our day to day businesses will primarily be subject to Financial Conduct Authority (FCA) supervision (although Rathbones has a banking licence so will be lead regulated by the Prudential Regulatory Authority (PRA).

We currently provide services for over 200,000 individual clients, charities and pension funds. We can all trace our ancestry to the eighteenth century during which time we have acquired a reputation for trust and probity for private investors. Between us we have £57 billion under management and 58 offices around the UK, Ireland and the Channel Islands.

In recent years the cost of regulation and red tape has escalated to around 5% of our turnovers – and this figure excludes the Financial Services Compensation Scheme (FSCS) levies of £12.3 million we paid between us this year, due to failures in other parts of the industry. These significant costs are increasingly pricing our services out of the reach of small investors. Our mantra used to be – never too small to start saving and investing – in reality the barest minimum investment for the services and investment advice we provide are now well over £100,000.

We welcome the opportunity to provide evidence to the Joint Committee on the Government's Draft Financial Services Bill. We intend to concentrate our remarks on that part of the Bill which has the greatest potential impact on our business, the creation of the FCA.

We recognise that we have a "once in a generation opportunity" to ensure the regulatory system in the UK is fully fit for purpose. We believe the FCA can achieve this goal by working more closely with the industry to prevent the problems of the past – which have resulted in compensation payments of over £15 billion and a catastrophic loss of confidence in the whole financial system. Unfortunately we still have significant concerns that the proposals miss this opportunity and that if they are implemented as currently proposed by the FSA, there is a risk that the private investor in the UK will be left with less effective regulation.

We do not believe that there has been sufficient effort to identify accurately where and why the failures occurred; why certain existing powers were not used, or to produce a targeted response. . Instead, it seems that the interpretation by the FSA of the Treasury's principled proposals, 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.

We believe an innovative approach to "Simplified Advice" and investor protection could help achieve a greater level of confidence and certainty for the great majority of consumers. Such an approach would deliver better protection for the most needy and if deployed in combination with prudent product intervention and better use of intelligence gathering from the market, would represent the route to enhanced Regulation in the UK. We are

developing ideas around such a model and would welcome the opportunity to start a dialogue on how these might be implemented within the new regime

It is in all our interests that is the Government; Regulators; Consumers and Regulated Firms, that we have a strong and well regulated financial services industry. Firms and regulators are mutually responsible for the future of the industry's reputation; the nation's savings and for paying compensation when things go wrong. Making it is as much in our interest that problems are spotted early as it is in the interest of the Government and its agent, the Regulator.

Please find attached our response to your call for evidence and we would welcome any opportunity to discuss these points or provide more details that could be helpful to the Committee.

Response to specific questions from
Brewin Dolphin, Cazenove Capital Management and Rathbones:

4. Are the accountability and governance arrangements for the Bank of England, FPC, PRA and FCA satisfactory?

The four new bodies which will provide governance for this important industry must all recognise that they are the Agent of the Government and be fully accountable to HM Treasury and to Parliament. It is clear that the failures of the current tripartite regime were in good part due to their lack of transparency and accountability to Parliament and to each other. As a result, we believe that the new framework requires:

- Clarity about the relationship between the PRA and the FCA – especially for dual regulated firms
- We support the proposals for the FCA to have Treasury appointed Non-Executive Directors and a Senior Independent Director who should also be a member of the Financial Policy Committee. We are concerned that the line between the FCA and the FPC is not as strong as the reporting line from the PRA to the FPC
- Greater scrutiny of FCA consultations by both consumers and practitioners and that responses to consultations should be published in full (as Parliamentary consultations)
- That the Regulators' service levels to firms and consumers are specified and accounted for.
- We welcome the proposed new power to hold the Regulator to account for any significant regulatory failure. However, this does raise three key issues: (a) **There is a need to define significant regulatory failure**; (b) Measures to be taken against the regulator for any failure are still to be prescribed; (c) Compensation procedures for those negatively affected – both consumers and firms, also need to be clarified.

12. Are there any risks in the Government's proposed 'judgement-based' regulation?

The early identification of potential problems would be welcomed by all responsible practitioners. There are presently wide variations between distributing firms' classifications of financial products, with some judging certain funds complex and others the same funds non complex – leaving many investors confused and potentially exposed. For example, while

UCITS products require pre approval many banking and structured products which have been at the root of many of the recent problems – do not.

The FCA's proposed methods for information gathering give us significant cause for concern. We do not believe that business analysis is an adequate substitute for good quality relationship management and "face to face" time spent with both practitioners and investors. Business analysis is likely to be academic, largely desk-based and therefore disconnected from the practical issues concerning firms and consumers. It will certainly be no less expensive and may well lead to conflicts of interest with firms, if outsourced. The FCA will need outstanding intelligence if it is to spot emerging risks, which will not necessarily show up in models. We are concerned that adopting this approach is unlikely to help the FCA staff develop a broad and deep understanding of the firms, the products and the markets they are regulating.

The FSA has also stated that the FCA's interventionist stance and lower tolerance for consumer detriment is likely to result in more enforcement cases. If this approach is intended to target 'boiler rooms', unregulated financial services including money lenders, we will wholeheartedly support it. However, we are concerned that the FCA is jumping to such a pessimistic conclusion about the impact of its new approach on its regulated firms. Successful product intervention and a generally preventative approach to regulation should lead to less, not more, enforcement cases. There is a danger that an objective with such an approach will do little to enhance confidence in the UK financial system, likely as it is to generate many column inches of media coverage.

14(i) Given that the PRA and the FCA will inherit FSA staff does the draft Bill do enough to ensure a new regulatory culture and a more proactive approach to regulation?

With our knowledge of the numbers of staff leaving the FSA throughout the last year and the morale of those left behind, we are concerned that the regulators will not be able to recruit a sufficient number of executives of the necessary calibre to complete the task or command the respect of the industry.

The proposals that the FCA plans to use business analysts and call centres, in place of much of the supervision they do now – raises the concern that they will not easily develop an effective and proactive regulatory culture. It is the route to lower quality regulators with less practical knowledge of the industry and its clients.

It appears that, in the new model, contact between the vast majority of firms and the FCA will be limited to the following:

- <u>Contact centre staff, in a helpline format</u>. Contact via the helpline is largely initiated by firms and available to all firms in every sector. A firm calling the contact centre is unlikely to deal with a member of FCA staff that has detailed sector knowledge, and therefore the contact centre staff will not be able to apply context to the nature of the call. In the spirit of mutual responsibility this is of particular concern to us. The new powers to publish a warning notice in relation to a disciplinary matter, will almost certainly drive problems underground rather than be openly discussed with contact centre staff.

- A themed review, approximately once every four years. Themed reviews are always staffed by specialists, who do not have a broad knowledge of the sector or the firm built up over time. There will be no continuity for firms as different specialists will be present on different reviews.

In our view, the cornerstone of strong, proactive supervision is the understanding built on supervisors' on-going knowledge of firms, their people, the sectors in which they operate and trust between supervisor and firm. We reject the argument that this is a cost issue, because where there is understanding and confidence in the supervisory relationship, supervision is not resource intensive for a regulator.

We understand that the FCA will have 24,500 firms to regulate and that there will never be the resources to fully supervise a fraction of this number. Nevertheless the FCA should have service level agreements with those it serves i.e. firms and consumers. To deliver this it must have at least some annual contact with all firms – even if only the promise of a mystery shopping visit for all.

We also believe it would be valuable to set up more formal arrangements for whistle blowing. Where firms raise issues with a submission from their CEO to the FCA – there should be some specified level of investigation and response. Equally, individuals within firms should be encouraged to raise concerns, clearly with a suitable filter for vexatious claims. We do not believe this is adequately addressed in the draft Bill.

We recognise the Treasury's reasons for introducing new powers of enforcement and the publication of warning notices. However, the FCA's proposed approach to these new powers is of significant concern. Under the new regime, the FCA intends to publish the fact that a warning notice in respect of an enforcement action has been issued (i.e. before an investigation has been undertaken). In our view, this approach has a number of major problems:

1. It will act as a strong disincentive for firms to engage with the FCA, forcing the FCA and firms even further apart. There is no incentive for a firm to 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 referral to enforcement and the issuance of a public statement, all prior to an investigation.

2. The publication of a warning notice has the potential to mislead consumers and result in consumer detriment. For example, consumers may respond to the publication of a notice by exiting a firm's product or service at a loss, yet a full investigation may show that no issues exist.

3. The publication of these notices will have significant commercial implications for firms and we therefore consider it unfair that issues behind the notice are not fully investigated and fairly considered prior to publication. It is particularly dangerous where the firm is publically quoted and could lead to a false market in the company's shares. There is an argument circulating that the financial services industry should be able to mount a judicial review against the FCA regarding this new power of early publication of decision notices. The right to a fair hearing is enshrined in Article 6 of the European Convention of Human Rights, and is enforced in the UK. Firms will not

be getting a fair hearing if the regulator is releasing information into the public domain prior to a hearing. So not only will this cloud any successful bilateral relationship between the regulator and the industry, but is also potentially unlawful and contrary to any concept of natural justice.

4. There is also the question of what form of redress firms will have against the FCA following an incorrect challenge – which may have resulted in considerable losses for consumers, shareholders and staff. Will the FCA have total immunity from damages? We refer to our point above about the need to define 'significant regulatory failure' and ask how redress might be made in the event.

We agree that the regulator needs a strong and fair enforcement capability and a credible deterrence. We believe that the existing supervisory powers of capital loading should be properly applied to any firm, from a universal bank to the smallest IFA when concerns are raised, thus putting the onus on the firm to correct their position as soon as possible. If necessary these powers could be extended in the legislation, so they can be applied as the FCA thinks best and with the benefit of the FSA's hindsight.

14 (ii) Will these two new bodies have staff with the appropriate skills and expertise?

As stated above we believe it will be a huge challenge for the FCA to acquire enough appropriate staff. We believe that the FCA would be better able to tackle many of the recognised problems by working more closely with the industry and we welcome the proposals in relation to additional Panels and the NAO, as mentioned above. We also believe that a move towards regulation via call centres and academic research will make in even harder for the FCA to recruit high calibre employees.

The FCA cannot expect to recruit the range of expertise to fully police the increasingly complex financial product market. For this reason it should draw on the experience of firms in the sector to aid its work. The industry could be asked to resource a Product Scrutiny Committee and other Committees as necessary, which should meet regularly to review and give advice on financial products (which would be brought to it on an anonymous basis). We have already offered to second analysts to any relevant committees.

17. Does the draft Bill strike the right balance between the responsibilities of consumers and firms?

We have given our strong support to the principles outlined by HM Treasury in its New Approach to Financial Regulation and we look forward to working with the FCA to achieve these objectives. We are especially pleased that these include value for money and cost effectiveness; the acknowledgement that senior managers are responsible for managing their firms (not Regulators) and that consumers of financial services are ultimately responsible for their own decisions (within a fair market operating with the upmost integrity).

We do believe that the distinctions between responsibilities of firms and the rights and responsibilities of consumers and the clear definition of each will be crucial to the success of the new regulatory structure. We would like to give a huge welcome to 'the general

principle that consumers should take responsibility for their decisions' and we would hope that in a well regulated industry consumers will feel comfortable about the decisions they take.

While we do recognise that there are on-going problems, for example the mis-selling of payment protection insurance, many of the proposals and recent pronouncements of the FSA appear to be based on the premise that the majority of customers are treated unfairly by the financial services industry and that this majority habitually suffer poor outcomes.

Such an approach fails to distinguish between certain problem areas and the many firms who provide a good service to their clients and indeed protect them from products, firms and markets that are not suitable to their circumstances. We are concerned that some of the recent rhetoric coming from the FSA about these reforms may have the effect of further eroding confidence in the industry, while also raising consumers' expectations that the FCA will deliver fail safe products and eradicate mis-selling with their new powers of intervention.

Are the FCA's new powers in the area of consumer protection appropriate?

Our first concern is the lack of clarity within the definition used for consumers, we believe it will lead to confusion because the word consumer has a clear meaning which the legislation is distorting; general consumers of basic financial services may require higher levels of protection than more sophisticated investors or wholesale market participants. The definition does not address the 'various levels of knowledge and sophistication' as we believed was the Government's intention.

At 1 subsection (3), (c) and (d) are not included in FSMA's current definition of 'consumer'. It also confuses the definitions established by the EU's MiFID legislation– i.e. Retail; Professional and Counterparty. There is a danger that the very broad use of the term to encompass wholesale market funds as well as retail individual investors will encourage "one size fits all" regulation. Nor do the definitions define the role of Trustees and Local Authorities, a specific issue being addressed in MiFID2.

At the FSA launch of their proposals for the FCA, it was suggested that it would be reasonable for the regulator to make suitability judgements on behalf of the consumer.

It is increasingly recognised that many consumers e.g. those with less than £100,000 or [£500 per month] to invest, are becoming priced out of investment advice. The FSA acknowledges that around 20 per cent of IFAs will no longer practice after 2013 and several banks are withdrawing their advisory services and polarising offerings between execution-only sales and full wealth management services. It is becoming clear that the move to transparent charging is leading to minimum annual fees of around 1 per cent of assets under management, and that portfolios of less that £100,000 are becoming uneconomic for qualified investment advice services.

We agree that the FCA should consider the conflict between choice and personal protection by helping those consumers who lack the investment experience to make what they will find complex financial decisions. One means of achieving this goal would be for the FCA to be prescriptive on the products used for "Simplified Advice". This would offer enhanced protection across a range of key basic financial products for the more vulnerable

and less well off in society. But it would also permit more sophisticated investors, or those who can tolerate a higher appetite for risk, to choose from a wider range of services and products and be able to take more responsibility for their own decisions about what may be appropriate investments for them.

19. Will the new regulatory arrangements reduce the risk and costs of dealing with mis-selling of financial products?

We are not convinced that the new arrangements will reduce the risks and they will certainly not reduce the costs (as outlined above).

However, we do welcome the recent report published by the Financial Services Consumer Panel – Defining Straightforward Outcome Products – and will be very pleased to contribute to these proposals, particularly in the interests of reducing costs and red tape for the whole industry and equally delivering more assured consumer protection for the vast majority of consumers.

September 2011

British Bankers Association (BBA) – written evidence

Introduction

In addition to the detailed questions the Joint Committee is interested in whether the draft legislation will or could better:

- Prevent another financial crisis;
- Handle a financial crisis;
- Deal with bank failure and protect the public purse.

The answer to this has to be that the new structure brings with it the prospect of contributing to each of these objectives though supporting a more intense regulatory engagement and the application of a macro-prudential element to regulation. It needs to be appreciated, however, that achieving these three goals – increasing the resilience of the banking system and firms within it, improving crisis management and making further changes to improve loss absorbency on the part of the industry – rests as much with the broader banking reform programme being pursued not only in the UK but on the international and European stage. These measures are wide-ranging and we have attached as Appendix 1 a summary prepared by the BBA for the Independent Commission on Banking.

The Joint Committee is also interested in whether the proposals in the draft Bill will increase or decrease the risk or regulatory arbitrage of financial businesses. This question could either relate to shadow banking or to the prospect of arbitrage as a result of differences in regulation between jurisdictions. In the case of the former, effectiveness will depend upon whether the statutory provisions provide sufficient powers to bring within regulatory scope activity that may prove of systemic relevance to financial stability and it is arguable that the powers are being drawn up on too narrow a basis; in the case of the latter, as with other measures, effectiveness will to a large extent depend upon whether measures sit comfortably with the direction of changes in the international regulatory regime and within other financial centres.

We should add that the BBA is in the process of finalising its response to the Treasury consultation 'A new approach to financial regulation: the blueprint for reform' and will make this available to the Joint Committee upon completion.[43]

Specific questions

1. Is the separation of prudential and conduct regulation into a "twin peaks" system the right approach?

The thinking behind a "twin peaks" approach based on prudential regulation and conduct of business regulation is that greater focus can be brought to both. Changing the regulatory structure in this way, however, brings a new set of challenges. The answer to whether this is the right approach will depend upon whether the new authorities are given the right direction through the definition of their statutory objectives, the quality of their staff and the practical efforts made to ensure that 'focus' does not come at the price of coherence. The way in which we have drawn up our twin peaks makes this critical.

[43] BBA response to the HM Treasury consultation 'A new approach to financial regulation: a blueprint for reform' available from 8th September.

2. What lessons can be learnt from the approach of other countries to regulation of the financial sector?

We would comment as follows in response to this question:

- First, the financial crisis provides little evidence of one regulatory model being inherently superior over another. Twin peak models failed just as much as unified models and the telling factors in whether or not institutions faired better or worse tended to be more to do with supervisory approach, risk management and business mix and diversity. The question therefore perhaps is whether one form or another better supports the intention that prudential supervision and conduct of business regulation be both more strategic and better focused.

- Second, there are immense benefits for financial stability in the banking reform programme overall being taken forward within a coherent and coordinated international framework. The UK has provided thought leadership to many of the measures coming out of the Financial Stability Board and the Basel Committee on Banking Supervision, in particular on recovery and resolution plans, which are central to ensuring that no bank need be viewed as 'too big to fail'. We should aim to provide a global lead by grounding our statutory regime – and other domestic measures under consideration - within this framework.

- Third, the twin peaks model proposed by the Government bears broad similarity with the Dutch and Australian regulatory frameworks in place for around a decade. There are presumably learning lessons to be made from their efforts to ensure that the benefits achieved from a more focused approach are not outweighed by the added complexity deriving from firms having to meet the requirements of more than one core regulatory authority. The US Dodd-Frank Act has provisions relevant to the Joint Committee's interest in the scope of regulation.

- Fourth, there are key learning lessons on the design and application of macro-prudential tools to be gained from elsewhere in the World, notably the Far East. The BBA has done a substantial amount of work on this and has inputted papers to both the Bank of England and the Treasury. Examples of this work are footnoted below[44] and our response to the Treasury 'blueprint' consultation will include a summary of the strengths and weaknesses of a number of macro-prudential tools – attached as Appendix 2 for the Joint Committee's consideration.

We would further add that the position in other jurisdictions is not necessarily as straightforward as first meets the eye. The US Dodd Frank Act, for instance is often cited as an indication that the US is more advanced in its response to the crisis and yet the US approach remains dependent upon regulatory measures still being drawn up.

3. Is it appropriate to make such major changes to the regulatory system by way of amending legislation, rather than starting afresh?

[44] See for instance BBA paper 'A possible macroprudential approach', July 2010 or the update provided as appendix 2 in the BBA's 4th July 2011 response to the interim report of the Independent Commission on Banking.

There are pros and cons with either approach. Starting afresh would clearly have enabled the statutory provisions to have set out with greater clarity the vision, objectives and operating framework of the new authorities and their place within the broader environment. Utilising the existing legislation, on the other hand, reduces the time needed on clauses relating to unchanged aspects of the regime and delivers other significant time savings. An issue for the committee may be whether a means can be found of providing assurance to the market that FSMA will largely remain intact and that aspects relevant to the change in the regulatory architecture only will be re-opened.

4. Are the accountability and governance arrangements for the Bank of England, FPC, PRA and FCA satisfactory?

- *Bank of England:* we have inputted to the deliberations of the Treasury Select Committee and understand that the Joint Committee has access to this evidence. We are amongst others who believe that the concentration of power within the Bank of England's hands necessitates stronger governance and accountability mechanisms. It is important that the FPC comes to be regarded as having the same stature as the Monetary Policy Committee.. There is also a clear need to strengthen the Court and its oversight of the Bank's decision-making and due processes.

- *Financial Policy Committee:* we see benefit in there being as much symmetry between the governance and accountability arrangements for the FPC and MPC as possible. We place a premium on the FPC attracting high calibre independent members and believe that the deliberations of the FPC should be undertaken in as open and transparent a way as possible. Arrangements already envisaged include the publication of its minutes, the bi-annual Financial Stability Report and the publication of the minutes of the bi-annual meeting between the Governor of the Bank as Chair of the FPC and the Chancellor of the Exchequer; we see grounds for adding to this a requirement that the FPC be required to write to the Chancellor outlining the reasons behind any decisions to use macro-prudential tools together with a cost-benefit analysis supporting any decision. .

- *Prudential Regulation Authority:* clarity is needed, however, on how the Bank will maintain an appropriate divide between strategic direction within its sphere or responsibility and supervisory execution which should rest with the PRA; key to this would appear to be an appropriately strong PRA Board with widely experienced, authoritative independent Non-Executive Directors. We were highly concerned at the original suggestion that the PRA could in some way be excused from the usual standards of consultation and impact analyses and were pleased to see a change of direction in this regard; there remain, however, concerns about the appeals mechanism on supervisory decisions given that that (when called upon) the Tribunal will no longer be able to substitute its own opinion for that of the regulator, leading to a potentially toothless review process. This represents a serious erosion of firms' rights to an independent review of contested decisions and we believe that it would be more appropriate for the Tribunal to retain the authority to overturn decisions with which it disagrees.

- *Financial Conduct Authority:* key needs for the FCA include the establishment of a strong Board, the extent to which coordination with the PRA is successful, the successful delivery of cross-team coordination within the FCA and ensuring that equal weight is given to both its conduct of business and markets responsibilities. We would be keen to understand what performance information will be required of the FCA, in particular in

respect of the use of its new powers – for example, how will the different levels of engagement with the supervision teams will be monitored to ensure consistent product intervention outcomes. Will the FCA publish information about the extent to which Warning Notices (about which information has been published) are subsequently discontinued or amended?

5. Are the FPC's objectives the right ones? Is the concept of financial stability adequately understood for the FPC to be able to perform against its objectives?

We are concerned that, as currently struck, the proposed framework falls short of setting a clear and simple mandate for the Financial Policy Committee and would urge the Government to consider the development of a regime analogous with that of the Monetary Policy Committee. This structure is well understood by the market and its democratic accountability via Parliament is clear. We therefore see a very strong case for the Financial Policy Committee's objectives, structures, proceedings, governance and accountability to mirror - as far as is possible given their different functions - those of the Monetary Policy Committee.

With this in mind, we believe that the FPC's remit should be to ensure a sustainable *supply* of credit to the economy in the same way that the MPC's remit is to ensure the stable *price* of credit. This is not to say that we believe the Government should set a quantitative target on credit growth in aggregate but that the Treasury should outline the factors the FPC should consider when it is assessing the level of risk in the economy and the likely impact of this on the supply of credit. In our view, this mandate letter should specify how the maintenance of financial stability and the promotion of economic growth should be balanced – reflecting the desirability of credit growth varying somewhat across the cycle.

As with the MPC, we believe that the FPC's mandate should include a requirement to support the Government's economic policies in respect of growth and employment. This in our view would provide an essential context for the specific reference to contributing to the Bank of England's Financial Stability Objective. This will permit macro-prudential policy to be struck in a way which considers the wide range of systemic risks to the financial system from both within and outside the regulated sector: a key consideration with regard to the joint Committee's interest in ensuring that appropriate arrangements are put in place of the oversight and control of shadow banking.

We believe that framing the mandate in this way will underscore the dynamic nature of macro-prudential policy and offers much the same ability to promote financial stability while at the same time mitigating concerns about unnecessary constraints being placed upon growth.

6. Should the FPC be limited in the actions it can take which might affect the growth of the financial sector?

We would suggest that the legislation underpinning the FPC should specify that its objective is to maintain a sustainable supply of credit to the economy and, subject to that, support the Government's economic policy and contribute to the achievement by the Bank of England of the Financial Stability Objective. In keeping with the Bank of England Act 1998, we believe that the Treasury should write to the FPC annually specifying the factors it is to consider

when assessing the level of risk in the economy and its likely affect on the sustainability of the supply of credit, including how the maintenance of financial stability and the promotion of economic growth should be balanced. We would suggest that this appropriately balances the need for the FPC to take steps which may reduce economic growth with the need to take effective action.

7. How will the interaction between macro-prudential and monetary policies be handled by the FPC and the MPC?

To be successful, we believe it is imperative that macro-prudential policy be coordinated with both monetary policy and fiscal policy. We believe that this is one of the key learning points from the operation of macro-prudential policy in those economies which have already incorporated macro-prudential policy into their regulatory frameworks. To ensure this takes place, we believe that the annual remit letter from the Chancellor to the FPC should specify how the Committee should consider the Government's wider economic objectives when setting policy. The Governor should also use the proposed bi-annual meetings with the Chancellor to discuss any risks to financial stability linked or exacerbated by fiscal policy.

We accept the Government's argument that the overlap in membership between the FPC and MPC should help reduce inconsistencies in policy. The ability for members of the FPC and MPC to attend briefings from the Bank staff supporting each committee should also enhance coordination; we would further suggest that members of either committee should have full access to information made available to the other. Fundamentally, however, it is for the Chancellor to use his annual remit letters to the two committees to minimise any discrepancy in policy.

8. Has the right balance been struck between the powers of the FPC and the powers of the Treasury?

As discussed in our answers to the previous questions, we see a case for greater engagement of the Treasury in the setting of the objectives of the FPC, in the form of an annual remit letter setting out how the FPC should balance the various parts of its mandate.

We also believe that the Governor of the Bank as Chairman of the FPC should be under a duty to write to the Chancellor to explain the decisions behind any direction or recommendation of the FPC. This letter should include a cost benefit analysis of the proposed direction or recommendation, and an assessment of the possible economic impact. The letter should be copied to the Chairman of the Treasury Committee.

9. Can Parliament take an informed decision about the proposals for the FPC without details of the macro-prudential tools at its disposal?

We do not believe it is necessary to have full knowledge of the macro-prudential tools which will be available to the FPC before the legislative underpinnings for the Committee are agreed. However, the consequence of this is that Parliament must satisfy itself that there are appropriate accountability arrangements in place to govern the oversight of the FPC and that the mechanisms through which the use of the tools will be authorised are struck in a manner which requires consultation and deliberation of the likely impacts ahead of authorisation.

We broadly support the authorisation process for the use of macro-prudential tools but would urge the Committee to consider whether the period for which tools are authorised should be limited through the use of sunset clauses. We also believe that there is a case for the FPC to report to the Chancellor on an annual basis how it has used the tools available to it and for this to be laid before Parliament. Other than this, we believe the proposed process reflects the early stage in the development of macro-prudential tools and the need for a system with sufficient flexibility to accommodate the evolution of financial markets and the dynamic nature of risks to financial stability. We provide an analysis of the strengths and weaknesses of a number of potential macro-prudential tools in the annex.

10. Does the draft Bill adequately deal with the risks posed by the shadow banking system?

The Bank of England's paper 'Our approach to banking supervision' in May 2011 stated that the PRA will be able to regulate all firms posing potentially significant risks to the financial system because their activities are in substance analogous to deposit taking. The intention therefore is to empower the PRA to regulate the relevant firms should it need to, without potentially restricting its reach by defining too closely who will come under the scope. It is arguable however that the proposed focus on activity analogous to deposit-taking is too narrow and that the power to regulate should be based on a broader definition of business analogous to banking activity with a potential to give rise to systemic risk. As mentioned above, the US Financial Stability Oversight Committee will have power to designate a non-financial entity which it believes should be subjected to prudential supervision[45].

For the sake of future interpretation we recommend that this is reflected with greater clarity in the Bill. The power of the Treasury to provide for additional objectives in the future also provides scope for addressing the risks posed by the shadow banking system if required.

11. Are the PRA's objectives clear and appropriate?

We support the PRA's main objectives of promoting the safety and soundness of PRA authorised persons through ensuring the conduct of business does not adversely affect the financial system, and minimises the impact of any on the financial system. We agree with the strategic and operational objectives proposed for the PRA insofar as they go and can also see the logic in expressing a set of regulatory principles to be applied to both the PRA and FCA. We are pleased the Treasury will have the power to set additional future objectives for the PRA, ensuring the regulator's objectives and can be changed according to future needs.

[45] The Dodd-Frank Act states that the FSOC may require that a "nonbank financial company" become subject to consolidated, prudential supervision by the Board if the Council determines that material financial distress at the company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the company's activities, could pose a threat to the financial stability of the United States.2 Section 113 of the Dodd-Frank Act specifies a number of criteria that the Council must consider in determining whether to designate a nonbank financial company for supervision by the Board. These factors include the size and leverage of the company, as well as the extent and nature of the company's transactions and relationships with other "significant nonbank financial companies" and "significant bank holding companies.' See also Federal Register, volume 76, No. 26, 11 February 2011 on proposed amendments to Regulation Y on the criteria for determining whether a company is "predominantly engaged in financial activities" and define related terms.

We are also highly supportive of the principle that the PRA will not be operated on a "zero failure" basis. This sends out the correct message to the industry and removes the well-documented dangers of firms thinking they will not be allowed to fail.

We are disappointed however that the Government has not accepted the case for the PRA and FCA also being required to bear in mind international competitiveness, innovation and growth. We would like to see this reconsidered.

We cannot see why the Government would not wish to send out a strong signal that "Britain is open for business" by committing to a competitive regulatory regime. The attractiveness of the UK as a place from which to conduct financial services cannot be taken for granted and there increasing anecdotal evidence of new operations being opened up overseas in preference to in the UK. We therefore see a case for a renewed commitment to better regulation and the avoidance of gold plating. We also disagree with the assessment that innovation should not be a relevant factor for the PRA and FCA.

We would see this as being entirely consistent with the objectives set for the three European Supervisory Authorities under recital 9aa of the Regulations applicable which require that in each case the authority should take due account of the impact of their activities on competition and innovation, global competitiveness, financial inclusion and the strategy for jobs and growth.

The fact that the European authorities accept this makes the UK Government's reluctance all the more difficult to comprehend.

12. Are there any risks in the Government's proposed 'judgement-based' regulation?

Judgement-based supervision brings with it a need for a more consultative approach on strategy, openness and a workable mechanism. It is therefore pleasing to see the Government reconsider its earlier position which suggested a lack of appreciation of the need for consultation.

It logically follows that the quality of any judgement-based decisions will be heavily dependent on the knowledge and application of those responsible for making them. We support the Government's acknowledgement that the quality of the PRA staff is important, as is that any decisions will be rigorously evidenced based. We think it is important to emphasise that it is of paramount important that these two principles are meticulously adhered to.

Judgement-based supervision also increases the need for a mechanism to appeal supervisory decisions and it is hard to see the justification for the proposed weakening of these arrangements.

We welcome the proposal for a new 'business markets and analytics' team which will clearly play a key role in setting policy but also in determining what action to take in specific cases i.e. the exercise of product intervention powers – we welcome the emphasis on the importance of understanding the market. It is essential that the staff in that team have the right skill-sets, that there is transparency about the work they do and that there is early dialogue with firms.

Members are, however, concerned at the FSA's stated intention that the FCA should make 'value for money' judgments. Neither competition authorities nor specialist economic regulators make such judgments. There is a real risk that inappropriate use of the FCA's product intervention powers in order to achieve 'value for money' may result in less choice. As far as we are aware it is not intended that the FCA be a price or economic regulator.

13. Is the Government's proposed approach to 'orderly' firm failure satisfactory?

We strongly support the development of crisis management arrangements, including measures such as 'living wills' to minimise the likelihood of a bank failing and the concept of the Special Resolution Regime, introduced by the Banking Act 2009. We see much of this thinking reflected in the work of the European Commission and Financial Stability Board and attach our recent submissions to each on this topic. In our opinion, the need for orderly resolution regimes, which permit action to be taken to protect financial stability before balance sheet insolvency, are one of the key lessons to be learned from the financial crisis and the most effective way of reducing moral hazard. Put simply, we believe that no firm should be considered too big to be subject to an orderly resolution regime.

Whilst we believe responsibility for the different functions of the crisis management regime have been appropriately allocated, we suggest reconsideration of the point at which the Bank should engage the Chancellor. Clause 42 currently places an obligation on the Bank to notify the Chancellor when there is likely to be a call on the use of public funds. In our view, this should be amended to include situations in which the Bank might reasonably be expected to trigger the SRR. This will ensure that the Chancellor is fully engaged in the decision making process at an early stage and reflect the lower probability that public funds will need to be used to resolve a failing institution – given the development of 'bail-in' and other powers to protect the taxpayer. There is also a case to be made that the MoU between the Treasury and Bank should stipulate the ex ante establishment of a small crisis management committee (a financial 'COBR') comprised of the Chancellor and the Governor to oversee the handling of any crisis.

14. Given that the PRA and the FCA will inherit FSA staff does the draft Bill do enough to ensure a new regulatory culture and a more proactive approach to regulation? Will these two new bodies have staff with the appropriate skill and expertise?

The essential consideration is not so much whether the Bill will ensure a new regulatory culture and more proactive approach but whether the culture and approach will be well adapted to achieving the public policy objectives. Retaining and recruiting expert and skilled staff will be crucial to the success of the new regime, PRA, and FCA. Imbuing the EU authorities, in particular ESMA and EBA, with similar expertise and skills will also be essential (see also Q21 below). The impact assessment which accompanies the draft bill suggests that the set up of the PRA will involve the development of new IT systems. Appropriate consideration of the cost and timescales for putting in place such infrastructure is necessary to ensure PRA staff have adequate IT support upon commencement of the new regulatory framework.

Aside from the need for knowledge of consumers, markets and products we also believe that there is a real need for staff to be open, clear and consistent about perceived risks and

maintain a proactive dialogue with firms either individually or the industry as a whole about these risks. Given the interventionist nature of the FCA's powers and its approach to the exercise of those powers it is essential that firms understand what is expected of them in response to the exercise of these powers.

The emphasis on the calibre of FCA staff has been mentioned elsewhere (e.g. under Q4) and is equally applicable in the context of a fundamental culture shift towards proactive product intervention as envisaged in the FSA's paper on the operation of the FCA. Suitable qualification, with practical experience from within the industry at an appropriate level of seniority, might be helpful indicators of technical know-how.

15. Are the FCA's primary objectives appropriate? Is [sufficient] emphasis given to the promotion of competition?

We support the FCA having a strategic objective to protect and enhance confidence in the UK financial system and this being complemented by the operational objectives identified. We are also supportive of the Government elaborating on the FCA's objectives to ensure that the FCA must, wherever appropriate, exercise its general functions in a manner intended to promote competition. The Government has deliberately made the promotion of competition a secondary duty, and one which is to be carried out so far as is compatible with the primary objectives. This is appropriate, and in line with the secondary nature of this duty the FCA is to have the statutory power to make an enhanced referral to the OFT (or CMA) when it believes competition issues merit further investigation and remedy. It would not be appropriate for the FCA – which is not an experienced competition authority – to have the promotion of competition as its primary duty. The identification, analysis and resolution of competition issues should remain the responsibility of the competition authorities which are better placed to carry out sophisticated and proportionate analysis.

16. Are the responsibilities of the FCA towards the regulation of markets appropriate?

There have been some encouraging statements on the approach proposed for the FCA with, for instance, the FSA explaining in its 30th June document that it proposes significant continuity with the existing regime. This could usefully be bolstered to include commitment to consider the way in which European rules are being applied elsewhere as goldplating brings with it the risk of damaging international competitiveness and the effectiveness of UK regulation through scope limitations and regulatory artibitrage.

17. Does the draft Bill strike the right balance between the responsibilities of consumers and firms? Are the FCA's new powers in the area of consumer protection appropriate?

Under the new, all-encompassing definition of 'consumer', it is important to distinguish appropriately between different types of 'consumer' in different markets, in particular to continue to focus regulatory effort on more vulnerable retail investors, and not to overprotect users of wholesale markets. The FSA's commitments on this point in its 30th June document are welcome, as is the emphasis that consumers - as broadly defined - should continue to take responsibility for their own informed decisions.
We believe that the effective and proportionate use of the FCA's powers of intervention in particular will largely depend on how the FCA defines the circumstances in which it will

exercise those powers. Although FSMA requires that the powers be used in advancement of the consumer protection or efficiency of choice objective, the legislation has not defined any further parameters around their use. Instead the FCA must publish a policy setting out its approach to the use of its temporary intervention powers – so it is not yet clear whether the FCA will exercise its consumer protection powers appropriately.

18. Are the prudential regulatory responsibilities of the FCA towards FCA-only regulated firms given sufficient emphasis and detail?

We believe that where banking groups have entities which fall within the scope of PRA supervision then the group should be regulated by the PRA in its entirety. The alternative is less effective supervision and inefficiencies in internal management and governance. If this is accepted, the FCA would be in a better position to focus its prudential responsibilities upon the different classes of firm which fell within its scope.

19. Will the new regulatory arrangements reduce the risk and cost of dealing with mis-selling of financial products?

We appreciate that the new product intervention approach is intended to deliver improved outcomes for consumers, which should both reduce the risk of mis-selling and the subsequent and associated costs but it is important to structure expectations along the lines suggested by the FSA; on occasions risks might be missed or equally over-interpreted. We would be keen to understand how the different levels of engagement with the supervision teams will be monitored to ensure consistent product intervention outcomes, which raises an issue of communication to ensure that all involved in the development, manufacture or distribution of a particular product or service are aware of the FCA's emerging and ongoing thinking. This is an important component of regulatory certainty for firms.

This also highlights the need for adequate intervention tools that in themselves do not become so protracted that they water down the value of timely intervention. This might involve the development of specific timelines for review (along the lines of a 'Super Complaint' under the Enterprise Act (2002)).

We would also make the point that unless product intervention is carefully controlled it creates a risk of detriment to consumers and can create unintended consequences that may be of detriment to consumers in the longer term. There is also a need for a clearer understanding of the relationship between forward-looking intervention and backward-looking redress.

20. Are the proposals for co-ordination between the PRA and FCA clear and adequate? What would be the advantages and disadvantages of having a Single Point of Contact and/or a joint rule book for dual-regulated firms?

We welcome the statutory obligation for the PRA and the FCA to coordinate, the specific statutory obligation on the two to work under an MOU and the provision for its maintenance and public accountability for its use. It is essential that the Treasury's commitment that the FCA will not be a 'junior partner' of PRA is borne out. Similar statutory obligations to coordinate should also be specified for the FCA and the Bank of England, given the latter's proposed responsibility for regulating market infrastructure providers. Consistent and coordinated decision-making between all three authorities, in

particular between the PRA and the FCA in relation to particular firms, will be essential, regardless of whether or not there is a single point of contact or single rule book. It is important to note that under the new EU regime the 'single rule book' will in any case be largely determined at EU level (see Q21 below).

21. How do the proposals in the draft Bill fit within the new European regulatory regime? What freedoms and constraints will the UK have to operate within that regime?

Under the new EU regime, the EU authorities, including the EBA and ESMA, will assume a greater competence for rule-making. This underlines the importance for the new UK structure to link up with the European authorities in an effective way.

Within this context, we note that the White Paper identifies the need for the forthcoming revision of the Capital Requirements Directive (CRD IV) to permit member states to exercise discretion in the use of macro-prudential tools. We support the European Commission's decision to require maximum harmonisation of the majority of the CRD IV requirements in the interests of promoting a safe and level playing field across the Single Market. That being said, we believe that the current iteration of the CRD IV text grants national authorities sufficient discretion to implement macro-prudential tools. We set out our understanding of this flexibility in the annex.

In terms of the FCA, the intention as set out in the FSA paper is for policy based on business and market analysis; the risk framework as a driver of resource allocation; continuity with existing market regulation; market failure and regulatory failure analysis; sensitivity to commercial impact; recognition of consumer responsibilities. We support this and would view it as essential in the new environment to imbue ESMA with these disciplines as well. Given the significance of wholesale markets to the proposed FCA objectives and UK and EU economic prosperity, the FSA's expertise in wholesale market regulation must be carried forward into ESMA. In particular, the FCA's objectives, policy and supervisory coordination needs to be consistent with ESMA's rule-making, and fully informed and influenced by appropriate differentiation between different markets and different types of 'consumer'.

22. Does the draft Bill contain any proposals or omissions, not covered by the questions above, which cause concern?

We would highlight the importance of the various MoUs and the insight that they provide into the way in which the authorities envisage the mechanics working within the statutory framework. Sight of these is needed in order for the scrutiny process to be as informed as possible.

We believe the statutory regime could be strengthened in respect of consumer redress and have prepared draft New Clauses which bring greater coherence to the regime, which we have included in our response to the White Paper.

If the FCA is to have a wider remit going forward, for example assuming responsibilities relating to the Consumer Credit Act or the Lending Standards Board, full consultation with all interested stakeholders must be facilitated and appropriate transitional allowances incorporated into planning for any resulting change.

Although the FCA approach document has set out what will be undertaken by the FCA to achieve its strategic and operational objectives, it does not include any detail of what will happen regarding the responsibility for consumer credit regulation if this is transferred from the OFT to the FCA. Where the regulation does transfer to FCA, we assume the FCA objectives and approach will apply to this area of business but the rules would need to be appropriate for the specific risks entailed by such business: care will be required given that considerations for CCA-regulated lending must be different to savings, insurance and mortgages.

A further issue for the Joint Committee to consider would be the basis upon which the consultation exemptions can be invoked, including those for temporary product intervention rules (Sections 138M and 138N). These arguably need to be tightened given their far reaching nature.

2 September 2011

Appendix 1: The banking reform programme

The stability of individual banks, and the system as a whole, has been improved radically by the reforms that have been agreed over the past two years and will be strengthened further by measures in hand. Taken together, these will ultimately place banks on a very different footing to where they stood pre-crisis. The measures predominantly include:

- **Core Tier 1 capital:** international agreement has been reached on the Basel III capital accord and is close to being made a statutory requirement in the European Union in the form of the Capital Requirements Directive IV. It requires Core Tier 1 capital to be raised to 7; the standard set by Basel II was 2% common equity supplemented by other capital which under stress provided only partial loss absorbance. As part of this, risk weights applied to instruments within the trading book have increased substantially. Notwithstanding losses, based on the definitions used by the Bank of England for its Financial Stability Report, Core Tier 1 capital held by UK banks has risen from £100bn in 2000 to £300bn at the end of last year.

- **Additional capital requirements:** it is accepted in Europe, but not necessarily in the United States, that there should be an additional countercyclical capital buffer up to 2.5% at the top of the cycle; discussion is advanced on a potential SIFI surcharge of up to 3%. The Basel Committee will release further proposals on the trading book this Autumn.

- **Further loss absorbency:** work is also being undertaken to ensure that subordinated debt is truly loss absorbing at the point of non-viability. Consideration is also being given to whether under 'bail-in' arrangements creditors should bear the cost of failure if the tools and powers available under resolution regimes are not sufficient to resolve a failed institution.

- **Leverage:** discussions are at an advanced stage in the Basel Committee on the introduction of formal leverage ratios; in the meantime leverage in UK banking has almost halved since the period directly before the financial crisis.

- **Liquidity:** the need for higher liquidity requirements was a key learning point of the crisis and the volume of instruments held for liquidity purposes has increased at least fivefold. This will be formalised in a new Liquidity Coverage Ratio to apply from 1 January 2015.

- **Funding:** discussions are at an advanced stage in the Basel Committee on the introduction of ratios limiting the reliance that banks and other financial institutions can place on short-term wholesale funding. This will restore the relationship between deposit-taking and lending. While further work needs to be undertaken e.g. on the underlying accounting rules a new 'Net Stable Funding Ratio' will apply from 1 January 2018.

- **Taxation:** the annual £2.5bn UK banking levy – which is at the top end of levies introduced within the EU and elsewhere – taxes short term funding at a higher rate than long-term funding and so adds to the incentive to rely less on short-term wholesale funding.

- **Infrastructure:** changes are being made to require OTC derivatives to be cleared through central counterparties supported by higher collateral arrangements in effect building stronger firewalls into the financial system; payment and settlement systems overall are also to be more closely supervised.

- **Recovery & resolution:** the Banking Act 2009 established a Special Resolution Regime in order to provide the authorities with a legal framework and range of tools to resolve a failing institution in a manner which minimises the impact on financial stability, protects depositors and protects public funds; attention has since turned to individual institutions preparing Recovery & Resolution Plans intended to strengthen their contingency planning and to underpin the resolution regime.

- **Depositor protection:** in addition to deposit insurance limits rising from 90% coverage of £33,000 to 100% of £85,000 under the FSCS scheme funded by financial institutions, UK banks lead the field in the establishment of a 'single customer view' designed to facilitate the continuity of essential banking services in the event of failure and 7 day payout as a backstop.

- **Customer confidence:** UK banks are seeking to overcome the loss of trust and confidence in which they are held and as part of this have committed to making available lending capacity and under the Business Finance Taskforce skills and resources to assist SMEs access finance.

- **Banking supervision:** the FSA signalled an end to 'light touch regulation' as part of its post-Northern Rock analysis and has since embarked upon a substantial shift in its approach to banking supervision – a process that will be continued by the new Prudential Regulation Authority.

- **Accounting:** the International Accounting Standards Board and the US Financial Accounting Standards Board are working together on a convergence programme aimed strengthening the key accounting standards that apply to banks and other financial institutions; this work will largely be completed by the end of the year. Key changes

include simplified measurement and classification aimed at making a clearer distinction between traditional banking and trading activity and the introduction of expected loss provisioning.

- **Corporate governance:** the Walker Review into the corporate governance of British-owned financial institutions made 38 recommendations spanning the size, composition, qualification, functioning and performance evaluation of boards of directors, the role of institutional investors, risk governance and remuneration. Many of these recommendations have fed into the Financial Reporting Council's Corporate Governance Code; others have been acted upon by the FSA and banks themselves.

- **Macro-prudential supervision:** as part of the changes in the UK regulatory arrangements the Bank of England has established its Financial Policy Committee on a shadow basis and this will start work on overseeing financial stability and macroeconomic risk within the financial system. The FPC for instance will be responsible for assessing whether counter-cyclical capital weights need to be applied to particular asset classes as we work through the economic cycle.

While there are instances where the UK authorities have adopted a leadership position on reform – notably in signalling a changed approach to banking supervision, front-running liquidity requirements and putting in place the statutory framework needed for the resolution regime – they have largely worked through international bodies such as the Financial Stability Board and the Basel Committee to reach agreement to reform measures on a global basis. This is important given the global nature of financial services and the fact that some of the seeds of the financial crisis can be said to have lain in key regulatory differences between different jurisdictions.

A global approach reduces the prospect of regulatory arbitrage, thereby strengthening financial stability and, importantly, ensures a level playing field. This gives the market confidence in reforms being capable of implementation without damaging international competitiveness. It also reduces complexity since it provides a global regulatory framework that has a good level of coherence and common understanding.

The Basel Committee is currently undertaking a comprehensive cost/benefit analysis to understand better the impact of these changes overall on banks including their lending capacity. It will clearly be important for the UK authorities to adopt a similar approach in assessing the form of any potential supplementary measures.

Appendix 2: Macro-prudential tools

The table below summarises the strengths and weaknesses of a number of possible macro-prudential tools. It draws on the experience of our members who have encountered a number of these tools during their operation in some of the Asian markets.

Tool	**Strengths**	**Weaknesses**
Counter-cyclical capital buffers	• Can reduce overall lending • Build a cushion that can be drawn down during a	• To reduce overall lending, banks may choose to lend less to socially beneficial areas, and maintain lending

	downturn in the economic cycle • Basel III envisages reciprocity agreements to deal with concerns of cross-border leakage	to lucrative but risky sectors • Buffer can be undermined by additional capital raising by banks, arbitrage and cross-border lending and lending by non-banks • Too blunt an instrument, may stunt growth • Drag on banks' return on equity (ROE), which may encourage risky behaviour to maintain ROE
Ante-cyclical asset class-specific capital adjustment, through systemic changes to risk weightings	• Build buffers against losses on risky loans • More targeted than system-wide measures, thus likely to be more effective • Can be implemented by asset class-specific adjustment of the Basel II scaling factor	• Difficulties of categorising 'risky' sectors • Does not address lending to specific sectors by non-banks
Expected loss provisioning	• Builds cushion that can be drawn down during a downturn in the economic cycle • Creates perception of systemic prudence	• Future losses are hard to estimate, could lead to inefficient allocation of banks' capital • Potentially misleading if badly estimated and may encourage moral hazard assuming there is protective cushion for the downside
Dynamic provisioning	• Looks further forward than expected loss provisioning, i.e. through the cycle	• Distorts financial statements as it applies to business not yet on the balance sheet • Does not reflect the remaining life of assets on the balance sheet
Variable liquidity ratios	• Reduce overall lending • Mean that cash and other liquid assets are available when a crisis hits	• Inefficient use of liquid assets that could be used more productively • Very costly for banks, thus could have negative impact on the financial system and the economy • May encourage risk-seeking behaviour by banks to maintain ROE • Liquidity metrics for micro-prudential regulation will not be properly calibrated for some time
Reserve requirements	• Reduce total volume of lending by requiring banks to hold more deposits at the central bank • Easy to implement	• Not effective when banks have other sources of funds than deposits, or if reserves are already high • Not the most efficient use of finance • Reduce overall lending but not necessarily risky lending
Haircuts on repo agreements & margin requirements on equities or other instruments	• Could reduce the pro-cyclicality of margin requirements • Can target provision of liquidity from the shadow banking sector	• Difficult to implement • Easy to circumvent • Can indirectly constrain leverage by increasing the cost of capital
Limits on	• Limit default if local currency	• Prevent access to potentially cheaper

currency mismatches	suddenly fluctuates	finance thus preventing financial development and efficiency
Loan quotas	• Redirects overall lending	• Require tight regulatory oversight • Difficult to enforce, especially in a market with too many credit providers or sophisticated credit markets • Distortion of the lending process
Loan-to-value (LTV) caps	• Reduce lending to risky sectors thus preventing the build-up of systemic risk • Limit speculation as speculators need more equity and face lower returns • May limit the risk of property bubbles • Intervention s targeted; thus quite effective and with limited side-effects • Easy to implement and tweak according to developments in the market without losing credibility	• Difficult to implement in a financial system with large shadow banking sector, non-bank credit providers, or deep credit markets • Can be circumvented by borrowers topping up their mortgages with other personal loans • Potential for policy errors • May be perceived as discriminating against less wealthy people so polemically challenging • Less relevant for private banking but disrupts their activities
Debt-to-income (DTI) caps	• Only qualified borrowers get access to credit • Less reliance on asset collateral	• Can be pro-cyclical, as personal income correlates with economic cycle • May not prevent defaults in downturn for borrowers who suddenly find themselves out of a job
Property taxes	• Increase holding cost of property or transaction costs, thus limiting demand	• May discourage home ownership for less privileged
Prohibitions on risky products (e.g. , multiple mortgages by the same person)	• Direct limit on leverage	• Can be circumvented by taking out loans in different buyers' names • Interventionist, may encourage corruption
Caps on a single counterparty or asset-class exposure	• Direct limit on risk exposure • Limit on concentration risk	• Could be seen as a form of directed lending • Inefficient allocation of resources in case of policy error

British Private Equity and Venture Capital Association (BVCA); Association of Private Client Investment Managers; Association for Financial Markets in Europe (AFME); Investment Management Association and National Association of Pension Funds – oral evidence (QQ 351-437)

Transcript to be found under AFME

British Insurance Brokers' Association (BIBA) – written evidence

The British Insurance Brokers' Association (BIBA) is the UK's leading general insurance organisation representing the interests of insurance brokers, intermediaries and their customers.

BIBA membership includes 1,700 regulated firms. BIBA brokers handle around half the value of all UK home, contents, motor, travel, commercial and industrial insurance policies. Insurance brokers make a direct and indirect contribution of 1% to UK GDP.

The UK insurance industry employs more than 275,000 people, generates more than £1.5 billion of insurance premium tax and £2 billion of corporation tax.Brokers provide professional advice to businesses and individuals, playing a key role in the identification, measurement, management, control and transfer of risk. They negotiate appropriate insurance protection tailored to individual needs. BIBA is the voice of the industry advising members, the regulators, consumer bodies and other stakeholders on key insurance issues. BIBA provides unique schemes and facilities, technical advice, guidance on regulation and business support and is helping to raise, and maintain, industry standards.

Our views

BIBA has previously responded to HM Treasury that the FSA regime was inappropriate, disproportionate and overly costly in the manner in which it regulated insurance brokers. We are therefore keen to see the legislation give the new FCA greater flexibility in being able to more appropriately and proportionately regulate and supervise our sector and to take into account the variety and style of firms therein.

One of our major criticisms of FSA in recent times is their devising supervisory solutions in one sector (most notably in banking) and then applying these across other sectors, hence our comments on inappropriateness. The legislation should seek to limit this.

The cost of FSA regulation is hugely out of line in the UK – research previously given to HM Treasury shows the direct and indirect regulatory cost burden of UK insurance intermediaries to be three times higher than the second dearest in the EU.

BIBA is concerned that there is a danger than the FCA will become too consumer-friendly – the legislation needs careful drafting to ensure an appropriate balance is struck.

Finally, BIBA and our members fully support the concept of appropriate and proportionate regulation and we hope that the new FCA will work with the sector to identify risks and agree solutions and we hope the legislation will cater for this approach.

September 2011

The Building Societies Association (BSA) – written evidence

Introduction

1. The Building Societies Association (BSA) represents mutual lenders and deposit takers in the UK including all 48 UK building societies. Mutual lenders and deposit takers have total assets of over £365 billion and, together with their subsidiaries, hold residential mortgages of almost £235 billion, 19% of the total outstanding in the UK. They hold more than £245 billion of retail deposits, accounting for 22% of all such deposits in the UK. Mutual deposit takers account for about 35% of cash ISA balances. They employ approximately 50,000 full and part-time staff and operate through approximately 2,000 branches.

2. The BSA welcomes the opportunity to respond to the Joint Committee's call for evidence on the draft Financial Services Bill. We have made a few initial comments and then responded to most of the specific questions. We have included some technical material in appendices, hence the fact that the response is slightly over six sides.

General Questions

3. In addition to the detailed questions the Joint Committee is interested in whether the draft legislation will or could better –

- prevent another financial crisis,
- handle a financial crisis,
- deal with bank failure and protect the public purse.

While the measures in the Bill are important, they deal primarily with the regulatory architecture, and form only a small part of the overall package of post-crisis measures variously described as "regulatory repair" or "banking reform". They therefore need to be seen in the context, in particular, of (i) global toughening of capital and liquidity regimes, being introduced in the EU (including the UK) by the Capital Requirements Regulation ; (ii) an effective bank resolution regime, already introduced in the UK by the Banking Act 2009 ; and (iii) any structural measures to address the problem of major retail banks considered too big to fail, which may be proposed by the Independent Commission on Banking.

4. Having said that, the BSA is generally optimistic about the proposals, which appear to have taken on board lessons from the past. We have certain outstanding concerns -

- costs of the migration to a twin peaks model, especially those related to regulatory IT systems – the latest impact assessment revises the 'best estimate' of total costs from £400million to *£770million*
- continuing uncertainties about regulatory accountability, with the possibility of an 'all powerful' Bank of England emerging through the new architecture

- the need for careful planning to ensure that smaller firms are not disproportionately affected by regulatory burdens
- the importance of UK agencies consulting first, before adopting negotiating strategies with EU and international bodies that maximise the benefits to UK firms and financial stability.
- clarification of the proposed ‘product intervention’ powers
- concerns about the complexities of dismantling the Consumer Credit Act and porting it into the FSA/FCA Handbook – if the FCA is to assume responsibility, the BSA strongly believes that there should be a ‘lift and shift’ approach that minimises disruption for firms and consumers
- continuing concerns about certain aspects of the proposals regarding pre-publication of warning notices.

Specific Questions

1. Is the separation of prudential and conduct regulation into a "twin peaks" system the right approach?

5. Whichever regulatory system is employed, whether single regulator or ‘twin peaks’, it is unlikely to be successful unless the regulator has a properly focused objective and diligent, able staff at all levels who concentrate on the job in hand.

6. The new system, under which each regulator has essentially one key objective, should considerably assist regulatory focus and accountability. However, the move to ‘twin peaks’ regulation risks the abandonment of mechanisms that already work effectively and we believe it important that the good aspects of the FSA (especially flowing from its post-2007 supervisory enhancement programme) should be retained where practicable to do so. There is also the risk of separate functions developing that cause unnecessary duplication, complexity or confusion, especially for ‘dual’-regulated firms (ie those regulated by the PRA ***and*** the FPC).

7. The BSA acknowledges that regulatory restructuring will inevitably entail costs. Those costs should be reasonable and proportionate, especially in view of the fact that the financial services industry has already borne the costs of the FSA’s supervisory enhancement programme, that it faces certain other high costs (eg regarding the FSCS), and that it is operating in a market hit by recession .

8. Future IT expenditure is a particularly serious concern. Paragraph 41 of the latest impact assessment (page 404 of the White Paper) revises the upper limit for transitional costs for dual-regulated firms under the preferred option from £50/60million to £100million. In addition, the best estimate for total cost is raised from £400million to £770million. While we recognise that these items are estimated, and also welcome the confirmation in paragraph 33 that the FCA’s and PRA’s combined ongoing running costs “should not be materially different (in real terms) in aggregate from the current FSA budget of about £500

million", there appear to some worrying signs of significantly increasing costs; for example, recent impact assessments have stated that "The Bank is also clear that in order to contain costs in the long run it would not wish to share in the existing IT systems at the FSA, which have relatively high running costs. So in order to reach a position in which it can both ensure integration and exercise a proper control over future costs, the Bank will need to invest in the transition". Certain questions consequently arise –

- why is the Bank entirely convinced that it needs new, separate systems?
- if so, what measures will be put in place to ensure that their new systems are both fit for purpose and cost effective, and do not repeat past mistakes?
- how have we reached a situation where the FSA's IT infrastructure (after very substantial investment already paid for by FSA-authorised firms) has "relatively high running costs" and is deemed unsuitable for use by the PRA? What went wrong, and who is to be accountable ?
- in view of the fact that the FCA (as well as the PRA) needs considerable further IT investment what measures will be put in place to ensure that, going forward, the new systems are both fit for purpose and cost effective?

2. What lessons can be learnt from the approach of other countries to regulation of the financial sector?

9. The sector that the BSA represents operates almost entirely within the UK, so we have no comments on this point.

3. Is it appropriate to make such major changes to the regulatory system by way of amending legislation, rather than starting afresh?

10. Ideally, a fresh piece of legislation would be preferable, but we believe that, although it is by no means a straightforward exercise, the Financial Services and Markets Act should be able to bear the weight of the substantial amendments that are planned.

4. Are the accountability and governance arrangements for the Bank of England, FPC, PRA and FCA satisfactory?

11. We note that the Government continues to consider the important question of improving the Bank of England's accountability, in the light of the very substantial concentration of power and responsibility within the Bank group – a concern that the BSA shares. We therefore look forward to the further specific proposals on the Bank's governance that are promised in paragraph 2.30 of the White Paper. The BSA also notes the development of the concept of the FPC as now set out in the White Paper, and that the Government continues to gather views on the issue of the balance between Bank and external members on the FPC (paragraph 2.18).

12. We greatly welcome the Government's sensible decision not to limit the scope of appeal to the Upper Tribunal, as stated at paragraphs 2.64 – 2.67 of the White Paper. We also welcome the confirmation that the NAO will be able to conduct value for money studies of the PRA. This is all the more important in view of the already spiralling costs of

the PRA resulting from the Bank's determination not to make do with the FSA's existing IT systems.

13. The BSA broadly supports the proposals, referred to in paragraphs 2.124 – 2.129 of the White Paper, dealing with the governance and accountability of the FCA, including FCA Board arrangements, retention of the practitioner and consumer panels, maintenance of the arrangements for the investigation of complaints, freedom of information provisions and reporting to HM Treasury. However, there is a detail in the consultation requirements for the PRA and FCA in the Bill that has not come out right (please see Appendix 1).

5. Are the FPC's objectives the right ones? Is the concept of financial stability adequately understood for the FPC to be able to perform against its objectives?

14. We support the qualification of the FPC's financial stability objective and activities by reference to UK economic growth, as drafted in new section 9C. We welcome the setting up of the Interim FPC and its analysis of potential macro-prudential tools, leading to recommendations for the permanent FPC toolkit. We have suggested in responses to recent consultations that such analysis should include thorough back-testing using appropriate modelling. This should identify (within the limitations of any models) which tools, if used in known circumstances in the present or recent past, would have produced which outcomes. Such a process could be invaluable to help make wise use of these regulatory tools in future. In view of the stringent stress testing requirements now placed on firms (eg in respect of capital and liquidity), it would seem very odd if regulatory tools were not similarly subject to stringent testing.

6. Should the FPC be limited in the actions it can take which might affect the growth of the financial sector?

15. We assume that the FPC will be subject to general public administrative law, preventing arbitrary or disproportionate action. Otherwise, see reply to question 5.

7. How will the interaction between macro-prudential and monetary policies be handled by the FPC and the MPC?

16. Some of our comments in response to questions 4 and 5 are material to this question.

8. Has the right balance been struck between the powers of the FPC and the powers of the Treasury?

17. Some of our comments in response to questions 4 and 5 are material to this question. We also raise a further specific point below regarding the complementary responsibilities of the various authorities.

18. We have previously observed - in the context of the Special Resolution Regime and its Code of Practice – that it is not only public funds (taxpayers' money) that need to be protected. Funds held in the FSCS, or capable of being levied by the FSCS on banks and building societies, are not a "free good". They can be used either to finance a bank resolution or to pay deposit compensation directly. Where used for bank resolution, choices made as to which SRR tools are used, and at what stage early interventions are or are not made, could affect the ultimate cost via the FSCS to banks and building societies. In this context, we very much welcome the recognition (on behalf of the future PRA) at paragraph 9 of the Bank of England / FSA paper of 19 May "Our approach to banking

supervision" that deposit guarantee arrangements operated by the FSCS play an important part in reducing the impact of firm failure, and that surviving firms themselves will have to bear the cost of FSCS payouts. We therefore argue that such recognition should be given greater practical effect through the Bill, as follows.

19 Just as the Chancellor rightly protects the taxpayer interest, we argue that one of the authorities – perhaps the Bank – should also be tasked with minimising the recourse to the FSCS (whether as a resolution fund or as a compensation fund). Money drawn from the FSCS ultimately constitutes a "tax" on building societies, banks and their customers. And on the principle of no taxation without representation, it is also time to upgrade the formal role that deposit-takers have in overseeing the conduct of any SRR interventions that use FSCS money. The FSCS should be made accountable to a creditors' committee in respect of any interventions along the lines of Bradford & Bingley and the Icelandic banks.

9. Can Parliament take an informed decision about the proposals for the FPC without details of the macro-prudential tools at its disposal?

20. In our response to the February consultation, we said that the proposed MoU was a sensible idea, but that it should be subject to full consultation, and overlap with the existing SRR Code of Practice should be addressed. We welcome the undertaking to publish the draft MoU during pre-legislative scrutiny. The Memorandum will rightly focus *inter alia* on questions about the risk to, and possible use of, public funds. The draft MoU, together with the analysis of the macroprudential toolkit promised by the interim FPC, should inform Parliament adequately if made available in good time.

10. Does the draft Bill adequately deal with the risks posed by the shadow banking system?

21. We have no comments on this point.

11. Are the PRA's objectives clear and appropriate?

22. Yes, we agree with the Government that the proposed scope of the PRA does not need further change, and that the boundary of systemically important investment firms that PRA will regulate can be based on designation criteria developed by PRA , rather than stated in the Bill itself. While the Proactive Intervention Framework described in more detail in the 19 May paper continues to be a sensible system and guide to fair and consistent intervention activity, we do share the concerns summarised at paragraph 2.63 of the White Paper that any attendant publicity could reinforce a downward spiral. The PRA needs to be clear – in practice, rather than in theory – how this risk will be averted. Otherwise the remedy will be worse than the problem.

12. Are there any risks in the Government's proposed 'judgement-based' regulation?

23. We agree that there should be baseline supervision of all deposit-takers, but – more importantly- that the intensity of supervisory engagement should relate to the degree of systemic stability risk posed by firm (overview in the White Paper, paragraph 12 and page 11). However, the BSA is concerned at the proposals for disclosure of supervisory returns (Box 3, page 11) and it is particularly appropriate that we remark on this in the context of the Bill (see Appendix 2). In summary, there are some risks, but the prospect of a regulatory system better tailored to genuine instances of systemic risk, rather than across

the board box-ticking, makes this worth a try. The accountability mechanisms also provide safeguards.

13. Is the Government's proposed approach to 'orderly' firm failure satisfactory?

24. We strongly support the focus of supervisors on the "big picture", with a high materiality threshold, early intervention to reduce the risk of disorderly failure, and the involvement of senior people at PRA.

14. Given that the PRA and the FCA will inherit FSA staff does the draft Bill do enough to ensure a new regulatory culture and a more proactive approach to regulation? Will these two new bodies have staff with the appropriate skill and expertise?

25. Since its regulatory enhancement programme, the FSA has become a much more effective regulator. We believe that it is appropriate to consider these questions in the context of the FSA in 2011, rather than the pre-2008 FSA and we are working constructively with FSA colleagues to assist in this process. In that light, we are optimistic that the PRA and the FCA will be able to hit the ground running from early 2013. The UK economy, businesses and consumers badly need strong, consistent, proportionate and fair regulation of the financial services industry. While naturally the new regulators will be keen to make their own mark as new organisations, we believe it imperative that they build on the many positive developments of the preceding three or four years, rather than seek to revisit the fundamentals of prudential and conduct of business regulation – this is particularly important for the FCA because conduct of business regulation is not – yet - dictated by Europe to the same extent as prudential regulation.

15. Are the FCA's primary objectives appropriate? Is significant emphasis given to the promotion of competition?

26. We support the FCA's single strategic objective, ie protecting and enhancing confidence in the UK financial system, underpinned by the specified operational objectives and the regulatory principles concerning efficiency and economy, proportionality, consumer responsibility, transparency etc. It is very important that these principles are fully adhered to in practice. We support the conclusion in the White Paper (paragraph 2.115) that the FCA should have power to initiate an advanced referral to the competition authority, but should not become a competition regulator – such activity should be left to the relevant competition authorities.

16. Are the responsibilities of the FCA towards the regulation of markets appropriate?

27. The BSA is relatively inexperienced in wholesale market matters. We agree, in principle with the decisions to retain the listing function as part of the FCA and to retain the Part 18 FSMA regime for recognised investment exchanges, but we defer to more experienced commentators in respect of technical details.

17. Does the draft Bill strike the right balance between the responsibilities of consumers and firms? Are the FCA's new powers in the area of consumer protection appropriate?

28. Broadly speaking, we are content on these matters. Undoubtedly there have been serious episodes of poor conduct of business by some firms, which the FSA failed to address

properly and we welcome stronger regulation in this area. We note and welcome the change of name from CPMA to FCA and the clarification (in Building a Stronger System) about the FCA's consumer champion role and, in particular, the confirmation that the FCA will be an entirely impartial regulator from whom firms and consumers can expect fair treatment. In the light of the assurances in the last CP, we presumed there would be no objection to including a requirement in the forthcoming Bill on the FCA to be a fair and impartial regulator. It is disappointing that such an explicit clarification is not included in the Bill and, whilst the Government's assurances are welcome, an explicit statutory provision would put the matter beyond doubt.

18. Are the prudential regulatory responsibilities of the FCA towards FCA-only regulated firms given sufficient emphasis and detail?

29. All BSA members will be 'dual'-regulated by the PRA and the FCA, so it is not appropriate for us to comment.

19. Will the new regulatory arrangements reduce the risk and cost of dealing with miss-selling of financial products?

30. The BSA supports the FSA's aim to "intervene earlier in the product chain if necessary, to anticipate consumer detriment and choke it off before it occurs". Appropriately focussed early intervention would benefit consumers and firms by reducing the risk of large scale product failures which damage the reputation of the financial service industry, harm consumer confidence and cost the industry large amounts in redress. In practice, the right balance will need to be struck between the greater use of regulatory powers to prevent consumer harm and allowing firms the freedom to develop innovative products and services. Therefore, we welcome the recognition, in paragraph 2.98 of the White Paper, that the use of the power must be appropriately safeguarded. There are a number of outstanding practical questions in this area that require continued examination and discussion. We are working closely with the relevant FSA conduct of business teams to help the success of this work.

20. Are the proposals for co-ordination between the PRA and FCA clear and adequate? What would be the advantages and disadvantages of having a Single Point of Contact and/or a joint rule book for dual-regulated firms?

31. While fully accepting that each new regulator will need to conduct their activities using methods that they regard as effective, we have already noted that the move to 'twin peaks' regulation risks the abandonment of mechanisms that already work and the risk of separate functions developing that cause unnecessary duplication, complexity or confusion, especially for dual-regulated firms (ie those regulated by the PRA and the FPC). In practice, the risks could be reduced by the retention of –

- a common gateway for dual-regulated firms in respect of authorisations, approvals, variations, waivers, notifications etc

- the integrated regulated reporting system (GABRIEL)

- a single regulatory handbook.

The sharing of back office functions by the PRA and the FCA (eg IT systems), wherever practicable, would also be desirable – these should flow readily from the transitional regulatory structure.

32. We particularly note the confirmation in the White Paper that "Industry representatives were almost unanimous in their view that there should be some form of 'single point of contact' or 'shared services' for regulatory processes" and are encouraged by the Government's decision to incorporate arrangements for a single gateway into the draft bill.

33. The White Paper acknowledges the point about integrated reporting systems (paragraph 2.134), but states that the Government will leave operational specifics to the regulators, rather than the Bill. The BSA recognises that there has to be a limit to the practical arrangements that may suitably be included in legislative provisions. Therefore, it is particularly important that the new regulators coordinate in order to ensure that mechanisms that work well, and could apply equally to a twin peaks system as to a single regulator arrangement, are retained. The PRA paper states that consideration will be given to common standards and rules for risks that are directly relevant to both regulators and the White Paper confirms that the Bank and the FSA will publish a paper on operational coordination. Again, this is helpful.

34. The White Paper states that shared services are not prevented by the legislation (paragraph 2.135) and we hope that, having regard to their statutory obligations regarding coordination and efficiency, the new regulators will go as far as is reasonably practicable in sharing back office arrangements.

21. How do the proposals in the draft Bill fit within the new European regulatory regime? What freedoms and constraints will the UK have to operate within that regime?

35. While we welcome the retention of full consultation on PRA rule-making generally, the insistence on full scale CBA for rules based on EU Directives at the point of implementation seems to us a victory of form over substance. It needs to be recognised that much, perhaps most, micro-prudential policy (eg on capital and liquidity) is now settled at EU level with the UK having less and less room for independent manoeuvre[46]. So - in future - it will be even more important to have advance consultation (with CBA) on the agreed outcomes that the UK should seek from current and future EU regulatory initiatives, which will then inform the UK negotiating strategy. Informal soundings are simply not robust enough.

22. Does the draft Bill contain any proposals or omissions, not covered by the questions above, which cause concern?

36. In our view, there are certain omissions – see our replies to certain of the above questions and the appendices to this response. The BSA welcomes the minor amendments to the building societies' legislation, flagged in paragraph 2.167 of the White Paper. We

[46] The proposal for the Capital Requirements Regulation covering capital and liquidity, and published on 20 July, illustrate this point: the Regulation will be directly effective and so will not require implementation via FSA or PRA rules (nor permit gold plating) – thereby bypassing the consultation stage the Government is so keen to preserve.

understand that, although the relevant provisions are not yet in the draft bill, they will be included in due course.

Appendix 1

Under existing FSMA, FSA must publish what is generally called a "compatibility statement" in accordance with present section 155 (2) (c) explaining why it believes making the rules is compatible with its general duties under section 2. Those duties are not only to act in a way that furthers the FSA's objectives, but- critically - also to have regard to the "principles of good regulation" in section 2 (3).

The equivalent requirements on PRA / FCA express the requirement to publish a compatibility statement differently. For the PRA, new section 138K (2)(d) simply calls for " an explanation of the PRA's reasons for believing that making the proposed rules is compatible with section 2B (1) ". New Section 2B (1) refers only to the PRA's single general objective. The duty to have regard to regulatory principles is found later, only in new section 2G. The effect is that the compatibility statement does not cover an explanation of how making the rules has had regard to the regulatory principles.
A similar position arises in relation to the FCA under new section 138J (2) (d) and new section 1B (1). So, the scope of the compatibility statement is narrowed and the transparency and accountability of the new regulators' observance of the regulatory principles is undermined from the start. The drafting needs to be amended. We also observe in passing that in the consolidated version of FSMA the references to the FCA's and PRA's objectives in new sections 138 J and K have ended up the wrong way round.)

Appendix 2

FSMA (section 348) prohibits the disclosure of supervisory information, and this in turn reflects superior European law – the confidentiality obligations in the current banking directives. We do not see how these would permit the PRA to "publish returns", nor-incidentally – can we identify any amendments made by the Bill to section 348 that would purport to permit such publication. The correct place for such disclosures in any case is in the Pillar 3 framework – this should not be muddled up with the completely separate channel of confidential returns to the supervisor. We consider that this sets a dangerous precedent, which PRA will in due course regret.

We turn also to the question of the use of third party reporting to for instance verify regulatory returns (mentioned at paragraph 70). The FSA has already begun to increase the scope and extent of the use of section 166 of FSMA to demand such reports. Our members are concerned that this is proving an extremely costly habit, and are even more concerned that the habit may grow in the future.

The effect of using section 166 at present is to outsource significant regulatory costs from the FSA itself (as the firm has to pay for the report), and thus - in effect - conceal them. We argue that the total burden of regulatory costs can neither be controlled or scrutinised while this back-door route is used. We suggest one of the following routes to achieve better cost control and accountability in the use of section 166 –

(i) routine section 166 reports should in future be paid for by the PRA – so the costs will come within its budget/outturn, and be scrutinised there (arrangements could be made for the costs of non-routine section 166 reports to be recovered from firms where related enforcement action follows within a stated period); or

(ii) the external cost of any section 166 report demanded from a firm in one financial year should be offset against the PRA regulatory fees otherwise payable by that firm for the following financial year – again, perhaps with a saving where relevant enforcement action is in train.

September 2011

The Building Societies Association (BSA); Association of British Credit Unions Limited (ABCUL); Association of Financial Mutuals; Association of Independent Financial Advisers; Institute of Financial Planning; International Regulatory Strategy Group; Financial Services Practitioner Panel; FSA Smaller Businesses Practitioner Panel; Financial Services Consumer Panel and Office of the Complaints Commissioner – oral evidence (QQ 438-557)

Transcript to be found at Association of British Credit Unions Limited

Lord Burns; Charles Dumas, Lombard Street Research Ltd and Gillian Tett, Financial Times – oral evidence (QQ 1-63)

Transcript to be found under Gillian Tett

Campaign for Community Banking Services – written evidence

From our discussions and correspondence you are aware of the problems caused to local communities by the banks' closure of neighbourhood branches, particularly when it is the only (remaining) bank in a rural or less well-off urban community. Concern has resumed as the banks, given their perception that government is not interested in the issue, are escalating closures again as the attached chart reveals: 2011 is expected to exceed 2010 when the final numbers are in.

Noting the government's decision to leave this to the ICB, you will recall Mark Hoban's letter of 19 May to you (attached) on my behalf, and the Treasury Committee's specific recommendation in April that the ICB should consider inter-bank agency agreements and shared branches, my Steering Group was astonished that the ICB chose not to make any recommendations at all in the area of branch access. By then the cut-off date for submissions to your Committee had passed and, instead, we made representations to the Treasury Committee whose recommendation was effectively disregarded by the ICB.

If the government (you have a copy of my letter to Mark Hoban 14 September) do not pursue this important omission in its formal response to the ICB and if the Treasury Committee do not take it up in their Inquiry into the ICB Final Report, then protection of vulnerable communities against bank loss – and all the knock-on community sustainability disadvantages that result – will almost certainly not be re-visited in this Parliament by when it will be too late.

Talking to some Steering Group members in advance of our meeting next week, it appears that some representations may have been made so, in the hope that it is not too late, I want to at least bring the present situation to your notice.

In essence we are saying that the UK regulator, the FCA, should have some powers regarding the social responsibility of those banks exceeding certain levels of market share in a manner similar to those of utility suppliers, Royal Mail and British Telecom. In the US regulators, under the Community Reinvestment Act, have to evaluate each institution's record in meeting the needs of low and moderate income neighbourhoods which includes a 'service test' which examines the delivery of retail banking services to communities and neighbourhoods: the record becomes a factor in the authorities' decisions on mergers and take-overs, for example, and compliance is taken very seriously by US banks.

We understand that HMT did some preparatory work on this prior to the Election and in the public meetings held by the ICB the main 'big idea' to come out of the process was the suggestion that banks should be regulated like telecoms and broadcasters, being forced to provide some form of public service if the market shares were allowed to exceed certain levels. Regrettably this very public show of enthusiasm by the Commissioners, which I personally witnessed at the London meeting but was reported as having featured equally strongly at others, disappeared by the time the ICB went to print.

Peter, I hope you will forgive me for bringing this aspect to your attention so late in the day but my Steering Group, representing national organisations, are very concerned that the issue has not received the attention it deserves from the ICB which it could reasonably have

expected to lead to some form of regulatory enforcement of a community service obligation. From talking to the main banks, at executive level, this week it is apparent that without some form of government intervention they will continue to close branches in vulnerable communities at a steady rate, despite there being a cost effective alternative in the form of neutral shared branching, successfully operated throughout the US, available.

19 October 2011

Cazenonve Capital Management, Brewin Dolphin and Rathbone Brothers – written evidence

Evidence to be found under Brewin Dolphin

The Chartered Financial Analyst Society of the United Kingdom (CFA UK) – written evidence

The Chartered Financial Analyst Society of the United Kingdom (CFA UK) welcomes the opportunity to respond to the Joint Committee on the draft Financial Services Bill – call for evidence.

About CFA UK and CFA Institute

The society represents investment professionals in the UK, most of whom work as front office investment professionals (managing portfolios, researching securities and advising on asset management). This response has been prepared by CFA UK's Professional Standards and Market Practices Committee. The society has not surveyed members in relation to this consultation.

The CFA Society of the UK (CFA UK) represents the interests of more than 9,000 leading members of the UK investment profession. The society, which was founded in 1955, is one of the largest member societies of CFA Institute and is committed to leading the development of the investment profession through the promotion of the highest ethical standards and through the provision of continuing education, advocacy, information and career support on behalf of its members. Most CFA UK members have earned the Chartered Financial Analyst® (CFA®) designation, or are candidates registered in CFA Institute's CFA Program. Both members and candidates attest to adhere to CFA Institute's Code of Ethics and Standards of Professional Conduct.

CFA Institute is the global association for investment professionals. It administers the CFA and CIPM curriculum and exam programs worldwide; publishes research; conducts professional development programs; and sets voluntary, ethics-based professional and performance-reporting standards for the investment industry. CFA Institute has more than 100,000 members in 140 countries, of whom more than 90,000 hold the Chartered Financial Analyst (CFA) designation.

Response to the call for evidence

Rationale, observations and context for our evidence

"I made a mistake in presuming that the self-interests of organizations, specifically banks and others….were best capable of protecting their own shareholders and their equity in the firms…….. you know, that's precisely the reason I was shocked, because I have been going for 40 years or more with very considerable evidence that it (free market theory) was working exceptionally well." Alan Greenspan.

CFA UK is of the view that the recent crisis and those before it were caused by financial amnesia and ineffective regulation. The FSA[47] continues to address the crisis in conduct and regulatory failures which occurred during the pre and post-crisis period - events which have

[47] FSA refers two banks to enforcement over high risk consumers
http://www.moneymarketing.co.uk/regulation/fsa-refers-two-banks-to-enforcement-over-high-risk-customers/1033258.article
Arch cru package does not hide FSA failings
http://www.moneymarketing.co.uk/investments/arch-cru-package-does-not-hide-fsa-failings/1035215.article

been less widely reported but still highlight the extent to which market integrity has been compromised. We remain concerned that the new framework is fighting the last war, that it is overly focused on bank failure and that it will be ill-equipped to deal with the next crisis in the UK financial services industry.

Financial amnesia

Financial amnesia is when financial market participants forget or behave as if they have forgotten the lessons from financial history. Financial market participants are composed of two main groups, regulated financial firms and regulators. Despite the history of bitter experience, the same mistakes occur with alarming regularity (see Appendix 1). The three key lessons that participants appear to forget are:

Lesson 1: "Innovation", the illusion of safety and "this time it's different": "The world of finance hails the invention of the wheel over and over again, often in a slightly more unstable version" (Galbraith).The expansion of credit plays a key role in fuelling "innovation" while the creation of an illusion of safety results in a "this time it's different" approach that enables the continuation of unsustainable activity and risk taking. Sadly, each time it is always the same and never different.

Lesson 2: Regulated financial firms are prone to failure: It has been presumed that regulated financial firms by acting in their own self interest and in the interests of their shareholders, impose market discipline. History has demonstrated that because failure to impose market discipline is not uncommon, over-reliance on market forces can be misleading.

Lesson 3: Ineffective regulation. The frequency of market failure places a greater onus on the regulator to be more effective in encouraging and imposing market discipline. Sadly, regulators focus on the symptoms of failure rather than its root causes. Furthermore, regulators often ignore the root cause of their own inability to act promptly and thereby contribute to the risk of systemic governance failure. The drive to introduce a new framework via the Financial Services Bill is another example of a failure to address root causes by focussing solely on symptoms.

Effective regulation involves the design of policies, rules and laws that are effectively monitored and supported by the credible threat of enforcement. The new framework is focused on new architecture rather than making the existing one work more effectively. The tripartite system failed because insufficient emphasis was placed on supervision and enforcement. In our opinion, the risks of regulatory failure have not been reduced.

CFA UK believes that effective regulation is essential for the laws of demand and supply to function appropriately. History has demonstrated that market discipline cannot be reliably imposed by all regulated financial firms. The high risk of market failure makes the regulator the last line of defence for maintaining market integrity and thereby trust and confidence. Sadly, the evidence demonstrates that the regulator is also prone to failure. CFA UK calls upon regulators to learn from financial and corporate history and to make material changes in their regulatory approach to deliver the following outcomes:

1) Firms conduct themselves to the highest professional and ethical standards and place clients' interests first.

2) Enhance financial capability so that consumers become a more robust source of market discipline on firms.

3) Establish a regulatory philosophy and approach which acknowledges that we live in a world populated by people who do not always act rationally and imperfect markets. Rather than facing a binary choice of market mechanism or command and control, the philosophy should embrace asymmetric paternalism. This would create an environment of market command with robust control mechanisms and make it possible for firms to fail without endangering the system or imposing major costs on the rest of society.

Just like regulated firms, senior regulators should also be held to account. However, along with the senior managers at financial firms that had engaged in inappropriate activity, very few senior regulators have been held to account following the crisis.

As La Porta et al[48] suggest "these laws and the quality of their enforcement by regulators and courts are essential elements of corporate governance and finance… in contrast, when the legal system does not protect outside investors, corporate governance and external finance do not work well." On occasion it may be more beneficial to enforce existing laws and regulations than devise new policies, or as La Porta et al state: "the strategy for reform is not to create an ideal set of rules and then see how well they can be enforced, but rather to enact the rules that can be enforced within the existing structure."

By improving the quality of the regulatory environment, the level of trust and confidence can be raised. The onus will be on each generation of regulators to learn from the mistakes of their predecessors. By fulfilling the essential role they play in enhancing the quality of market integrity, regulators will be able to further strengthen the UK's position as a leading global financial centre.

Below is our opinion as to whether the draft legislation will or could do better.

- prevent another financial crisis

"We can't hope to prevent financial crises from happening, but we can build institutions that help to ensure that our financial system is more resilient in the future." (Mervyn King)[49]

The draft legislation has been based on the premise that the next financial crisis will be similar to the most recent one. The current approach is based on fighting the last war rather than addressing the root causes of the financial crisis, namely a systemic governance failure resulting from financial amnesia and ineffective regulation. Based on our assessment the proposed framework is unlikely to prevent another crisis, but is likely to change the location of the next crisis. The framework itself is a lesser issue, the more important question is whether or not the framework will be implemented effectively to reduce the impact of the next crisis. The UK's regulatory history does not persuade us that it will.

- handle a financial crisis

Based on our view that the proposed legislation fights the last war and the next crisis will be different, the new framework will be exposed again. The new framework demonstrates it has not learned the harsh lessons of financial history and is thereby ready to repeat the same

[48] La Porta, Rafael, Lopez de Silanes, Florencio, Shleifer, Andrei and Vishny, Robert W., "Investor Protection and Corporate Governance" (June 1999). Available at SSRN: http://ssrn.com/abstract=183908 or DOI: 10.2139/ssrn.183908
[49] http://www.telegraph.co.uk/finance/economics/8597139/Financial-Policy-Committee-the-key-quotes.html

mistakes. Before finalizing the new legislation it would valuable for the government to produce some evidence to demonstrate how the new framework would have delivered a better outcome than the existing tripartite system in the following areas:

1) Reduced the threats to market integrity and trust.

2) Ensured that those responsible would be held to account.

3) The costs to the taxpayer and the wider economy would have been greatly reduced.

The new framework relies on rhetoric to demonstrate that it can handle the next crisis. Neither the UK Government nor the FSA have produced evidence to demonstrate/ show how the proposed architecture would have been more effective in handling the last crisis, let alone the conduct failures that continue to come to light. More evidence is required from the policymakers to demonstrate that the proposed regulatory architecture would have done a better job in addressing the root causes of the financial crisis.

- deal with bank failure and protect the public purse.

The public purse has been left in a precarious condition because of the economic impact of the recent crisis. According to The Economist[50] the impact on the UK economy of the current financial crisis is that Gross Domestic Product (GDP) remains 15% below the level at the end of 2007. To provide a meaningful international comparison, UK's real (taking into account the effects of inflation) GDP per person has declined by 4% since Q4 2007. Based on the list of 28 countries provided by The Economist, the UK has fared fourth worst during the crisis. Only Italy, Greece, and Ireland have performed worse than the UK. Given the consequences of systemic governance failures on the wider economy, the public purse is unlikely to be protected when the next crisis takes place. The public purse will need to be restored to health before it can cope with the next crisis. We have yet to see the full impact of the Eurozone debt crisis - another example of a systemic governance failure.

The legislation may be better placed to address bank failure, although it remains to be seen whether or not the public purse will be insulated. There is insufficient evidence provided by the government and regulators to convince us that the already strained pubic finances will not be called upon again, should another major bank run into major difficulties. There is also little comfort or reassurance that once again, political motives will not interfere with and hinder the orderly failure of a major financial institution without calling upon the taxpayer.

The Joint Committee is also interested in whether the proposals in the draft Bill will increase or decrease the risk or regulatory arbitrage of financial businesses.

The last crisis highlighted that some major financial institutions were willing to undertake activities that, while in the name of the law were acceptable, proved not to be in the spirit of the law. Some firms will always be willing to take regulatory risks, but what a regulatory framework that is effectively supervised and enforced can ensure is that the costs of engaging in activity to circumvent the rules exceed the benefits derived from those activities. When firms are found to engage in activity that is against the spirit of the regulation, they should be made an example of to those in the industry who are considering similar types of activity. In our view, the ability of the new framework to provide effective regulation is still open to question

[50] "Which economies have fared best and worst during the global financial crisis," The Economist ONLINE, 18 August 2011.

.Our comments on your detailed questions are given below

1. Is the separation of prudential and conduct regulation into a "twin peaks" system the right approach?

We now have a variation on the tripartite system and it remains to be seen if it is more effective. The case for the new framework being more effective has not been well supported. With regard to separation of prudential and conduct regulation, this is only the case with banks, insurance companies and some investment firms. The FCA will be responsible for prudential and conduct regulation for 24,000 firms.

The focus on bank failure also highlights that the key issue of systemic governance failure is being overlooked. As has been demonstrated by the recent and previous crises, firms failed because of a breakdown in governance, which demonstrates that prudential supervision is in itself intertwined with conduct regulation. As Paul Moore (former senior risk manager at Halifax Bank of Scotland) stated in a television interview[51] - "I realised the bank was moving too fast and I raised those challenges very strongly at board level. I also raised issues of cultural indisposition to challenge and inappropriate behaviours, and ultimately I was sacked…. I raised and reported all of this whistle-blowing claim that I had with the FSA but they did nothing either."

The separation creates a potential risk of gaps developing, as they did in the tripartite regime.

2. What lessons can be learnt from the approach of other countries to the regulation of the financial sector?

The key lessons the UK needs to learn are that regulators should make it clear that they will not tolerate firms behaving in any inappropriate manner that undermines market integrity or engages in activities that result in significant consumer detriment. Furthermore, firms should be in no doubt that the costs of inappropriate behaviour will significantly exceed any benefits from such behaviour.

What we can learn from other countries is that an effective regulatory environment is a public good. We can learn (from other countries) that the regulator needs to have courage and the will to act decisively. Also, that the regulator is able to make an example of firms, even large ones, when they act against their clients' interests or compromise market integrity. We should learn why some national banking systems did not suffer as greatly as the UK's and understand the structural reasons for these positive outcomes, especially in terms of cost to the tax payer and the wider economy. In addition, for non-bank financial firms we should also be aware of how non-UK regulators address firms that act inappropriately. In Japan for example, large firms can have their right to conduct financial business revoked on a temporary basis. This demonstrates that fines, however large on a headline basis, may be insufficient as a deterrent to firms considering inappropriate behaviour.

3. Is it appropriate to make such major changes to the regulatory system by way of amending legislation, rather than starting afresh?

As we have cited above, the most effective way forward would have been to supervise and enforce existing requirements more effectively rather than rearrange the current tripartite system. Instead of fixing a bolt on the stable door, the proposals are knocking down the

[51] http://news.bbc.co.uk/1/hi/uk_politics/7882119.stm

existing stable and building a new one, which based on our assessment, still has no effective bolt on it.

4. Are the accountability and governance arrangements for the Bank of England, FPC, PRA and FCA satisfactory?

History has demonstrated that senior regulators are rarely held to account. They were not held to account for the regulatory failure during the pre-tripartite era nor has anyone been yet held to account for the failure of the tripartite system. The new framework will be staffed by many of the key personnel that were in post in the period prior to the recent crisis.

5. Are the FPC's objectives the right ones? Is the concept of financial stability adequately understood for the FPC to be able to perform against its objectives?

"*We can do a lot better job than in the past… There were warnings, from this institution (Bank of England), some from the FSA, many from abroad, and yet no one picked up the warnings and ran with them.*" (Paul Tucker)[52]

The quote from Paul Tucker demonstrates that the success of the FPC as well as the new framework will be determined by how effectively the FPC's recommendations are put into action in a timely manner.

6 Should the FPC be limited in the actions it can take which might affect the growth of the financial sector?

The aim should be to ensure that rather than growth at any cost, it is the quality of the financial sector that is protected. The regulator's mandate should be to ensure that the UK financial sector is of the highest quality possible. Firms that wish to conduct business here can signal their quality by being able to demonstrate that they adhere to the highest professionals and ethical standards and place their clients' interests above their own.

7. How will the interaction between macro-prudential and monetary policies be handled by the FPC and the MPC?

No comment

8. Has the right balance been struck between the powers of the FPC and the powers of the Treasury?

Not entirely as there is still the risk that the political drivers at the Treasury may influence the FPC. The UK Government has not provided sufficient evidence to show that the FPC will not be unduly influenced.

9. Can Parliament take an informed decision about the proposals for the FPC without details of the macro-prudential tools at its disposal?

As stated above, Parliament will have a difficult challenge to assess the FPC without the information and evidence to support how the FPC will meet its objectives.

10. Does the draft Bill adequately deal with the risks posed by the shadow banking system?

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[52] http://www.bbc.co.uk/news/business-13782849

This question demonstrates that there is an overemphasis on symptoms rather than root causes. The shadow banking system[53] demonstrated one of the unintended consequences of the financial industry that regulators were not fully aware of (and if they were, they had not appreciated the implications of its existence). The shadow banking system was not harmful in itself, as it offered many valuable aspects not available in traditional banking; these were not driven by regulatory arbitrage. However, it was how the system was used that proved to be so costly. The shadow banking system was primarily driven by regulatory capital arbitrage. If the new regulatory framework is looking for risks from the shadow banking sector it may overlook those posed by other means used to conduct regulatory arbitrage. The PRA will need to be up to the job of spotting and assessing the inappropriate aspects of the next version of the "shadow banking" system.

11. Are the PRA's objectives clear and appropriate?

Yes, although the PRA is a response to the symptoms of the last crisis. There is little evidence provided by the government to show how the PRA would have made a significant difference in identifying the activities that resulted in the recent crisis.

12. Are there any risks in the Government's proposed 'judgement-based' regulation?

There are always risks in any judgement-based approach, especially the risk of getting it wrong. However, the key factor to consider is whether the people making those judgments have the appropriate skills, expertise and have the information to make the appropriate assessments. Even more important is whether these same people have the willingness and ability to act decisively. Based on the inability of the key regulatory personnel to identify and act to counter the recent crisis, CFA UK is not persuaded that the next set of regulators will meet these requirements.

13. Is the Government's proposed approach to 'orderly' firm failure satisfactory?

On paper the approach appears sensible, although the government should provide concrete examples of how this approach would have delivered better outcomes than those used in the recent crisis. The approach is bank focused and further evidence should be provided should a major investment firm or insurance company fail. Perhaps the UK Government can provide a case study of a hypothetical situation of demonstrating how the new framework would respond if a major bank or insurance company like AIG failed, and why such a failure might have been missed by the new framework.

14. Given that the PRA and the FCA will inherit FSA staff does the draft Bill do enough to ensure a new regulatory culture and a more proactive approach to regulation? Will these two new bodies have staff with the appropriate skills and expertise?

Please see our answers to questions 4 and 11.

15. Are the FCA's primary objectives appropriate? Is significant emphasis given to the promotion of competition?

The FCA's approach is fine on paper but too much is demanded of it. The FCA is being asked to do too much and it will probably lack the resources to act effectively. The promotion of competition needs to be reframed with the emphasis on quality rather than

[53] http://www.newyorkfed.org/research/staff_reports/sr458.pdf

quantity. The time has come to improve the quality of the market. The FCA should ensure that together with the PRA and FPC, it achieves the aims we have set out in our summary.

16. Are the responsibilities of the FCA towards the regulation of markets appropriate?

Please see our response to question 15.

17. Does the draft Bill strike the right balance between the responsibilities of consumers and firms? Are the FCA's new powers in the area of consumer protection appropriate?

Please see our summary.

18. Are the prudential regulatory responsibilities of the FCA towards FCA-only regulated firms given sufficient emphasis and detail?

The FCA has a considerable remit. The responsibilities may be well defined, although we remain to be convinced that the FCA has the expertise, skills, resources and courage to act decisively when it matters. More evidence is required from the FCA to demonstrate how it and the new framework would have delivered a better outcome had the proposed architecture been in place instead of the tripartite system.

19. Will the new regulatory arrangements reduce the risk and cost of dealing with the miss-selling of financial products?

The new framework does not demonstrate that the key lessons from history have been learned.

20. Are the proposals for co-ordination between the PRA and FCA clear and adequate? What would be the advantages and disadvantages of having a Single Point of Contact and/or a joint rule book for dual-regulated firms?

With firms that will be dual regulated it would be better to maintain the current system of a single contact that was fully aware of each firm's business and operations, as well as the extent to which the firm complies with the spirit of the regulation. Having one person look at prudential regulation and another at conduct can create a regulatory gap and myopia that could result in regulatory inertia. Firms in the PRA remit will have two regulators to deal with and this could double the risk of capture. Prudential regulation is important, although firms willing to take prudential regulatory risks will be seeking to undertake conduct that may well be not in the spirit of the regulatory requirements. The quality of conduct and appropriate firm governance will determine whether or not the new framework is successful.

21. How do the proposals in the draft Bill fit within the new European regulatory regime? What freedoms and constraints will the UK have to operate within that regime?

The UK has an excellent opportunity to demonstrate practical leadership in the area of financial services regulation, although based on our assessment, this has been an opportunity missed.

22.Does the draft Bill contain any proposals or omissions, not covered by the questions above, which cause concern?

Please see our summary and basis for response at the beginning of this document that set out the key omissions and the risks of repeating the mistakes from the past.

We trust that these comments are useful and would be pleased to meet the Joint Committee staff to explain them or to develop them.

September 2011

Chartered Insurance Institute (CII) – written evidence

Executive summary

The Chartered Insurance Institute (CII) welcomes the opportunity to provide evidence to the Joint Committee scrutinising the draft Financial Services Bill. Whilst we generally agree with the 'twin peaks approach' set out by HM Treasury, we have a number of specific points relating to the proposals:

1. Conduct of business regulation

- The CII welcomes the FCA's proposed stance to "***place particular focus on firms' culture as a potential root cause of poor outcomes***". It is now important to develop a clear framework for how the FCA identifies appropriate/inappropriate cultures.

- Our proposition, which is supported by previous FSA research, is that those **firms and practitioners** demonstrating professional behaviour through a verified commitment to qualifications, continuing learning and a code of ethics are less likely to mis-sell products to consumers and therefore cause detriment. We believe that improved professional conduct fits well with the ambition of the FCA to prevent rather than 'clear up' detriment.

- **In a new era of 'differentiated', risk-based regulation, FCA supervisors must distinguish between those that make a demonstrable commitment to professionalism from those that do not.**

2. Prudential regulation

- Similar to conduct of business regulation, effective prudential regulation also depends on supervisors making judgements about firms' cultures and behaviours.

- Unfortunately, the PRA's proposed approach to take account of firms' cultures does not appear substantially different to the current 'risk assessment framework'. Senior FSA, HM Treasury and Bank officials are adamant that supervisors will have "no right culture in mind" when assessing the level of risk posed by firms. The implication is that they will only seek to address cultural deficiencies after detriment has occurred.

- **In our view, this stance is worrying**. To demonstrate this, we reflect on the latest research into the attitudes and opinions of practising risk managers which suggests that those working within the field of risk management place far greater emphasis on micro-level human and social factors as **determinants** of financial crises than those working in regulation.

3. Separate insurance objective

- The CII welcomes the approach to regulate insurance differently to banking and the new objective to protect the policyholder from an 'Equitable Life type' event.

- However, it is concerning that, as a result of the new objective, insurance is likely to face proportionally more intense supervision than banks. In the context of the recent banking crisis and the continuing concerns resulting from banks' exposures to European sovereign debt, this outcome would not seem like a 'risk-based approach'.

- **It would be wrong for supervisors to spend more of their time focusing on the insurers when the banks continue to face such significant threats to their solvency.**

4. Financial policy committee

- **Governance:** there remains a risk that issues that arise in the insurance sector are missed or misunderstood if the Committee members do not have sufficient background expertise in the sector.

- **Accountability:** before Parliament can endorse the proposals for the FPC, it must have details about how possible macroprudential tools will work in practice and what trade-offs these will involve.

5. Coordination

- Effective coordination will ultimately be determined by the **attitudes and behaviours** of line supervisors and policy teams. In this context, we hope that the Bank of England and FSA paper to be published later this year on operational coordination will provide details of how a culture of cooperation can be instilled across the new regulatory regime. The new mechanisms will only be as good as the individuals providing the oversight.
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About the CII

The Chartered Insurance Institute is the world's leading professional body for insurance and financial services with over 100,000 members in more than 150 countries. We are committed to protecting the public interest by maintaining the highest standards of professional and technical competence as well as ethical conduct. We are a not-for-profit organisation governed by a Royal Charter, which sets out our public interest remit "to secure and justify the confidence of the public and employers" in the profession.[54]
Our membership includes over 29,000 members of the Personal Finance Society which is the UK's largest grouping of financial advisers and related roles. We promote the highest standards of professionalism for the financial services community and we do this in part by setting exams and awarding qualifications to financial services practitioners at the Certificate, Diploma and Chartered levels. We also require our qualified members to sign up to a Code of Ethics and undertake annual continuing professional development, both of which we enforce through disciplinary measures.

1. The Financial Conduct Authority

1.1 Culture and conduct regulation

[54] Chartered Insurance Institute, Charter and Bye-Laws, Art 3(a).

The CII welcomes the FCA's proposed stance to "**place particular focus on firms' culture as a potential root cause of poor outcomes"** [55]. It must be the case that when assessing the probability of consumer detriment, the regulator takes account of the behaviours and cultures of firms and their employees, as much as the more traditional structural and market-wide factors. Only then will the regulator be able to attain a "**deeper understanding"** of the "**commercial and behavioural drivers** and the multiple causes of poor outcomes for consumers". The challenge now then, is to develop a clear framework for how the FCA can identify appropriate/inappropriate cultures and behaviours.

1.2 Poor cultures, mis-selling and their implications

Poor cultures and behaviours have been a key cause of recent mis-selling scandals. In turn, these scandals have helped to reduce consumer trust in financial services. The result is that the general public are reluctant to engage with financial services even when it is in their best interests. We must reverse this cycle if public trust is to be regained. The recent FSA rule changes to the financial advice market (the Retail Distribution Review) represent an attempt to deliver such a reversal by creating a step-change in the professional standards of practitioners.

1.3 Consumer detriment caused by mis-selling scandals

Consumer detriment related to the selling of pensions and endowments and more recently payment protection insurance have one thing in common – poor behavioural standards of practitioners resulted in the selling of financial products that were unsuitable for the end consumer. To act ethically it is not merely sufficient to have good intentions in terms of putting the consumer first. Those advising customers must also be competent enough to understand the risks associated with various financial products and their own limitations in advising on such products[56]. It follows that mis-selling is often both a function of deliberately selling an unsuitable product for financial gain and/or poor levels of competence and understanding about the risks of financial products and the related risk appetite of customers. The FSA identified both issues as key causes of consumer detriment as part of the Retail Distribution Review.

1.4 Decreased trust in financial services

Poor cultures do not just cause consumer detriment through mis-selling but also, as a result of reduced consumer trust, are an important contributing factor to the UK's large savings and protection gap.

Trust of financial services in general is relatively low. The decline in levels of trust was well documented in a survey undertaken by the CII in late 2010 which found that one in five respondents will never trust financial services again and 72% of people have not very much trust or no trust at all in financial advisers and life insurance providers[57].

Low levels of trust is a key cause of **inertia** whereby consumers fail to act even when it is in their best interests. In this context it is worth referring to a recent report by the Social

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[55] FSA (June 2011), ***Financial Conduct Authority: Approach to Regulation***
http://www.fsa.gov.uk/pubs/events/fca_approach.pdf

[56] K. Redhead, "***Behavioral Perspectives on Client Mistrust of Financial Services***," *Journal of Financial Service Professionals* (Working paper)

[57] CII (February 2010) ***What we talk about when we talk about trust***, p.12
http://www.cii.co.uk/downloaddata/Trust_CII_2010.pdf

Market Foundation which neatly explains why distrust of financial services is such an important cause of inertia:

> *"A pervasive sense of distrust among consumers means they are likely to write financial service providers off as 'all the same', without even checking what is on offer on the market. Furthermore, behavioural economics suggests that consumers become disengaged in the face of market complexity: they are therefore less likely to check the market if they cannot easily understand or compare products on it."*[58]

Inertia has therefore helped contribute to the significant savings and protection gap that was quantified in the Treasury's Simple Products Consultation Paper earlier this year. It is estimated that around **a quarter of UK households have no savings at all** and that the protection gap – the difference between "the amount of cover people hold and the level they should ideally have in place to cover their protection needs" is close to **£2.5bn**[59].

1.5 Delivering an appropriate culture through professionalism

Raising the professionalism of practitioners is one way to tackle the problem of mis-selling and the related problems of consumer distrust and inertia. By professionalism we refer to three elements of professional standards:

1. **Qualifications:** Improvements in qualifications to raise the level of knowledge and understanding of practitioners.

2. **Continuing professional development (CPD):** By undertaking continuous learning, practitioners are able to keep their knowledge and understanding up to date.

3. **Ethics:** A commitment to act in the interests of consumers is crucial to ensuring honest selling practices.

Each of these 'pillars of professionalism'[60], are directly associated with the likelihood of consumer detriment. If practitioners adhere to the highest standards of qualifications, CPD and ethics, it is less likely that they will either deliberately mis-sell for personal financial gain at the expense of the consumer, or accidently mis-sell a product due to a lack of understanding about product risk. Distributors will want to deliver a service that matches the customer's risk appetite and they will have the skills to do it. They are therefore more likely to sell products that are appropriately tailored to the individual.

The FSA and the Treasury have acknowledged the importance of each of these characteristics of professionalism for improving consumer outcomes as part of the Retail Distribution Review (RDR) which is aimed at raising the standards of retail investment advice. FSA research, referred to by the current Financial Secretary to the Treasury in November 2010,[61] found in one specific survey of the quality of advice, that advice from practitioners meeting the highest professional standards was deemed suitable in **71%** of

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[58] Social Market Foundation (July 2011) ***A Confidence Crisis? Restoring Trust in Financial Services*** edited by John Springford, p.13

[59] HM Treasury (December 2010) ***Simple Financial Product Consultation Paper***, p.9 http://www.hm-treasury.gov.uk/d/simple_financial_products_consultation.pdf

[60] PARN's research into the ***three pillars of professionalism*** can be found via their website: http://www.parnglobal.com/the-three-pillars-of-professional-standards_2.htm

[61] Mark Hoban, (29 Nov), ***Commons debate about the regulation of Independent Financial Advisers*** http://www.publications.Parliament.uk/pa/cm201011/cmhansrd/cm101129/debtext/101129-0004.htm#1011302000275

cases whereas advisers with the current mandatory qualification delivered suitable advice in just **11% of cases.**[62]

However, professionalism in insurance and financial advice does not just refer to the characteristics of individual advisers, brokers or underwriters. Firms as a whole can also make a commitment to professionalism of which characteristics can include:

- **Corporate experience and expertise:** management that has the necessary experience and expertise to ensure that the business model is sustainable implemented effectively;
- **Corporate systems and controls:** including corporate governance that exerts appropriate levels of control over the running of the business including risk management, maintaining adequate capital, record keeping, training and competency programmes and developing a culture that encourages the fair treatment of customers; and
- **Employee professional support:** encouragement of professional standards for employees through supporting technical training and development and encouraging appropriate behaviour.[63]

In summary, regulators and their supervisors should not just consider whether individual practitioners have made commitments to professionalism but also whether firms have made an organisation-wide commitment to the highest professional standards. Those that do commit are likely to pose less risk of consumer detriment than those that do not.

1.6 Evidencing professionalism through verifiable standards

As the leading professional body for insurance and financial services the CII is committed to protecting the public interest by guiding practitioners in the sector towards higher ethical and technical standards. As part of this process we award Chartered status to those individuals demonstrating the highest levels of qualifications, CPD and ethics. They must maintain these standards to continue to hold the title Chartered. *We also award the Chartered title to firms demonstrating commitment to higher professional standards.*

Chartered firms

To become Chartered, firms must ensure staff members acquire and retain the necessary knowledge and skills to deliver the highest quality services and advice. They must also work in an ethical manner that places clients' interests at the heart of the services they provide. Chartered status, granted by the Privy Council, gives insurers and financial planners parity with other professional firms and distinguishes the Chartered title holders from competitors.

For example, **Chartered broking firms** must meet a number of key requirements including:

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62 FSA (June 2010) Consultation Paper 10/14: ***Delivering the RDR*** http://www.fsa.gov.uk/pages/Library/Policy/CP/2010/10_14.shtml

63 Each of these characteristics were identified in a CII report (2007) entitled ***Professionalism and Reputation*** http://www.cii.co.uk/downloaddata/pfs_rdr_professionalismandreputation.pdf

- A minimum of one of the board's members must personally hold the CII Chartered Insurance Broker title.
- **One of the firm's board or highest management team (who, as an individual, holds the Chartered Insurance Broker title), must take on the role of Responsible Member.**
- The entire board or highest management team together with a minimum of **90% of customer facing staff** must be members of the CII.
- Access to a Chartered Insurance Broker must be available to customers.
- Firms must have a professional development programme in place.
- Firms must have core values that align with the CII's Code of Ethics.

A corporate Chartered title is therefore a commitment to an overall standard of excellence and professionalism. A firm which holds each of these elements is one whose strategy is focused on delivering quality products and services to the consumer – epitomised through the achievement of rigorous learning and development for employees and a proven commitment to ethical practice.

We suggest that FCA supervisors should take 'Chartered' into account when assessing whether or not firm's governing bodies have "set, embed[ded] and maintained a firm-wide culture that supports an appropriate degree of protection for customers". At the very least, the fact that firms have spent time, money and intellectual effort to attain the title Chartered shows that they are not just driven by a concern for profit at any cost but have made a commitment to professional standards. Indeed for these firms, reputation for quality is paramount.

Professionalism is of course only one part of the mix of indicators that the FCA will have to look at when assessing the level of risk posed by firms on consumers. But by failing to understand a firm's commitment to best practice in this way, they will miss an important part of the picture.

While the concept is still a relatively new one, it is developing support rapidly as it offers an interesting option to develop professional standards at a firm rather than individual level. There are currently **over 400** Chartered firms.

Aldermanbury Declaration

In co-operation with leading figures in the general insurance market, the CII formed a task force in 2009 to raise professional standards in general insurance. The result was the Aldermanbury Declaration published in March 2010 calling on the sector to commit to a common framework of professional standards for its practitioners. The Declaration is a voluntary industry-led initiative that seeks to deliver the following benefits:

- Better outcomes for customers.
- Improved standards of risk management.

- A more confident, trusted profession.
- More talented people attracted to a career in insurance.
- Increasingly rewarding careers for those within insurance.
- Reinforcing the reputation of the London wholesale insurance market.

By the first anniversary of the Declaration, 200 firms including all major insurers had signed up to this commitment. We believe these proposals are ambitious but realistic and have called on all firms signing up to implement the changes by December 2013.
Firms that have signed up to the Aldermanbury Declaration have also made a long-term commitment to professionalism suggesting that their management are also determined to improve the outcomes for consumers. The fact they have made such a commitment should be noted by supervisors as part of their assessment of firms' cultures.
The FSA has, through the Retail Distribution Review, already explicitly recognised the importance of raising professional standards for improving consumer outcomes. We believe the FCA should welcome and acknowledge these latest industry-led initiatives to promote the same end.

Both the Chartered firms and Aldermanbury Declaration initiatives, reflect a growing movement towards higher professional standards across general insurance and financial planning. If, as we believe, increased professional standards decrease the risks of consumer detriment, then a firm that adheres to one or both of these initiatives is likely to deliver better consumer outcomes than would otherwise be the case.

1.7 Professionalism and consumer trust

As well as reducing the chances of mis-selling, there is also evidence to suggest that professionalism helps tackle the associated problem of consumer trust and inertia.

In 2009, on behalf of the CII, YouGov surveyed over 2,000 members of the public in an effort to understand consumer views about Chartered firms and individuals. This in-depth survey found that an important factor in determining whether or not people trusted a financial services firm or practitioner was whether they held the title 'Chartered'[64]. The headline results were:

- Consumers expect greater professionalism from Chartered persons and organisations.
- Consumers have greater trust in advice from Chartered professionals than professionals that are not Chartered.
- Consumers believe that you can generally trust the advice you get from Chartered organisations.
- Consumers have more confidence in the quality of organisations that use the term Chartered than those that are not Chartered.

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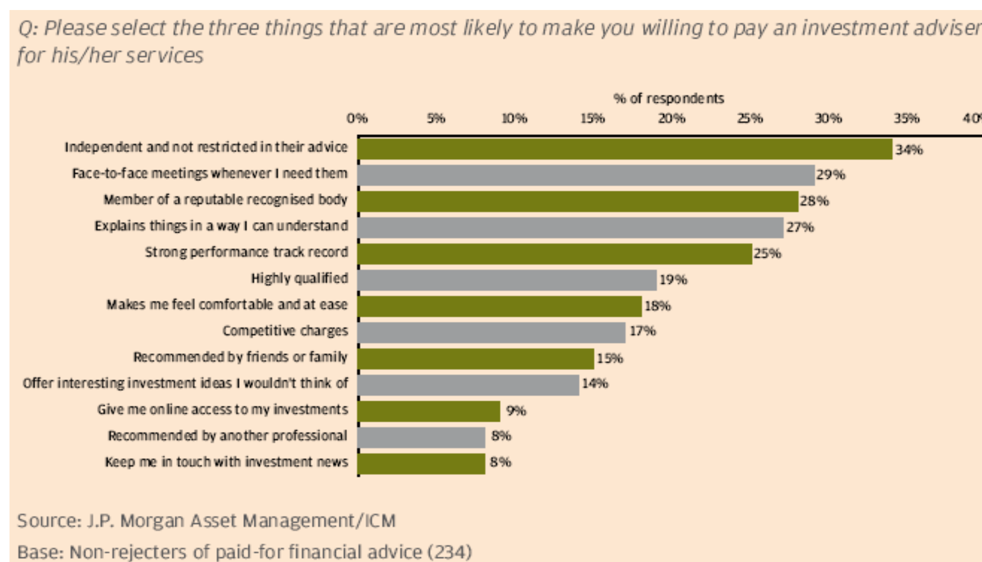
[64] CII (Polling by YouGov) (2009), ***Consumer Views of Chartered Status*:** http://www.cii.co.uk/downloaddata/Consumer_views_of_Chartered_status.pdf

There has also been research published on the links between professional body membership and consumer trust. A recent survey conducted by JP Morgan on financial advice found that a key driver determining whether a consumer is willing to pay for advice is membership of a professional body.[65]

Figure 1. Drivers that make consumers willing to pay for an adviser



Source: J.P. Morgan Asset Management

A paper written for the FSA by Jackie Wells and Mary Gostelow explains why membership of a professional body may inspire consumer confidence:

> *"Professional bodies play an important role as a proxy that enables consumers to place their trust in a professional. Knowing that a professional is regulated, meets certain standards of knowledge and is subject to a code of ethics facilitates trust even when the individual professional themselves is not known."* [66]

The above research is noteworthy, particularly in light of the Government's priority to close the savings and protection gap.[67] *High levels of professionalism epitomised by the title Chartered and membership of a professional body, appear to act as a break against the current wave of mistrust felt by the general public towards financial services. It follows that an increase in the number of Chartered firms and practitioners may, over time, lead to an improvement in the levels of trust and engagement with financial products and services.*

By ensuring that supervisors take account of developments like 'Chartered' and the Aldermanbury Declaration in their risk assessments of firms, the regulator can provide an incentive for other firms to adopt best practice helping to improve standards across the industry.

1.8 Other general points: the FCA's new powers of intervention

The CII recognises the need to reform conduct of business regulation given the occurrence of significant consumer detriment under the FSA. Part of rebuilding confidence in financial

[65] J.P. Asset Management (May 2011) ***Adviser charging: putting a price no financial advice*** http://www.jpmorganassetmanagement.co.uk/Adviser/_documents/JPMAM_Adviser_Charging_Report.pdf
[66] Wells and Gostelow (Nov 2009, updated 18 March 2011) ***Professional Standards and Consumer Trust***, Prepared for the FSA: http://www.fsa.gov.uk/pubs/other/psct.pdf
[67] See for example the recent discussion paper from the Treasury on **Simple Financial Products:** http://www.hm-treasury.gov.uk/consult_simple_financial_products.htm

services relies upon consumers being able to trust financial services regulation. However, as implied during Hector Sants speech at the FCA conference[68], the regulator's new powers for intervention could, if left unchecked, significantly increase costs for consumers whilst reducing innovation and choice.

New powers for transparency, disclosure and early publication could also, if used hastily, risk unnecessarily damaging consumer confidence in financial services by wrongly punishing firms that have been behaving correctly. Whilst we therefore support the approach for more regulatory intervention at both the design and distribution stages of the product lifecycle, more consultation is needed in order to strike the most appropriate balance between protection, trust and consumer choice. The public interest must remain paramount but it can be served by appropriate and proportionate interventions rather than merely a general increase in regulation.

2. The prudential regulation of insurance firms

2.1 Culture and prudential regulation

The PRA approach document gave a clear indication that understanding firms' cultures and behaviours would be an important element of the new supervisory process. The document specifically stated that the prudential regulator will 'take account of firm's cultures', and in his speech at the PRA Insurance Conference, Hector Sants spoke about the limitations of risk mitigation based on modelling alone. The remedy said Sants, was more experienced supervisors, better analysis of firms' business models (especially capital and funding models), better analysis of firms' governance model, and a **"clear understanding of the firm's culture and the implications of that culture on its risk profile"**[69].

This provision for culture in the prudential supervisory process is welcome. However, on paper at least, it does not look substantially different to the current 'risk assessment framework' which also considers **management, governance and culture**. Indeed from a close reading of the PRA approach document, it appears that supervisors will only make judgements about a firm's culture after detriment is likely to have taken place:

> *"...**supervisors will not have any specific 'right culture' in mind when making assessments**, but they will focus on whether a firm is achieving the right regulatory outcomes. Where those are not being achieved, however, the PRA will expect the governing body to reconsider culture and, where necessary, to make changes to improve regulatory outcomes."* [70]

In short, the regulator will seek to understand the cultures of firms but will only act once failure to achieve other regulatory outcomes has occurred. In our view, this would still demonstrate a rather reactive approach to supervision and not a step-change in the nature of prudential regulation as proposed by the Government and FSA.

Micro-level human and social factors (such as risk cultures, management attitudes and skills) are important if often neglected causes of financial crises. Recent research undertaken by risk management expert and Associate Professor Simon Ashby, reveals that many practicing risk managers place significant emphasis on these human factors as key reasons for the recent financial crisis[71].

Figure 2. Some commonly cited causes of the financial crisis

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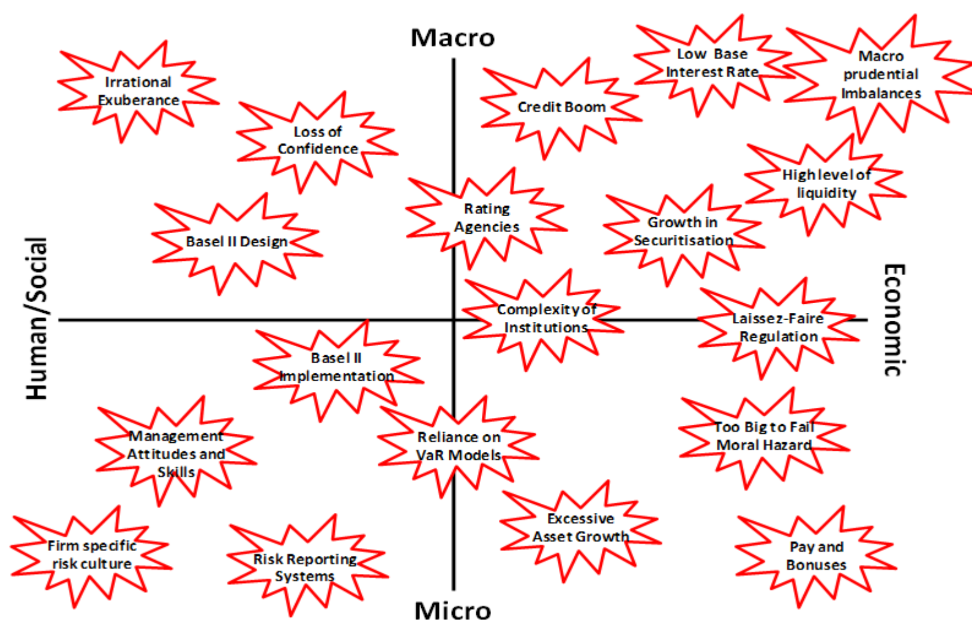
[68] Hector Sants (June 2011) ***Speech by Hector Sants, Chief Executive, FSA at the Financial Conduct Authority Conference*** http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2011/0628_hs.shtml

[69] Hector Sants (June 2011), ***Speech by Hector Sants, Chief Executive, FSA at the PRA Insurance Conference***, http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2011/0620_hs.shtml

[70] FSA and Bank of England (June 2011), ***The Bank of England, Prudential Regulatory Authority: Our approach to insurance supervision*** p.12 http://www.fsa.gov.uk/pubs/other/pra_insurance.pdf

[71] Simon Ashby (August 2011), ***Back to Basics: Rethinking Risk Management and Regulation in a post-crisis world***, CII Thinkpiece no. 61. This thinkpiece follows on from Ashby, S. (2010) ***The 2007-2009 Financial Crisis: Learning the Risk Management Lessons***, Financial Services Research Forum, Nottingham



Source: Ashby (2011) undertook in depth interviews with twenty risk management professionals from across financial services.

During his interviews, Ashby found that none of the risk managers...supported the view that risk-based capital regulations underpinning initiatives such as solvency II or Basel II, "will lead to improvements in risk management. Indeed for some, the financial sector's increasing reliance on models was seen as a key cause of the crisis." Ashby therefore argues that discussions about the "structure of financial institutions cannot be divorced from those about the behaviours and competencies" of management.

> *"Even in high risk environments, risk can be controlled by effective management (**who are competent and professional**, and are prepared to communicate with each other and work together) operating within an appropriate risk culture that promotes awareness, values management judgement as much as models and links risk and strategic management."*

From this analysis it is clear that PRA supervisors must not just seek to understand a firm's culture and how this impacts upon levels of risk, but also take action when they deem a firm's culture to be 'inappropriate' even if firms are achieving other regulatory outcomes. In short, **it must be the case that supervisors' judgements on culture play a key role in determining where firms are placed within the new 'proactive intervention framework'.**

3. The separate insurance objective

The CII welcomes the approach to regulate insurance differently to banking and the new objective to protect the policyholder from an 'Equitable Life' type event. It is absolutely right that the regulator should be looking to sustain a financial world where an insurer has a "high probability of meeting claims from and material obligations to policyholders as they fall due"[72]. However, it is concerning that, as a result of the new objective, insurance is likely to

[72] FSA and Bank of England (June 2011)

face proportionally more intense supervision than banks[73]. In the context of the recent banking crisis and the continuing concerns resulting from banks' exposures to European sovereign debt, this outcome would not seem like a 'risk-based approach'. **It would be wrong for supervisors to spend more of their time focusing on the insurers when the banks continue to face such significant threats to their solvency**. The Treasury, together with the Bank of England and FSA, must make more of an effort to ensure that prudential regulation is proportionate to risk.

4. Financial Policy Committee

4.1 Governance

The Treasury, Bank of England and FSA have all tried to dispel industry concerns that regulating insurance will be a secondary concern as the new architecture takes hold. The separate PRA insurance document, new insurance objective, and the implication that insurance firms may have to be regulated more intensely than similar sized banks, all reflect this. Given these efforts then, it is odd that the Financial Policy Committee, with its powerful remit to spot emerging crises and initiate mitigating action, has minimal insurance expertise. There remains a risk that issues that arise in the insurance sector are missed or misunderstood if the Committee members do not have sufficient background experience.

4.2 Financial Stability and Growth

Macro-prudential tools can be broadly grouped into two categories. The first is to "address the fundamental vulnerabilities in the system, while the second is to increase the resilience of the financial system to cyclical developments"[74]. Whichever macro-prudential tools are used, there will be consequences on the level of supply and price of credit available to the real economy.

In its submission to Government, the Treasury Select Committee neatly explains:

> *"...by increasing capital adequacy requirements, banks will need either to raise extra capital or to reduce their risk-weighted assets, from which the consequences will be a higher lending rate and reduced availability of lending, including mortgages, from UK banks. Introducing a loan-to-value cap and leverage limits will have similar effects - as long as funds do not flow from non-bank sources, or from overseas."*[75]

The deployment of macro-prudential tools may therefore have adverse implications for individual consumers and by implication, economic growth. It is crucial that before deploying such tools, the FPC is confident that the financial stability benefits outweigh the likely economic costs. From this analysis a key question arises: how much financial stability risk will the FPC be prepared to take before committing to a course of action that might threaten growth?

In our view, this is not just a question for members of the FPC but also for society as a whole. Just as Hector Sants has said it is up for society to decide how far the FCA should go in trading costs, innovation and choice for greater consumer protection[76], so society must play a key role in determining how far it is prepared to go in trading economic activity for

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[73] See comments made by Hector Sants (June 2011), ***Speech by Hector Sants, Chief Executive, FSA at the PRA Insurance Conference,*** http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2011/0620_hs.shtml

[74]Treasury Select Committee (January 2011) ***Financial Regulation: a preliminary consideration of the Government's proposals*** http://www.publications.Parliament.uk/pa/cm201011/cmselect/cmtreasy/430/43006.htm#a12

[75] Ibid

[76] See comments by Hector Sants (June 2011) ***Speech by Hector Sants, Chief Executive, FSA at the Financial Conduct Authority Conference*** http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2011/0628_hs.shtml

financial stability. It is therefore essential that there are proper **accountability mechanisms involving Parliament and the Treasury**. Whilst we welcome the statutory obligation to reduce the impact of FPC activities on economic growth, and the requirement to publish biannual financial stability reports before Parliament, we still think that the proposals are relatively light in this regard. **In our view, before Parliament can endorse the proposals for the FPC, it must have details about how possible macroprudential tools will work in practice and what trade-offs these will involve.**

5. Coordination

5.1 General Coordination

The new regulatory architecture will be more operationally complex than the FSA's. It is therefore likely to face greater challenges in terms of coordinating its response to specific regulatory issues, its day to day supervision and its policy making. In this respect we welcome the proposed statutory duty on the PRA and FCA to coordinate their activities, the obligation to prepare a memorandum of understanding and the commitment to having cross membership of boards.

However, whilst these additions may help to ensure a minimum level of coordination, ultimately effective collaborative working will be determined by the attitudes and behaviours of line supervisors and policy teams. Therefore, whilst the nature of financial regulation is often fairly secretive due to the sensitive nature of the commercial information being handled by supervisors, management must, where possible, promote the benefits of close working relationships with other teams, other regulatory bodies and outside experts. In this context, we hope that the Bank of England and FSA paper to be published later this year on operational coordination will provide details of how a culture of cooperation can be instilled.

5.2 International Coordination

As the current Eurozone crisis demonstrates, the UK's financial stability is intrinsically linked to the fate of other nations. If Spain was to default on its debt repayments, UK banks would face estimated write-downs of up to £75bn[77] making further Government-led recapitalisations necessary. This example illustrates just how important it is for the UK to be strongly represented at the international level.

To ensure a consistent strategic view internationally, the Consultation and draft legislation proposes a MoU between the various interested bodies. We believe that this may not be sufficient to ensure that the UK speaks with a single authoritative voice in international debate. We would therefore reiterate the CBI's call for the establishment of "an executive level international coordination committee, directly accountable to boards of regulatory bodies. The Committee would be comprised of representatives of the PRA and FCA and would oversee and be responsible for the regulators' international engagement"[78].

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[77] Jill Treanor (April 2010), ***Debt crisis: UK banks sitting on £100bn exposure to Greece, Spain and Portugal,*** Guardian http://www.guardian.co.uk/business/2010/apr/28/debt-turmoil-bank-crisis-fears

[78] CBI (April 2011), ***CBI response to A New Approach to Financial Regulation: Building a Stronger System*** http://www.cbi.org.uk/pdf/20110401_cbi-response-building-a-stronger-system.pdf

6. Conclusion

In summary, whilst we agree, in principle, with the general thrust of the 'twin peaks' approach to regulation as set out by the Treasury, there is still significant work to be done in order to ensure an effective regulatory system. In particular, we hope that in coming to judgements about the prudential and conduct of business risks posed by firms, supervisors in their new bodies take account of the cultures and behaviours driving individual and as well as firms' decision making. Without this provision for culture, the regulators will fail in their job of delivering a proactive regulatory regime that is able to prevent financial crises and mis-selling scandals from occurring in the first place, instead of being preoccupied with clearing up the mess afterwards.

2 September 2011

Citizens Advice Bureau – written evidence

Summary

Citizens Advice is primarily concerned with the parts of the Bill relating to conduct regulation and the Financial Conduct Authority (FCA).

We believe that an effective conduct regulator is vital to ensure that consumers can have confidence in a financial services market. The recent history of the financial services sector shows a regulatory regime that has not been able to act quickly or effectively enough to prevent widespread consumer problems.

We welcome:

- the proposals in the Bill to give the FCA additional tools to deal with business conduct causing or likely to cause consumer detriment
- the measures on product intervention, greater regulatory transparency, misleading financial promotions and the requirement to satisfy the regulator that a business model is suitable.

We call for the following changes to the Bill:

- The Bill should include a clear duty to respond quickly and effectively to evidence of emerging widespread consumer detriment would make a big difference.
- The new regime must provide adequate protection for the most vulnerable consumers, including those on low incomes.
- The Government needs to clarify how the new powers will work in practice, for example, by showing how the reforms in this Bill would have prevented and better dealt with problems such as payment protection insurance mis-selling and sub prime mortgage lending.
- The Bill must ensure that prudential regulators do not ignore the needs of consumers, particularly those consumers at the margins of the market.

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 provides free, independent, confidential and impartial advice to everyone on their rights and responsibilities. It values diversity, promotes equality and challenges discrimination. The service aims:

- to provide the advice people need for the problems they face
- to improve the policies and practices that affect people's lives.

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, including county courts, GPs' surgeries, hospitals, community centres, magistrates courts, and mobile services both in rural areas and to serve particular dispersed groups.

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 service has dealt with a succession of widespread consumer problems with financial products and services including mis-selling of payment protection insurance, 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.

Eradicating widespread consumer detriment and ensuring that the market in financial services works for consumers, including those on low incomes, is vital for restoring faith and stability in the financial services sector and must be a primary objective of any system of financial regulation.

We have only answered those questions in the consultation which are relevant to our experience of financial services regulation, i.e regulation of conduct.

Questions posed in the call for evidence

Q14: Given that the PRA and FCA will inherit FSA staff does the draft Bill do enough to ensure a new regulatory culture and a more proactive approach to regulation?

Our experience is that the FSA has significantly changed its regulatory culture and outlook over the past few years; with a new focus on outcomes and more appetite for earlier and more decisive intervention where consumer protection requires this. This is a big change for the better in consumer protection terms.
This change has happened because the Government have come to accept that firmer regulation of financial services is necessary and the leadership of the FSA has changed. This suggests that the regulatory culture of the FSA has up until now been largely driven by the

board and senior management rather than by the mandate given to the FSA by the Financial Services and Markets Act 2000. (FSMA).

For example, the Financial Services Authority has been frank in recognising that it should have taken stronger action sooner to deal with the widespread mis-selling of payment protection insurance. Failure to properly control the lending and arrears management practices of mortgage lenders (and sub-prime lenders in particular) also resulted in Citizens Advice Bureaux in England and Wales dealing with double the number of enquiries about mortgage and secured loan arrears in 2010/11 compared to 2005/6.[79] The FSA have since acted to improve the effectiveness of conduct regulation through the *mortgage market review*, but this only serves to highlight the weaknesses of their earlier approach.

We are concerned that culture change for the better has not been locked-in. The old culture that was too slow to adequately protect consumers and too trusting of firms to do the right thing could come back as quickly as it left. Whilst the Bill provides the FCA with new and better consumer protection tools, such as product intervention powers, it still falls short of placing the FCA under a clear **duty** to act to prevent or address consumer detriment, or to ensure that financial service markets work well for all consumers. Consequently, the crucial 'how, why and when' of exercising consumer protection powers will still be solely at the discretion of the FCA leadership. The lack of such a duty means that there is no obligation on the FCA to guarantee that consumer problems are dealt with quickly and comprehensively. Citizens Advice therefore believes that this Bill should embed the 'tougher and bolder' culture of earlier and more decisive intervention described in the recent FSA paper[80] firmly and permanently in the culture of the FCA.

However we believe that this Bill can make a huge difference by introducing a clear duty on the FCA to respond quickly and effectively to evidence of emerging widespread consumer detriment. Therefore Citizens Advice strongly supports the proposal set out in the *blueprint for reform* white paper for a 'super-complaint' like process for the FCA.

Such a process should *require* the FCA to investigate evidence of emerging problems causing or likely to cause significant harm to consumers. We also support the suggestion in *blueprint for reform* that this requirement would be triggered by evidence from a number of designated 'super-complainants'; this has been a successful feature of the current super-complaint process set out in Section 11 of the Enterprise Act 2002. For example, our 2005 supercomplaint on the cost and effectiveness of payment protection insurance led to the FSA making more stringent rules on selling, a ban on single premium insurance, and eventually banks having to compensate their customers who had been mis-sold PPI.

We believe that two further features of a super-complaint-like process would play a crucial part in locking-in a more pro-active and outcomes focused regulatory culture.

- Firstly requiring the FCA should be required to conduct an initial investigation in response to evidence of emerging consumer problems and report on those findings within a specified period. For example the Enterprise Act requires the Office of Fair Trading to respond to a super-complaint with a report of initial findings within 90 days. Such a provision would ensure that problems with potential to cause consumer

[79] In 2005/6, Citizens Advice Bureaux dealt with 51,530 problems about mortgage and secured loan arrears, compared to 103,487 in 2010/11.

[80] The Financial Conduct Authority: Approach to regulation; (2011) Financial Services Authority

detriment get on the regulator's agenda quickly and before large numbers of consumers begin to lose out.

- Secondly, if the initial investigation confirms or uncovers further evidence of consumer detriment, the FCA should be required to investigate further and take action (if necessary) to ensure that the problem is resolved and remedied as far as is reasonable and practicable within a period specified in the legislation. This should be a shorter period than the two years required under the Enterprise Act 2002 for the Competition Commission to come up with a plan of action. This has allowed consumer detriment to continue to increase in the meantime. For example, the outcomes from the Competition Commission's inquiry into payment protection insurance following our 2005 supercomplaint did not fully come into effect until this year.

We believe that such duty to develop a realistic action plan to remedy, mitigate and prevent consumer detriment within a specified period would have encouraged the FSA to deal with payment protection insurance problems far more quickly than they did.

Citizens Advice also believes that the FCA should be required to review the effectiveness of any remedy package it develops, to ensure that regulatory action actually translates into positive outcomes for consumers.

Q15: Are the FCA's primary objectives appropriate? Is significant emphasis given to the promotion of competition?

Whilst we support the FCA's new competition objective, Citizens Advice believes that that some of the FCA's primary objectives need to be improved. We set out our concerns below.

Consumer protection objective

The White Paper [paragraph 2.92] 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,* is clearer still in stating that 'It is in 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 welcomes this approach, but is concerned that it is not reflected in the consumer protection objective. Regulators only use tools to carry out their duties and functions, so its is important that the objectives of the FCA are in line with its tools. The Bill largely repeats the existing FSMA text, with giving nothing new in the consumer protection objective to suggest that the Bill will permanently embed a focus on consumer outcomes in the centre of the FCA's regulatory culture.

As a result we would ask the Joint Committee to consider whether the 'have regards' list in new Section 1C(2) of the draft Bill which directs the FCA to consider the appropriate degree of protection for consumers should be amended to include more explicit references to consumer protection outcomes, including:

- the need to be pro-active in preventing consumer detriment

- the need to minimise consumer detriment by responding quickly to evidence of problems in the market

Vulnerable and marginal consumers, the Equality Act and the regulatory principles

The current FSMA consumer protection objective requires the regulator to have regard to 'the differing degrees of experience and expertise that different consumers may have'. This is carried over into this Bill.

We believe that this is too vague and unfocused to ensure that the FCA will consistently pay sufficient attention to consumers who are either vulnerable or at the margins of the market because of the way the firms take account of their needs and personal circumstances. These are people with little consumer power, who often do not benefit from competition and who may find it more difficult to get firms to hear their complaints.

In addition, we note that the FSA has been defined as a public body for the purpose of the public sector equality duty under Section 149 of the Equality Act 2010. Assuming this passes to the new regulator, the FCA must have regard to the need to eliminate discrimination, which includes firms failing to make reasonable adjustments to meet the needs of disabled people. But there is nothing in the 'have regards' list to ensure that the FCA properly integrates its duty under the Equality Act into the consumer protection objective.

Citizens Advice also notes that the Bill requires the FSA to have regard to the regulatory principle that a burden or restriction it imposes should be proportionate to the expected resulting benefits. We are concerned should this be interpreted in a way that might disadvantage particular groups of consumers. The costs of an intervention across a market or sector that is necessary to ensure good outcomes for a group of consumers sharing a particular characteristic appear to outweigh the benefits of the intervention where that group is small in numbers, even though they have or may experience significant and severe detriment.

Therefore we believe that there is a potential for tension between a focus on vulnerable consumers and the 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 particular group of vulnerable or disadvantaged consumers. Perhaps the waiver in new Section 138M could be amended to take account of this.

We also believe that this provides another reason to look at amending the consumer protection objective 'have regards' to ensure that the regulatory principle on cost benefits is properly balanced against these consumer protection outcomes. By way of example, we would suggest the following two additions:

- Having particular regard to the needs of vulnerable consumers

- Having regard to the public sector equality duty and the need for business conduct of authorised persons to comply with the Equality Act 2010.

The efficiency and choice objective

Citizens Advice is concerned that the 'efficiency and choice' objective could fail to ensure that financial services markets provide products and services that work well for lower income consumers.

The scope and intent of the *efficiency and choice* objective is unclear, both in the Bill itself and connected policy statements by the Government and the FSA. This is a particular concern for Citizens Advice as this objective appears to be the only driver capable of committing the FCA to ensuring that lower income consumers can access essential financial services that meets their needs without exposing them to excessive costs and charges.

The HM Treasury February 2011 consultation[81] agrees that *financial inclusion* is an important issue that needs to be addressed [at paragraph 4.31]. It is argued that the *efficiency and choice* objective will give the FCA a mandate to do so, but that a more formal 'have regard' would be inappropriate as this is a matter for social rather than regulatory policy. We would ask the Joint Committee to consider what this might mean.

The explanatory notes to the Bill do not provide much more help, with paragraph 77 merely suggesting that the efficiency and choice objective *may* be used to promote choice in the market for basic financial products. The FSA document outlining the future FCA approach also discusses the efficiency and choice objective, locating this almost entirely with the role in promoting competition. But a key issue in financial inclusion debates is the recognition that competition does not always bring benefits to lower income consumers and may even exacerbate the problems they face.

Financial inclusion is something of a catch-all term that could pick up issues for regulatory policy, social policy or both. However Citizens Advice would argue that ensuring that essential transactional services (such as bank accounts, payment services and ATM's) meet the needs of all consumers should be a core function of the regulator.

We would also argue that an effective financial services regulator should have a key role in ensuring that products meeting other specified financial needs of lower income consumers do come to market. In the absence of such a role, financial inclusion initiatives such as HM Treasury work on simple and transparent products have no route to practical implementation and the new product intervention rules may result in firms leaving the market rather than considering the needs of lower income consumers.

Therefore we believe that the efficiency and choice objective should be supported by a clear 'have regard to the need to sure that all consumers have access to essential transactional financial services that they can afford and which meet their needs'.

We would like the Bill to go further, by including an aspirational 'have regard to the need to facilitate access for all consumers to suitable and affordable products' as specified in an order by HM Treasury. This would keep with the Government the social policy aspect of deciding

[81] A New approach to financial regulation: building a stronger system

when to intervene to prevent certain consumers' financial need being underserved by the market. While at the same time it would provide a power for the FCA to operationalise the government's policy intention through its regulatory tools and functions.

Competition

Citizens Advice supports the measures in the Bill that require the FCA to promote competition. 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. We also broadly 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 agrees with this.

Q17: Does the draft Bill strike the right balance between the responsibilities of consumers and firms? Are the FSA's new powers in the area of consumer protection appropriate?

The consumer protection parts of this Bill seek to find a new balance of responsibility between the regulator, firms and consumers. The series of mis-selling and other conduct issues described in the FCA's future approach document and elsewhere highlights how retail financial services markets have been out of balance. Firms have not paid enough attention to delivering good outcomes for their customers and the regulator has not been able to act quickly or robustly enough to prevent widespread consumer detriment.

This is the headline consumer protection story that this Bill tries to address by giving the FCA new powers to intervene to address business practices that produce, or are likely to produce, poor outcomes for consumers. Citizens Advice believes that the Government are right to lead on this and that the Bill provides some reasonable and workable solutions.

Balance between responsibilities of consumers and firms

FSMA already contains a general principle that consumers should take responsibility for their decisions. This is set out in the 'have regard' list that conditions the consumer protection objective. However the Bill appears to give this principle more prominence by adding identical wording to the list of regulatory principles in the new Section 3B.

The FCA must have regard to these regulatory principles when making general rules about conduct, so this appears to be a material change of approach to consumer protection. But we are unclear what difference this is intended to make in practice.

Citizens Advice supports the recognition that consumers need to approach retail financial products and services with a due sense of caution and responsibility. Through our debt advice work we continue to see the consequences of the 'easy credit' culture that firms have promoted for too long. Here are a few recent examples reported by bureaux:

> A CAB in the West Midlands saw a 24 year old man who was unemployed. He needed advice as he could not afford the repayments on three high interest loans he

had taken out online from his benefits. The client told the CAB that he had been able to take out all three loans in 45 minutes. The CAB was concerned that the lender had not looked at his ability to make the repayments.

A CAB in London saw a Ugandan woman who had come to the UK in 2000 as a refugee. She had been given leave to remain in the UK in 2010, but before then she did not have recourse to public funds and was not allowed to work. Nevertheless, she had been able to take out £35,000 of unsecured credit, including bank loans and credit cards. The CAB noted that the client should never have been lent the money in the first place.

A teacher sought debt advice from a CAB in the East of England. Both he and his wife worked and over the years their debt problems had grown because they had easy access to credit and the bank had consolidated debts into new larger loans. Their repayments had grown to approximately £750 per month. The client had come to the CAB as his bank were unwilling to reduce payments on his loan, but had simply offered a new consolidation loan.

To prevent or reduce the risk of such outcomes, we would welcome a stronger emphasis on getting consumers better help and explanations at and around the point of sale and over the life of agreements in order to understand the obligations, liabilities and consequences arising. Our experience of dealing with consumer problems tells us that consumer responsibility is both dependent on and closely connected with the responsibility of firms to put consumers in a position where they can make properly informed decisions.

Responsibility is thus a question of making good quality relationships between consumers and firms. But we are not sure that the regulatory principles in new Section 3B properly reflects this. So we would rather see a principle that required the regulator to ensure that firms help consumers to make responsible and well informed decisions.

This could be supported by an ancillary regulatory principle requiring the regulator to ensure that firms act in accordance with consumer interests; raising the *treating customers fairly* principle from a duty on firms to a duty on the regulator as well. We believe that this would help to lock in a pro-active regulatory culture and help underpin consumer trust in financial services.

But we would strongly oppose a view of consumer responsibility that turns back towards a "caveat emptor" approach that is over reliant on disclosure. The experience of PPI alone makes such a narrow view of consumer responsibility unsustainable and incompatible with putting consumer outcomes at the centre. We would be re-assured by a statement that this is not the intention of this regulatory principle as a trade-off to the product intervention rules and other regulatory powers in this Bill.

Are the FCA's new powers appropriate?

Citizens Advice believes that the FCA's new powers are an appropriate response to repeated widespread consumer problems. The measures in the Bill appear to be based on reasoned analysis as to why the FSA had not in the past been able to be more pro-active at preventing consumer problems or more effective at addressing problems when they arose. In particular Citizens Advice welcomes:

- **Threshold conditions** with a requirement that an authorised person must 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. The FCA might in future be able to prevent some serious detriment by some early questioning of business models that look likely to produce consumer detriment. This will be particularly important if the FCA takes responsibility of regulating consumer credit.

- **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 quick and decisive intervention. We believe that this will be particularly important if the FCA takes responsibility for consumer credit regulation, given the heterogeneous nature of consumer credit market with many niche products and sectors often targeted at financially vulnerable consumers. However the existing power to vary permissions is fairly opaque from a consumer advocacy point of point of view. So Citizens Advice would welcome some clarification as to how the FCA might use these powers as a micro-intervention to deal quickly with specific problems.

- **Product intervention rules** to address potentially harmful features of a product or service before a large number of consumers become exposed to the risk of harm. Citizens Advice believes that the lack of a power for the FSA to intervene to deal with problems in the design and content of products has been a missing piece of the effective regulation jigsaw. 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. However it is not clear whether the regulator could also use the rules to require firms to ensure that the needs of a particular group of consumers are met. In the absence of such a positive intervention power, would firms respond to the regulators concerns to protect a specified group of consumers by under serving those consumers or excluding them from the market?

- Citizens Advice welcomes the power for the FCA to publicise action it has taken against financial promotions that breach the financial promotion rules. Not informing consumers about action against misleading or otherwise unacceptable financial promotions seems a glaring omission in the current regulatory regime.

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. However

earlier publication by the FSA might have encouraged firms to address problems sooner or helped consumers to make better choices. For instance, early notification of poor complaints handling by a firm might encourage consumers to persist with a justified complaint and not be fobbed off.

Q19: Will the new regulatory arrangements reduce the risk and cost of dealing with miss-selling of financial products?

Citizens Advice believes that the package of powers that the Bill gives the FCA will significantly reduce the risks and costs to consumers associated with mis-selling of financial products and services. However, we believe that these powers need to be combined with a clear duty on the FCA to act and a set of objectives that are more explicitly focused on consumer outcomes and the needs of vulnerable consumers in particular. We believe that this would create a consumer protection package capable of raising and sustaining consumer confidence in retail financial services.

Q20: Are the proposals for co-ordination between the PRA and FCA clear and adequate? What would be the advantages and disadvantages of having a Single Point of Contact and/or a joint rule book for dual-regulated firms?

Citizens Advice has some concerns about the way that the Bill appears to give the Prudential Regulation Authority seniority over the FCA. While we are reasonably reassured that the PRA veto over FCA decisions in new Section 3H is intended to be used only in very exceptional circumstances, we are not sure how more day-to-day tensions between the approach of the two regulators will be resolved in a way does not undermine consumer protection.

By way of example, the FSA recently published draft guidance on prudential regulation aspects of the mortgage lenders deal with accounts in arrears. This described approaches to issues like the sustainability of forbearance arrangements in a way that could potentially (and unnecessarily) undermine other work by the FSA and other Government departments to support homeowners with mortgage arrears. The point here is that some tensions between prudential and consumer protection approaches are already apparent with a single regulator. The question we raise is how these tensions would be successfully resolved under a 'twin peaks' system.

We would also raise a question about the adequacy of safeguards to ensure that any direction on macro-prudential measures from the Financial Policy Committee does not have a disproportionately detrimental impact on any particular group of consumers. For instance, a macro-prudential measure designed to slow the growth of lending in an overheating mortgage market could possibly see a group of existing higher risk borrowers marooned with expensive mortgages or facing sharp increases in a variable mortgage rate charged by the lender. It is not clear how the Bill ensures that the interests of consumers (and those consumers at the margins of the market in particular) would be considered in such a situation.

September 2011

Citizens Advice, Consumer Focus and Which? – written evidence

When we came before the Treasury Select Committee on November 2nd 2011 we agreed, at the request of the Committee, to work together to produce joint wording regarding consumer responsibility for the Joint Committee on the Draft Financial Services Bill. Our respective research and work in the field of consumer protection has led us to similar conclusions on both how consumers behave in the financial services market and why the draft Bill needs amending.

Consumer responsibility
We do not dispute the notion that consumers have a duty to act as responsible citizens. Under the common law, consumer responsibilities are already established, including the principles of reasonableness, good faith, participation, disclosure and action. However, we do not think that the draft Bill strikes the right balance between the responsibility of firms and consumers, and is too geared to an unrealistic concept of consumer responsibility.

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".[82] As a result we believe it would be wholly inappropriate to extend consumer responsibility beyond the common law principles.

At a time when we need consumers to engage with the financial services industry to protect themselves and to save/invest for their future, we believe that any measures to increase the responsibility on consumers has significant risks. Focus group research[83] has found that consumers are put off by the existing extent of responsibility and they feel that they would be unable to fulfil the list of requirements which the FSA/industry suggested imposing on them. This in turn may make them less likely to purchase products leaving consumers unprotected and reduce market size for industry.

A question of balance
We are concerned that there is a significant imbalance between the responsibilities of consumers and firms as set out Section 3B of the Bill, and would like to see this addressed. As John Odgers, the barrister Which? commissioned, notes:

> "Regulatory principle (c) is 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."[84]

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[82] HM Treasury, Financial Regulation: building a stronger system, para 4.26
[83] Which?, Submission to FSA on DP 08/05
[84] Written advice from John Odgers, Barrister, 3 Verulam Buildings, 12th August 2011

PhD required?
Consumers in the UK are among those most likely to describe themselves as *'knowledgeable'* in theoretical market research polls but research shows that they are among those least likely to know their rights across a range of markets[85]. Meanwhile empirical 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 per cent of adults, asked to choose between receiving £30 or 10 per cent of £350, opt for the lower figure;
- A recent FSA survey asked the question: *'if the inflation rate is 5 per cent and the interest rate you get on your savings is 3 per cent, will your savings be worth as much in a year's time?'* – one in five gave the wrong answer[86].

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;
- it takes 55 minutes to read a standard consumer credit agreement, let alone understand it[87].

It would therefore be unreasonable in our view to argue that where a consumer has failed to fully understand a long and complex set of terms and conditions they should receive a lower level of protection.

Limits to 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). However, we must be realistic about the timeframe for improving personal capability and about how far education can realistically go in making us experts in markets and products that continue to get more complex[88].

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 service design should be based on empirical research on the probability of consumer detriment occurring. 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.

We fear, as drafted, the Bill could legitimise or even exacerbate current problems. For example, some firms provide reams of documents as a means of discharging disclosure requirements on the assumption that thereafter responsibility is transferred to the consumer as they 'should have read and understood' the documents. Accurate' information may have been provided to the consumer in this instance but not in a manner which is intelligible or appropriately presented.

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85 http://bit.ly/oq0eOZ
86 http://bit.ly/r3Ydnc
87 *Warning: Too Much Information Can Harm*, Better Regulation Executive/NCC http://bit.ly/oUP3lj
88 HMT Simple Products consultation paper.

Our fear is that the new FCA will be more likely to take the same view as these firms if the existing Bill remains unchanged.

Revised wording
Regulatory principles
In our opinion the evidence above supports a proposition to simply delete from the bill: *The general principle that consumers take responsibility for their decisions'* from the list of regulatory principles in Section 3B of the draft Bill.

Consumer protection objective
If it is considered essential that the FCA must have regard to the behaviour of consumers when it is pursuing its consumer protection objective we propose amended wording to the 'have regards' of *1C The consumer protection objective* as follows:
The FCA must have regard to:

> *(e) the needs that consumers may have for advice and information that is timely, accurate, intelligible to them and appropriately presented;*
> *(f) the general principle that consumers are responsible for acting reasonably in their dealings with financial services providers and their intermediaries.*

We propose a new 'have regard' to embed 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*'.

> (g) the general principle that firms will ensure, so far as is reasonable, the 'appropriateness of each product to the needs of the consumer.'

We hope these proposals will assist the Committee in its deliberations.

16 November 2011

Citizens Advice Bureau; moneysavingexpert.com; Mr Paul Lewis; Financial Services Compensation Scheme; Financial Ombudsman Service; Money Advice Service; Reserve Bank of Australia; Consumer Focus and Which? – oral evidence (QQ 99-206)

Transcript to be found under Consumer Focus

City of London Corporation – written evidence

Introduction

1. The City Corporation welcomes the opportunity to contribute to the Committee's scrutiny of the Draft Financial Services Bill.

2. The City is a strong advocate of a regulatory structure for UK-based financial services that will enhance the stability of the financial system, restore public confidence and safeguard the competitiveness of the sector. A healthy and thriving financial services sector provides funding and other support for business growth (including smaller businesses), creates employment, generates export earnings and produces tax revenue in order both to address the deficit and to finance public service provision. This UK-based activity therefore needs to remain competitive if Britain is to continue both to attract international business and to prosper in global markets.

3. The Corporation's work on financial regulation matters is informed by the International Regulatory Strategy Group (comprising senior representatives from a variety of industry sectors including investment banking, asset management, insurance, legal and accountancy services, exchanges and market infrastructure). Its role includes identifying strategic level issues where a cross-sectoral position can add value to the expression of views from particular sectors.

4. In the current economic climate it is clear that constructive collaboration is required between authorities and industry. Confidence in the financial services sector's ability to generate growth has been dented and maintaining the status quo in terms of financial supervision is not a realistic option. The need for adjustment to the regulatory framework is widely acknowledged as being necessary.

5. This memorandum addresses the general issues raised in the Draft Bill to which the City is in a position to respond. It acknowledges that there are widely differing views across business sectors and between companies and trade bodies. It does not seek to offer a consensus.

Roles and responsibilities of the new bodies

6. A particular concern in the new regulatory structure is that firms may be faced with being supervised by two separate regulators, since it appears that the authorisation of firms and individuals will be an overlapping responsibility between the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA). It is essential therefore that time-consuming duplication of work between these regulatory authorities is avoided, with an integrated model used as far as possible. There is also a risk in the new structure of separate and distinct rulebooks being produced by both the PRA and the FCA, particularly in the area of prudential regulation, where the two regulators share responsibilities. A single and consistent rulebook is essential for all regulated entities.

7. Authorisation should be dealt with by one authority, in order to ensure the efficient and consistent delivery of regulatory decisions. Giving the FCA responsibility for collecting fees from regulated firms reinforces the argument in favour of giving it also sole responsibility for the authorisation of individuals and organisations, in order to avoid duplication and to create a direct link between the handling of applications and the granting of authorisation.

8. The move towards a judgement-based approach, away from consultation and analysis, is likely to be detrimental to UK-based firms. Indeed, the PRA/FCA judgement-based approach may conflict with the move to a single rule book and supervisory convergence at the level of the European Supervisory Authorities, which the industry broadly supports. With the transfer of power to the ESAs there is a concern that national authorities might be tempted to use Pillar 2 powers to apply higher standards in an opaque fashion. There might therefore be a need to define more tightly the scope within which judgements may be made.

9. In addition, the new structure does create the possibility of duplication. This includes the proposals to separate out the FSA's existing authorisation, enforcement, and rule-making functions between both the PRA and the FCA. There is a clear need to examine more closely the level of benefit gained against costs incurred. If the supervisory duplication within the new structures materialises, there is a risk that the costs of these proposals may exceed those set out in the assessment. The estimate in the original impact assessment of transitional costs of £50 million spread over three years seems low in view of the scale of the reorganisation required.

10. The Government consultation implied that the main dangers that the changes in regulatory structure were designed to address were bank or building society failures on the pattern of the events of 2007-8. There can, however, be occasional failures in the non-banking area of the financial services sector. Effective powers of intervention should be in place to resolve such crises, although in the event of the failure of a non-banking institution, the appropriate point of intervention will need to be identified at the time, rather than setting a mandatory defined threshold.

Financial Policy Committee

11. The Financial Policy Committee (FPC) should be given the primary objective of setting capital ratios in a manner that would underpin financial stability, enabling it to use this instrument in a counter-cyclical manner. The FPC should also be able to apply other measures, since the use of capital ratios will not alone be sufficient to support financial stability. This could include the setting of liquidity ratios and leverage ratios appropriate to ensure financial stability.

12. These factors should be set as statutory objectives, but with the FPC having the discretion to determine the level at which capital, liquidity and leverage ratios should be set, keeping within the framework of Basel III/CRD4. There will be a need for international co-ordination, ideally within the framework of the G20, in determining the level at which all these new instruments are set in order to ensure that as far as possible policy contradictions in different markets are avoided.

13. Both the PRA and FCA should have regard to the primary objectives of the FPC, since it is the body charged with setting the parameters to achieve financial stability across the system.

14. The emphasis of all three new bodies should be on the quality and relevance of the information and intelligence they require and gather from regulated firms and markets, rather than its volume. The accumulation of reports and returns when there are neither the will nor the resources to process such information properly is of no benefit to good regulation and supervision.

Other issues

15. The proposed changes in the UK's regulatory structure will of course take place as rule-making powers move from domestic authorities to the new system of EU-wide supervisory institutions. The banking supervisor is based in London and it is essential that the new UK bodies, from the start, seek to influence the development of the EU-wide regulatory and supervisory structure, encourage secondments and develop a dialogue with equivalent bodies including those in the United States and the emerging financial centres of the Middle East and Asia. However, the UK authorities appear to be playing down the role of the ESAs, which could undermine the development of sound and effective regulation at the EU level if this results in the UK being less engaged.

16. The requirement for the FCA (and other regulatory bodies) to have regard to the competitiveness of the UK financial service sector is very strongly endorsed. Proper and effective regulation is essential for financial stability and both domestic and international trust and confidence and is the main mandate for the new authorities. It is however important that they should share the responsibility of HM Treasury to promote the competitive position of the sector, as a major contributor to employment, export earnings and tax revenue. It is essential that this position is not undermined by regulatory requirements and approaches which exceed in their prescriptive nature those of partners and competitors.

August 2011

TheCityUK – written evidence

About TheCityUK

1. TheCityUK is an independent membership organisation which represents the UK's financial and professional services industry. Our membership is drawn from over 250 financial and professional services firms from across the UK and includes retail and wholesale banks, insurers, asset managers, accountancy and legal firms. TheCityUK's key areas of activity include:

    - promoting the UK-based industry as a world leader offering unrivalled service and expertise to partners around the world;

    - creating a partnership for a sustainable industry: demonstrating the industry's role in enabling growth and prosperity in the wider UK economy; and

    - using research, evidence, insight, data and analysis to meet the needs of its members and to provide the evidence to support our promotional objectives.

2. TheCityUK welcomes the opportunity to respond to the call for evidence by the Joint Committee. In this response, TheCityUK builds on its submissions to HM Treasury's prior consultations into the 'new approach to financial regulation'.

3. TheCityUK is primarily concerned with the international attractiveness of the UK as a place to do business and the role of the UK financial and professional services industry in facilitating growth. This response focuses on the importance of the regulatory bodies taking a balanced approach in using their new powers, and of effective coordination in the EU and further afield. This corresponds to the questions in the Committee's call for evidence regarding accountability & governance and international cooperation, specifically questions 4, 11, 15 and 21.

Background

4. The UK has a vital national interest in the outcome of European and international financial regulation. Not only because nearly 2 million people are employed in the industry across the country, helping to make the UK the leading global exporter of financial and professional services, but because the UK sits at the crossroads of global commerce: recent Foreign Direct Investment figures showed that the UK is the leading European destination for FDI – across the globe only China and the USA hold a larger stock of FDI.

5. We should use the UK's considerable resources and expertise in financial services across government, regulatory bodies and above all in financial and professional services firms throughout the country to champion the UK's interests. We have a shared goal to shape global financial regulation along the principles of open and competitive markets espoused by the UK and to deliver a new system of financial regulation which restores confidence in financial stability and unlocks the flow of finance which is vital to economic growth.

6. Changes to financial regulation are clearly required to address failures in financial firms and in regulatory authorities which were highlighted by the financial crisis. Protecting consumers, businesses and taxpayers from the costs of failures in financial firms is rightly

the priority. A significant programme of change is already underway, and TheCityUK's members, alongside financial firms across the country, are willing partners working with policymakers and regulators to complete this programme of reform.

Balancing financial stability with economic growth

7. The new UK regulatory bodies will enjoy a wide range of new powers. Whilst it is important that they have the powers that will be required to enhance financial stability and to rebuild public confidence in the financial system, it is equally critical that the financial services sector can support economic growth: we should remember that the primary purpose of greater financial stability is to provide a platform for sustainable growth.

8. Our members believe that this need to balance the goals of financial stability and economic growth should be embedded in the objectives and governance of the new regulatory bodies.

   - The regulatory principles of the PRA and FCA should require them to assess ex-ante, and to measure ex-post, the impact of their decisions and actions on regulated firms and their customers across the economy and society. Such assessment should specifically address the impact on economic growth and employment and the sustainability of the UK as an international financial centre.

   - The governance and oversight of the new bodies should provide appropriate channels for independent challenge, particularly in the exercise of new powers such as the use of new macroprudential tools by the FPC, judgment-led regulation by the PRA and product intervention by the FCA.

   - The FPC and the Boards of Directors of the PRA and FCA should have a balance of experience from across the financial sector. The selection process for appointing members should be open and transparent.

9. We believe that balance in regulatory objectives, backed by independent challenge and oversight of regulatory approach and decisions, will lead to better outcomes for consumers and businesses across the UK, as well as maintaining the vibrancy and important economic function of the UK's financial and professional services sector.

Setting the international regulatory agenda

10. The financial services industry, the Government and UK regulatory authorities all have an important role to play in representing the UK in international discussions on financial regulation. TheCityUK's members recognise the need for the UK financial sector to engage with its international counterparts and with authorities in Europe and further afield.

11. The FSA and other UK regulatory bodies have a strong record of constructive engagement and influence in European and international bodies. The former head of the FSA's international division now leads ESMA, the Governor of the Bank of England holds leading roles in the ESRB and on governing committees of the Bank for International Settlements (the so-called "central bankers' central bank"), and the UK enjoys senior representation at the EBA, EIOPA and the Financial Stability Board.

12. The transition to the new UK regulatory regime will change responsibilities for representing the UK in European and international committees. There will not be a

perfect match between the scope of responsibilities of the new UK bodies and those of European and other international bodies, so there is a requirement for coordination between different UK bodies to effectively represent the UK's interests.

13. The proposed measures in the government's white paper and draft legislation oblige the UK regulatory bodies (HM Treasury, the Bank of England, the PRA and the FCA) to sign a statutory memorandum of understanding which should describe *"how they intend to coordinate the exercise of their relevant functions so far as they relate to membership of, or relations with, the European Supervisory Authorities, EU institutions and other international organisations."*

14. Our members believe that effective international coordination is so important to the broader UK economy as well as the financial sector, that a dedicated group or committee should be appointed to place sufficient priority, resources and responsibility into mobilising the UK's European and international representation. We note that recent comments by the IMF, in its report into the future of regulation and supervision in the UK, expressed a similar opinion. We propose the formation of an international coordination committee with specific responsibility for leading the UK's representation on European and international committees. The mandate of the committee should be to:

    - establish clear ownership and responsibility for any single issue: overlap or 'underlap' is undesirable in the UK's international representation just as in domestic regulation;
    - enable strategic objectives and the full extent of "the UK position" to be agreed in advance of EU or international negotiations, so that authority can be delegated to the UK representative to negotiate freely within the bounds of the agreed objectives; and
    - ensure that when determining international objectives Government and regulatory bodies harness the views, knowledge and skills of financial industry practitioners in the UK.

15. We would further advocate that the work of the international coordination committee should be supported by a shared international secretariat, staffed by members from the different regulatory bodies.

16. TheCityUK encourages the Government to consult further with financial services firms to make detailed proposals governing the UK's international representation and coordination. Procedures for incorporating the views of industry practitioners into the UK's strategic regulatory objectives, via market consultation, are of particular interest.

September 2011

Confederation of British Industry (CBI) – written evidence

The CBI represents firms from across the regulated and unregulated financial sector – including retail, universal and investment banks, insurance firms, investment firms and consumer lenders. We also represent the users of financial services as the UK's premier business organisation.

This document responds to the Joint Committee's call for evidence regarding the draft Financial Services Bill. It raises issues that our members have identified and suggests ways in which we believe the legislation could potentially be improved. These are based on principles that our corporate members believe should underpin the proposals for the UK's new regulatory architecture, and for financial service reform more widely.

The changes to the domestic regulatory framework will take place amidst far-reaching changes to the regulation of the financial services sector - from capital adequacy and liquidity reform and recovery and resolution regimes through to proposed financial market reforms and proposals by the Independent Commission on Banking - all of which contribute to a regulatory environment which is rapidly changing but overall looks promising in its ability to manage future crises.

Macro-prudential tools are a welcome addition to the regulatory arsenal; they provide an important mechanism to manage and counter systemic risks, helping to reduce the chance of severe financial crisis and likelihood of future taxpayer bailouts. But the novel and untried nature of these tools mean that there will need to be a period of experimentation and observation while the ranges of variables and thresholds for possible action can be identified.

We support the main elements of the draft legislation, but we believe there are improvements that can be made to ensure that the UK financial services sector can continue to support businesses and contribute to the UK economy in the coming years without running the risk of financial instability, failures of market conduct or mis-selling.

In this document we respond to the questions put forward by the Joint Committee.

1. Is the separation of prudential and conduct regulation into a "twin peaks" system the right approach?

There are benefits of both the single regulator and the "twin peaks" structure of financial regulation – so there is no right answer.

Our main concerns relate not to the principle of the proposed approach but to whether it can be implemented in practice effectively. It is essential that the transition to the new regime can be made without disruption to regulatory oversight of the UK financial sector and markets, while at the same time maintaining international influence. Once established the two regulators must act in a coordinated way, minimizing duplication and conflicting supervision.

2. What lessons can be learnt from the approach of other countries to regulation of the financial sector?

Perceived successes or failures of overseas regulators can be misleading as they need to be taken in the context of their national financial services industry and its history. It can often

be difficult to distinguish the factors that have led to a perceived regulatory failure, or success, and what its costs have been.

Where it is possible to draw on overseas experience in specific areas of regulation, we would encourage regulators to learn lessons from their overseas counterparts, for example the dangers of implementing procyclical rules. Legislators can also use comparisons with other jurisdictions when developing the regulatory objectives and framework.

However, it may be as interesting to consider that the full range of regulatory approaches have suffered failures over the past few years. There has been no particular approach that has clearly fared best.

3. Is it appropriate to make such major changes to the regulatory system by way of amending legislation, rather than starting afresh?

We believe that amending the Financial Services and Markets Act 2000 (FSMA) is more practical than introducing new legislation. This would extend the length of the legislative process significantly and would increase the uncertainty facing firms, markets and the UK economy in the interim.

Furthermore, the approach being taken has the advantage of focusing time and thought clearly and precisely on the new issues that have come out of the proposals for the changed regulatory regime – which require proper scrutiny if they are to be effective – without having to re-open past debates unnecessarily.

4. Are the accountability and governance arrangements for the Bank of England, FPC, PRA and FCA satisfactory?

The governance arrangements in and between the various regulatory bodies are crucial to ensuring that the bodies are effective and that their decisions are taken in a way that supports the objectives and purpose for which the regulators were established.

We have a number of concerns relating to the governance of the new regulatory framework and the accountability of the regulatory entities. We therefore believe that the Government should conduct an independent review of the proposed governance arrangements and their appropriateness, so that all stakeholders can be assured that these new regulatory bodies are structured in a way that effective and accountable and free from conflicts.

In response to this question we set out our views under the following headings:

- Governance
    - Structure
    - Membership
- Accountability
    - FPC
    - PRA and FCA

Governance

The governance arrangements of the regulators need to focus on securing a cross-sector level of expertise within the setup of each regulatory body, whilst ensuring that effective co-ordination takes places without large conflicts of interest occurring.

Structure

Although the Bank of England and the regulators clearly face different risks to corporates, there are a number of principles of good corporate governance practice that are relevant to the proposed structure. The box below sets out a number that have particular relevance.

Key principles of corporate governance that are relevant to the regulatory architecture

- The board and its committees should have the appropriate balance of skill, experience, independence and knowledge to enable them to discharge their respective duties and responsibilities effectively.
- There should be a clear division of responsibilities at the head of the company between the running of the board and the executive responsibility for the running of the company's business. No one individual should have unfettered powers of decision.
- Conflicts of interest can arise where individuals hold more than one position in an organisation or which have different objectives.
- The board should include an appropriate combination of executive and non-executive directors (and, in particular, independent non-executive directors) such that no individual or small group of individuals can dominate the board's decision taking.
- The board should identify each non-executive director it considers to be independent and state their reasons for that assessment.
- At least half the board, excluding the chairman, should comprise non-executive directors determined by the board to be independent.

However, we believe that elements of the bodies' governance arrangements diverge from general good practice. There are cases where conflicts might arise where committees and Boards which have significant overlapping membership have powers of direction over each other. There are also potential situations that can arise where individuals have to follow potentially conflicting objectives in different roles or exercise judgements outside of the formal decision making process.

Membership

Although the draft legislation sets out the FPC's membership criteria it does not set requirements on the breadth of expertise that is needed.

It is clear that without, for example, practical insurance experience, there is a risk that issues that arose in the insurance sector could be missed or misinterpreted. Although we are pleased that the Government has recognised that the insurance expertise represented on the interim FPC and the PRA board is limited, but this has not been addressed subsequently in the draft legislation. The legislation does not contain detailed provision relating to the expertise required of non-executive members or FPC members.

There should be a statutory requirement that the overall experience of the regulators' boards and the FPC should reflect the sectoral composition of the UK financial sector as a whole.

Accountability

The regulators should be sufficiently accountable for the 'reasonableness' of their actions to Government and Parliament but also to those they seek to regulate.

Financial Policy Committee

We welcome the requirement for the FPC to publish Financial Stability Reports and meeting records and to present its report to the Chancellor.

However, given the nature, importance and timescale over which the FPC's decisions will take effect, the Committee must be in a position where it can be directly challenged and held to account for its decisions by Parliament. In particular, we believe that the objectives of the FPC and the regulators should be framed in a way that permits Parliament and Government to consider and hold the bodies accountable for the 'reasonableness' of their actions, given the information they had when the actions were taken.

Financial Conduct Authority and Prudential Regulatory Authority

We support the proposals for accountability that are set out in the White Paper but believe that the regulators should also be accountable to the firms that they regulate. A stronger mechanism should be put in place by which regulated firms can challenge the decisions and approach of the regulators and hold them to account.

In order that the regulators can be challenged, it is important to set a clear standard against which they can be judged. We believe that this standard, and the legislation that underpins them, should be based on a test of 'reasonableness'. This would mean that the regulators would need to defend their actions in respect of individual firms or consumers on the basis that their decision was reasonable, given the information they had access to and the rules that were in place at the time.

This could be a test applied by the Upper Tribunal. Moreover, we believe that the remit of the Upper Tribunal should allow it to pass directions to the FCA, rather than just ask it to reconsider issues.

We also believe that the PRA should be required to hold an annual public meeting in the same way that the FCA does.

5. A) Are the FPC's objectives the right ones?

We are generally supportive of the FPC's objectives but believe that it should have a proactive focus on supporting economic growth. It is also important that the regulators consider the competitiveness of the UK financial services industry.

FPC growth objective

The FPC's macro-prudential powers are designed to support financial stability but they may, by their nature, also have an impact of economic growth.

The current text of the FPC's objective is designed to constrain the FPC from acting in a way which is likely to severely damage the economy in the medium or long term. HMT has stated that they believe that this provides for an appropriate interaction between financial stability and economic growth in the FPC's objective.

We disagree. We believe that the committee should have a more proactive focus on growth.

Although we welcome the recognition of the need for the wider growth and condition of the economy to be taken into account when setting FPC policy, the Committee should also focus on the active promotion of growth.

This would not conflict with the FPC's main objective because medium and long term economic growth is consistent with financial stability. It would be consistent with, for example, the objective of the European Systemic Risk Board ("ESRB") which requires the body to '*contribute to the smooth functioning of the internal market and thereby ensure a sustainable contribution of the financial sector to economic growth*'.

The objective could, for example, be phrased as:

"The responsibility of the Committee in relation to the achievement of that objective relates primarily to the identification of, monitoring of, and taking of action to remove or reduce, systemic risks with a view to protecting and enhancing the resilience of the UK financial system in a way which is consistent with promoting the medium and long term growth of the UK economy".

Alternatively, a secondary objective could be established which reflected the Monetary Policy Committee's ("MPC") secondary objective which requires it to support "the economic policy of Her Majesty's Government, including its objectives for growth and employment", subject to achieving its primary aim of maintaining price stability.

FPC competitiveness objective

We also believe that there should be a competitiveness objective to which the FPC should 'have regard'. A regulator that does not need to consider the competitiveness of the market might produce regulation that enhances stability or promotes good conduct while also damaging the market's competitiveness. It is therefore important that the regulatory bodies and FPC consider the competitiveness of the UK when taking regulatory decisions, although it should, of course, be secondary to the need for strong macro-prudential, micro-prudential and conduct of business regulation.

b) Is the concept of financial stability adequately understood for the FPC to be able to perform against its objectives?

Financial Stability is a concept that is referred to frequently in the context of the regulatory architecture - the Bank of England has a Financial Stability Objective (see below) and it appears in the Prudential Regulation Authority's (PRA) objectives. However, financial stability is not itself clearly defined in the legislation.

An explicit definition of Financial Stability should be determined. This would bring clarity to the FPC and PRA's objectives and their potential trade off with economic growth but also to enable greater accountability of the Committee in meeting those objectives. The FPC has no equivalent to the MPC's inflation target so a definition of Financial Stability would help to

increase the openness and transparency of the Committee, and may well prove useful in ensuring that the macro-prudential side of the Bank is as accountable as its monetary side.

A clear definition is also necessary so that it can be relied upon in the context of the other elements of the legislation and practical regulatory arrangements that refer to it.

The Bank of England's Financial Stability Objective is to: *'contribute to protecting and enhancing the stability of the financial systems of the United Kingdom'.*

6. Should the FPC be limited in the actions it can take which might affect the growth of the financial sector?

We do not believe that there should be any specific limitations on the FPC to prevent it from taking actions which might affect the growth of the financial sector, although its macro-prudential powers will need to be operated within a wider European framework, which will ultimately be overseen by the ESRB. However, as discussed under the previous question, we do believe that it should consider the impact of its decision on UK competitiveness.

7. How will the interaction between macro-prudential and monetary policies be handled by the FPC and the MPC?

The FPC and the MPC have a number of common members and both are ultimately accountable to the chancellor. However, we believe that it is essential that each operate solely within the mandates that they have been set individually.

If the governance of the regulatory bodies works effectively then the public reports that they both will make should ensure that they are scrutinized against their individual objectives and targets. But this can only be assured if the overall regulatory governance framework is - and is seen to be - effective in promoting independence.

8. Has the right balance been struck between the powers of the FPC and the powers of the Treasury?

The FPC has a broad mandate to pursue its objectives, and is likely to have a broad range of tools that it can use to achieve it.

The arrangements that have been proposed to ensure that the FPC will be held to account by the Treasury are appropriate. However, the objectives of the FPC and the regulators should be framed in a way that permits Government to consider and hold it accountable for the 'reasonableness' of their actions, given the information they had when the actions were taken.

This will ensure that the Committee is in a position where it can be directly challenged and held to account for its decisions by the Government.

9. Can Parliament take an informed decision about the proposals for the FPC without details of the macro-prudential tools at its disposal?

In principle, we welcome the range of powers and tools that have been proposed for the FPC and agree that the FPC should set out clearly how and when it intends to use the tools. The full extent of what macro prudential policy can deliver is still unclear, particularly given the concept of macro-prudential policy itself is still in its relative infancy. This, clearly, has an impact on the extent to which macro-prudential tools can currently be judged to be appropriate.

However, it should be recognised that the powers they have will be formed as part of a wider European framework, which will ultimately be overseen by the ESRB. Macro-prudential powers that it uses in respect of banks, for example, will only be possible within the framework of CRD 4. Although we hope that this will allow the FPC considerable flexibility, within certain safeguards and constraints, the legislation has not yet been finalised. Although specific details are not yet clear, the Treasury has set out an outline of details that are available.

One of the main features of an effective macro-prudential policy is that it must be flexible in order that it is able to address issues as they arise.

We believe that Parliament should be in a position to take a decision on the FPC's objectives and the outcomes that are intended to be achieved through the use of the tools, and therefore whether the legislation supports them. The tools that will eventually be developed should only be used to achieve these objectives. The FPC will be required to produce a report every six months and Parliament will be able to hold them to account for their use of the actual tools in practice.

Development of the macro-prudential tools

The FPC should consult on its policy statement proposals with the financial services industry and more widely to ensure that the right tools are made available and that they are deployed in the right way, drawing on firms' international experience. Consultation will also provide a mechanism for all stakeholders to buy into the use of the tools, and help to ensure that the full range of tools will be available for the FPC to use in practice.

As part of its policy statement, the FPC should indicate:

- how and when it would choose to use the powers, and what the triggers might be;
- the practical and political constraints and risks that are associated with each tool and how they might be overcome;
- how the use of the tool is consistent with international standards and how its use will be coordinated with overseas regulators and European and international bodies; and
- how the success of a power or tool might be measured and when, after being deployed, it would be reassessed.

10. Does the draft Bill adequately deal with the risks posed by the shadow banking system?

The recent financial crisis has given a clear demonstration of the risks that shadow banking can pose to financial stability, whether this was the role of US mutual funds or the Lehman Brothers prime brokerage operation. However, it is important to recognise that shadow banking is a broad term. It includes both the regulated and the unregulated sector and it may include entities such as investment firms, insurers, mutual funds, hedge funds, private equity funds, securitisation or other structured vehicles and non-bank lenders.

We believe that the framework does provide a basis for oversight of shadow banking to be effective. This is because:

- the regulatory perimeter is clear and the regulators will have sufficient power to take action against those firms undertaking regulated activities without authorisation
- The FPC's mandate does not limit it to the regulated sector. The legislation as drafted should put it in a position to consider issues that arise in shadow banks, however they are defined. It will also have the power to make perimeter recommendations to bring certain activities within the scope of regulation if necessary.
- The PRA and FCA's objectives and powers will allow them to oversee risks posed by the regulated non-banks that they supervise.
- The FCA, in particular, has made it clear in its Regulatory Approach document that it will focus on behaviours in the wholesale markets that can cause damage to the wider market and the economy at large.

It is, however, important to recognise that that there may be benefit to transferring risks to entities outside the banking sector which are better able to manage or absorb the risks. It should not be the regulator's objective to prevent this, unless this gives rise to systemic or regulated firm specific risks.

11. Are the PRA's objectives clear and appropriate?

We are generally supportive of the PRA's overall objectives. However we believe that they should also reflect the need for competitiveness of the UK financial sector and further consideration of the insurance implications may need to be undertaken.

Please note that the competitiveness point below relates to both the PRA **and** the FCA – please also refer to this section when considering question 15.

Competitiveness objective

We are disappointed that the objectives that are proposed currently do not reflect the need to maintain the competitiveness of the UK and its financial sector.

It is true that stability, fairness and a strong regulator are all features that are necessary for a financial sector which is globally competitive. However, it is also true that a regulator that does not need to consider the competitiveness of the market might produce regulation that enhances stability or promotes good conduct while also damaging the market's competitiveness.

It is therefore important that the regulatory bodies consider the competitiveness of the UK when taking regulatory decisions, although it should, of course, be secondary to the need for strong macro-prudential, micro-prudential and conduct of business regulation.

The competitiveness of the UK financial sector and of UK business more generally should be a regulatory objective for the PRA and FCA and an objective to which the FPC should 'have regard'. This would be consistent with the objectives of a number of other overseas regulatory bodies, some of which have the objectives of 'ensuring' their financial sector's competitiveness.

If, however, the Government does not agree that it should be included as a regulatory objective in its own right, it must instead be included as a regulatory principle for the FCA and PRA. This will encourage the regulators to act in a way that is consistent with placing UK firms on a level playing field both within the UK and internationally, unless there is a good reason why this would not be appropriate or it conflicts with one of the main objectives.

The regulatory principle that should be introduced could be phrased as set out below so that the regulators have regard to:

'the need for competitive equivalence between firms within the UK market, and between firms operating in the UK market and other international markets'.

Insurance objective

We are pleased the Government has recognised that the distinct nature of the insurance business ought to be reflected in the regulatory framework, and welcome that this will be included in the PRA's revised objectives.

However, we believe that more work needs to be done to ensure that the objectives coordinate and are compatible with the European regulations that the PRA will have to enforce, particularly relating to the objectives of Solvency 2 that set policy holder protection as an explicit objective.

We also believe that further clarity is also needed on how the inclusion of the statement that 'those who…may become policy holders' in the objective will apply in practice.

We believe that there should also be an explicit requirement for the expertise of the FPC and PRA Board to reflect the overall mix of the UK financial sector. This is particularly relevant to the insurance industry which is under represented on these key committees. Also see the section on FPC governance.

12. Are there any risks in the Government's proposed 'judgement-based' regulation?

The CBI supports a judgement based approach to regulation but more needs to be done to ensure that the approach works in practice.

Adequate skills and resources

We are pleased that there is recognition by the government and at the Bank of England and FSA of the importance of the quality of regulatory staff. Practical plans that explain how this will be achieved need to be published soon so that regulated firms can have confidence in the judgement led approach.

Accountability and the right to challenge regulatory judgements

The FSA and Bank of England have rightly recognised that a judgement led approach can lead to circumstances where the regulator and regulated disagree, and that sometimes the regulator will be wrong. The PRA has committed to ensuring that its most senior and experienced individuals will be involved in major judgements and that they will use a process which is rigorous and well documented.

This commitment is welcome but we believe there should also be a mechanism that firms can use to challenge the decisions that the regulators make, and also that there is some form of process that firms can use to hold the regulator to account if its judgements are not reasonable.

It is to be anticipated that firms will frequently challenge decisions informally, as this discussion and debate between the regulator and its firms will help achieve the best regulatory outcomes.

Formal challenges to decisions or processes to hold the regulator to account should be used far less frequently, and the bar for their use should necessarily be set high. But these processes are needed to ensure that the regulator always takes care to ensure that their actions are reasonable.

Proportionality of approach

The regulators' approach should be based on assessments of the risk that regulated firms' pose to their objectives. We welcome the recognition that this means more than just the size of total assets. For the PRA it will also include an assessment of their interconnectedness with the rest of the financial system and the substitutability of the services that they offer. For the FCA's risk framework the assessment will depend on the size of 'incidence', based on numbers of consumers, and its 'severity'.

The regulators should work with the Financial Services industry to develop these measures in more detail.

The European framework

The great majority of new prudential regulations will be developed at a European or international level for the foreseeable future. These are likely to give macro-prudential regulators flexibility to use discretion over their use of tools, and there will still be some flexibility for micro-prudential supervisors, for example under pillar 2. However, the development of a European single rule book will constrain the PRA's ability to use its judgement in areas where rules have been written, and even to allow waivers where they think it appropriate.

The use of Skilled Persons reports

The use of Skilled Persons reports (or 'Section 166 reports') has become increasingly frequent over the past few years. Although they can be expensive for firms, in some specific circumstances they can be the best regulatory solution.

There is a risk that an increased emphasis on using external skills through Section 166 reports will mean that the PRA and FCA loses knowledge of specific technical areas.

More clarity is needed, in particular, as to how these will interact with the PRA's judgement led approach. If this were to occur then it is not clear that the PRA would be in a position to take judgements appropriately. The PRA will also need to take care that the scopes of its

reports mean that it alone exercises its judgement, drawing on information provided by the Skilled Person, rather than delegating its judgement led approach to the Skilled Person.

13. Is the Government's proposed approach to 'orderly' firm failure satisfactory?

The UK's existing Special Resolution Regime has improved the ability of the authorities to resolve firms or to allow orderly failure. However, it needs to be viewed in the wider context of regulatory and legislative initiatives that are underway.

The FSA has already undertaken significant steps in developing its recovery and resolution regime. It has established a pilot scheme and issued a consultation on its overall approach. In addition, we are expecting legislative proposals from the European Commission on Bank Crisis Management.

In combination, these will add to regulatory powers substantially reducing the likelihood that there will be disorderly failures of regulated firms.

14. Given that the PRA and the FCA will inherit FSA staff does the draft Bill do enough to ensure a new regulatory culture and a more proactive approach to regulation? Will these two new bodies have staff with the appropriate skill and expertise?

We are pleased that there is recognition by the government and at the Bank of England and FSA of the importance of the quality of staff. This is primarily an operational issue but we believe that the regulators need to publish practical plans that explain how improving the quality of staff will be achieved so that regulated firms can have confidence in the regulatory approaches that have been set out.

15. Are the FCA's primary objectives appropriate? Is significant emphasis given to the promotion of competition?

Competition

The government has proposed that the FCA should be given the duty which requires it, so far as is compatible with its strategic and operational objectives, to discharge its general functions in a way that promotes competition. It is further proposed that it will be granted a number of additional powers.

We support the elevation of competition to being part of the general duties of the FCA. Competition can be used as an effective tool to improve consumer outcomes, particularly where issues arise across market sectors rather than at individual firms, although there are some areas where the competition objective could in fact reduce the stability of the financial sector, for example when dealing with market infrastructure.

The Government should also be explicit that the focus on competition to achieve regulatory outcomes does not mean that the FCA should consider competition in respect of issues outside its overall objectives. The competition objective should clearly constrain the FCA from, for example, interpreting its consumer protection operational objectives in a way that leads it to attempt to regulate prices or become an economic regulator.

For example, the FCA should be careful when considering taking action in respect of excessive charges. We do not believe that this would align with its objectives in most cases, and it runs the risk of constraining the market and competition.

Competitiveness

Please see competitiveness objective in section 11, which also applies to both the FCA and the PRA

16. Are the responsibilities of the FCA towards the regulation of markets appropriate?

We support the proposals for the general scope of the FCA's responsibilities in respect of markets regulation, in particular continuing to exercise the responsibilities of the UKLA. `The CBI will be happy to provide more feedback on these proposals after it has completed more detailed consultations with its non-financial listed members.

17. A) Does the draft Bill strike the right balance between the responsibilities of consumers and firms?

We welcome the Principle of Regulation that consumers should take responsibility for their decisions. This is an important concept but, of course, it needs to be implemented effectively in practice.

The FCA has indicated in its 'Approach to Regulation' document that the FCA will do more than the FSA has done to engage directly with retail consumers and to explain what they can expect from a regulated firm and from the FCA itself.

Although this is in itself welcome, we do not believe that it on its own will meet the demands of the Principle and the regulation. The regulators need to do more to explain to consumers what their responsibilities are and it needs to consider the principle when taking regulatory decisions and developing conduct of business policy.

B) Are the FCA's new powers in the area of consumer protection appropriate?

There are two main tools that the FCA has been granted in order to support its consumer protection objective which we believe require further thought. We also believe that some aspects of the FCA's relationship with the Financial Ombudsman Service ("FOS"), and the powers that it has in respect of it need to be looked at again.

Product intervention powers - Retail

The Government has committed to taking forward new product intervention powers. These powers are by their nature difficult to use effectively, even when there is no intention to use them to pre-approve products. We recognise that there might in theory be some circumstances in which product regulation could be effective if used selectively and in a well-designed framework but these circumstances would be extremely limited.

Product regulation powers have the potential to reduce the availability and variety of products for consumers as smaller regulated firms become less likely to invest in developing new or innovative products. It can also discourage larger firms from innovating if they believe they will be penalised or restricted from developing products which do not align with criteria imposed by the regulator.

The FCA should be wary of using product intervention powers when other measures may be more appropriate to counter mis-selling. We believe that the FCA should focus on product governance throughout the product life cycle, rather than the products themselves. This would include focusing on the process of designing new products including the approval process; financial promotions and marketing; the sales process; and customer satisfaction and complaints monitoring.

More detail is needed on how product regulation will interact with product governance, what the triggers for its use will be and the appeal process. We note that the FCA will be required to consult on and publish a statement of policy governing the circumstances in which it may make temporary product intervention rules. It should consider:

- the FCA's proposed risk appetite and the criteria that must be met before the tool is used – these should be set in order that the powers may only be used when other initiatives have failed or where no alternatives can be reasonably assumed to work;
- the cost benefit analyses that should be undertaken before the powers are used;
- the length of notice that the FCA believes will be adequate to give to affected firms in advance of them being required to amend or withdraw a product; and
- the appeals mechanisms which should be defined carefully so that individual firms or groups are able to challenge the regulator's judgements quickly and receive an independent hearing.

Product intervention powers - Wholesale

We are pleased that the government has indicated that it believes that the new product intervention power is unlikely to be appropriate in relation to the protection of professional or wholesale customers, and that the Government has decided to make explicit in legislation that the FCA may not use its new product intervention power to advance the market integrity objective without HMT direction. It is not clear, however, when this power of direction would be used.

The FCA will therefore need to be careful when it "reaches up the distribution chain" to apply the use of the tool to wholesale firms. The FCA should set out in its statement clearly how its approach regarding product intervention will differ for wholesale firms and their wholesale clients and the circumstances when it might apply its new powers to them.

Early disclosure of disciplinary actions

The Government plans to grant the FCA the power to publish enforcement actions early.

We are wary that this power could have a severe effect on a firm or individual against which it was used, both immediately as the warning damaged its product or sales strategy and over the longer term as its reputation is affected. Even if a 'notice of discontinuation' was issued, it is unlikely that this would repair any damage that had been caused. Information that is published is likely to be misinterpreted by consumers, the media and market participants.

There have, historically, been examples of FSA enforcement actions that have not been taken forward or have been challenged. Under these proposals, if the tool has been used then significant reputational damage could have been caused.

The Treasury has proposed a number of safeguards around the power's use (see box below). Although we support these safeguards that are being placed on the power, we

believe that the risks that these tools present for firms who are acting in a fair, honest and compliant way are sufficiently high that further protections are required.

If these powers are to be taken forward, there must be an effective right of appeal with an independent process that can be applied in advance of publication. There must also be a process that firms can use after the publication to hold the FCA to account. This would form an essential check on the regulators to ensure that this power was used only when it was reasonable and when no other measure would achieve their regulatory objectives.

We look forward to publication of the FCA's policy on how it will exercise its power, within the safeguards imposed through legislation. The FCA should develop this through a normal process of industry consultation and should publish the final policy so that it is clear to regulated firms and consumers how and when this power could be used.

Financial Ombudsman Service

The FOS has a key role in ensuring that complaints against regulated firms are dealt with appropriately. The FOS framework helps the efficiency of the complaints process and avoids the need on either side for lengthy and costly court battles. But there are elements of its governance, working practices and powers that need reform. One element that needs to be improved is its interaction with the FCA.

In the past, the FOS has taken rulings on individual cases which have then effectively set a precedent for future complaints reviews. This has raised concerns about the reasonableness of its judgements when considered in the context of the accountability of the process used to develop FSA rules and compared with the expectations that the regulator had at the time that the issue arose.

The FOS should view complaints in the light of the conduct rules and guidance existing at the time that the issue arose. It should not be able to extend its ability to take judgements on individual cases to set general regulatory policy.

Where the FOS takes decisions that are novel or are likely to set standards for wider groups of complaints or policy for regulated firms more generally, they should refer the decision to the FCA. The FCA should be the body which takes the decision to set standards about firms' behaviour and conduct of business. This will help ensure consistent treatment of consumers across the industry.

Similarly, where the FCA takes a decision on the approach that firms should use in respect of a specific issue that applies across the industry, the FOS must follow that decision and must make its rulings in accordance with it, whether or not it arises from a referral from the FOS.

18. Are the prudential regulatory responsibilities of the FCA towards FCA-only regulated firms given sufficient emphasis and detail?

There are a number of specific areas where further detail is required on the prudential responsibilities of the FCA:

- The approach used by the FCA to supervise the firms for which it has prudential responsibility
- The split of responsibilities between the FCA and PRA

- Coordination of the FCA and PRA

The FCA's prudential approach

The FCA will supervise the majority of its firms on a 'gone concern' basis, from a prudential perspective. However, it will aim to supervise some larger firms on a 'going concern' basis, for example large asset managers and investment firms that deal as principle. This is consistent with the PRA, which will supervise all of its firms on a 'going concern' basis.

The difference between 'gone' and 'going' concern relates to whether the objective of the prudential supervision is to ensure that a firm can be wound down in an orderly manner, or whether it should have a focus on reducing the likelihood that it fails.

There is, however, a large difference between these two approaches and size is not necessarily a good indicator of the risk that a given firm will pose to the FCA's objectives.

There may be an argument for extending the 'going concern' approach to investment firms that deal as principle but not to even large asset managers where not required by underlying European legislation.

The FCA will need to set out clearly, and be held to account on, how its prudential regulatory approach aligns with the objectives it has been set.

Split of responsibilities

We support the overall scope of responsibilities for each of the main bodies and we also agree that the practical arrangements for dividing responsibility for prudential supervision of investment firms between the FCA and PRA is an operational issue, agreed between the regulators to ensure flexibility and precision.

We believe that the practical proposals for dividing responsibility for the prudential supervision of investment firms between the FCA and PRA need to be set out. The split will pose challenges for coordination, particularly where there are firms of different sizes in the same peer group. There is a risk that the regulatory structure could favour one firm over another or act as a barrier to entry to certain markets or business models. It is therefore essential that firms have certainty about who their prudential supervisor will be over time and that firms are, where possible, supervised with their peer group.

The practical approach to the split that the regulators devise should be developed within a legislative framework of procedural safeguards and clear and transparent principles. These principles should be linked to both regulators' objectives and provide a clear and stable framework within which the scope of each regulator's responsibility can be set.

Coordination of prudential responsibilities between the FCA and PRA

The PRA and the FCA have different sets of objectives – whereas the PRA must contribute to the stability of the UK financial system, FCA must protect and enhance confidence in it; the PRA must promote the safety and soundness of PRA authorised persons, whereas the FCA must secure an appropriate degree of protection for consumers.

These differing objectives give rise to the potential for differences in their approach to prudential supervision. This may damage competition between firms that are close to the dividing line between being supervised by the FCA or PRA and could even be peers.

It is important that the differences in objectives and approach will not lead to a two tier regulatory regime for firms within the same industry.

This is particularly important in the context of group supervision. The PRA's assessment of impact will cover all relevant entities within the consolidated group and in some cases it will undertake consolidated supervision. However, the current proposal is that solo prudential regulation will be split between the two regulators, even within a group. Under these circumstances the importance of proper coordination between the regulators would be paramount.

19. Will the new regulatory arrangements reduce the risk and cost of dealing with miss-selling of financial products?

See question 17 B.

20. A) Are the proposals for co-ordination between the PRA and FCA clear and adequate?

The government has stated that it would not be appropriate to set out operational matters for the PRA and FCA in primary legislation. In particular, they argued against a legislative underpinning for coordination between the regulators. Instead, the FSA and Bank plan to publish a document later in the year setting out more fully their plans to deliver operational coordination.

We look forward to this consultation as we believe co-ordination would be a significant challenge. The FSA and Bank of England should publish their consultation and engage with the industry as soon as possible.

The arrangements for coordinating the two regulators will need to be flexible and dynamic if they are to be successful. This will require the MoUs and operating arrangements to be reviewed and to be subject to open and pragmatic external debate and consultation periodically.

There are a number of specific areas where co-ordination is particularly important, including:

- Prudential supervision (see question 18);
- International coordination (see question 21);
- Authorisation (see below); and
- The PRA veto (see below).

Authorisation process

We are pleased that the Government has decided to adopt the 'alternative approach'. It is logical that the authority with prudential responsibility should take the lead role in the authorization process. This will make the process more administratively efficient and avoid duplication of resources but, more importantly, reduces the risk that important elements of the applicant's business model or controls go unchallenged.

This introduction of this approach is also a good opportunity to improve the existing authorisation process. The impact of the timescales and administrative difficulties involved in becoming authorised is difficult to measure objectively but it is possible that it discourages

new entrants, particularly where they are not raising funds from single sources or are proposing innovative business models.

Given the FCA's competition objective, it is important that the authorisation process, and the process for cancelling permissions, is made as efficient as possible.

PRA veto

The PRA has been granted a veto over the FCA on the basis that it can be used if the action proposed by the FCA would:

- 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.

We recognise that there are circumstances when this could be used but further consideration should be given to how the veto would be used in relation to rule making and waivers, and where the action relates market abuse or criminal prosecutions.

B) What would be the advantages and disadvantages of having a Single Point of Contact and/or a joint rule book for dual-regulated firms?

Single point of contact

The potential for duplication and inefficiencies or underlap between the regulators is clear. This duplication is most obvious in an administrative sense – for example duplicate supervisory visits or reviews; or requests for similar but different information.

Duplication could also clearly arise in a more general policy sense. For example, the two regulators could introduce conflicting rules or regulatory action to address risks which arise in respect of a certain service or product. Costs arising from the duplication of supervision could in both of these cases be greater than the sum of each being undertaken independently.

This should be addressed by minimising the points of contact between firms and the dual regulators. Using a single channel or point of contact would be one way of improving efficiencies and coordination.

Shared functions

More generally, we believe that combining functions will help manage coordination as well as improving efficiencies. We believe that there should be scope to establish a number of shared services arrangements which can either be outsourced from one firm to the other or can be established in a third entity.

The establishment of shared services will clearly have some benefits and efficiencies for the regulators' costs but it is also important for simplifying their operational arrangements, firm interaction and transfers of staff between the organisations.

Although it is recognised that the two regulators will have separate remits and will need to exercise operational independence, this will help ensure a practical minimum of duplication

for dual regulated firms, and promote consistency in the data required of and provided by firms.

Joint rule book

The approach to rule making and supervision will differ between the two regulators. But from a practical perspective combining the rules within a single Handbook, as is currently the case with the FSA, will make it simpler for firms to apply. Given the size of the current Handbook, the benefit of this should not be underestimated. An overcomplicated structure of rules will increase the chances that firms, particularly smaller firms, are not compliant, as well as increasing the overall cost of regulation.

A large proportion of the rules in the rule books will be made at a European level which is also pursuing a single rule book project. The proportion of the rules which arise from Europe is likely to increase and the UK legislators and regulators should reflect this in their design of the UK rule book.

21. How do the proposals in the draft Bill fit within the new European regulatory regime? What freedoms and constraints will the UK have to operate within that regime?

The great majority of new prudential and conduct of business regulations will be developed at a European or international level for the foreseeable future and practical regulation will need to sit within the framework of European regulators and colleges of national regulators whose powers are established through existing and future European legislation.

Indeed, the FSA Chief Executive Hector Sants has remarked that the PRA will be “essentially a supervisory arm of a European regulatory regime”[89].

It is likely that new rules which are set at a European level will increasingly be in the form of regulations, applying directly within national jurisdictions, and the use of Level 2 regulations under the Lamfalussy process will further tighten the framework of rules which the UK regulators must enforce. The proposed CRD4 text, for example, delegates responsibility for approximately forty binding standards to the European Banking Authority.

We do not believe that the draft Bill raises any conflicts with the European framework, but the operational approach that is used by the regulatory bodies must reflect the wider European regime and be able to influence it proactively.

Macro-prudential supervision

Please see question 6.

Judgement led approach

Please see question 12.

Single rule book

[89] Hector Sants, Chief Executive of the FSA, 19 May 2011

Please see question 20.

International Regulatory Committee

It is vital that the regulators are able to influence the European regulatory regime. To do this they must actively engage with the European debate. This is especially crucial given the lack of a single regulator to voice UK concerns, as has been the case under with the FSA. There must be recognition that there has been a shift in Europe on regulatory issues, and that the new approach may well be more prescriptive.

Practically, UK representation on international and European regulatory bodies, committees and fora is essential if the regulators are to achieve their regulatory objectives. They must also engage actively with overseas regulators and regulatory colleges to ensure that supervision of individual firms and groups is appropriate.

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.

The legislation already requires an MoU to be put in place between the PRA and FCA. It should also mandate the establishment of an executive level international coordination committee, directly accountable to Boards of the regulatory bodies and ultimately to the Treasury.

This will ensure that the views of both regulators are represented and that the right expertise is deployed when necessary, for example if a discussion at ESMA is relevant for the PRA's prudential supervision.

UK regulators must also have the right level of skills in order that their interaction with European bodies is effective. This will include soft skills such as negotiation and influencing, as well as technical skills to influence the debates.

The International Regulatory Committee

The legislation should mandate the establishment of an executive level international coordination committee, directly accountable to Boards of the regulatory bodies. The committee should be comprised of representatives of the PRA and FCA and would oversee and be responsible for the regulators' international engagement.

The committee's mandate should include:

- coordinating involvement, influence and lead responsibility on new and developing regulatory proposals and later stage policy engagement;
- planning and implementing a long term strategy for UK regulatory interaction with the EU and international agenda, including ensuring that the UK view is well represented in the ESAs;
- managing the UK's response to international regulatory developments which impact UK firms directly, for example decisions taken by the ESAs;
- approving key areas of policy position and resolving areas of conflict; and
- managing the regulators' responses to significant international issues.

The committee itself could benefit from a joint secretariat which will work at an operational

level across the two organisations.

The regulators must also ensure that they are well coordinated when dealing with overseas regulators of international firms domiciled in the UK. The dual structure might give rise to confusion for some overseas regulators who could be unfamiliar with the structure, and having a single point of contact will help manage communication and the general relationship. We believe that the PRA should normally act as the main point of liaison for overseas regulators.

Long term engagement of UK regulators in Europe

The UK has the leading financial services industry in Europe and it is essential that the PRA and FCA are engaged with European regulators and legislators at all levels.

There are practical issues of international coordination that need to be managed over the next few years as the UK reforms its regulatory architecture. However, this time of reform is also an opportunity to ensure that the UK's financial sector is fully engaged in the European regulatory process.

London is the leading European financial centre and the expertise found in the UK cannot be found elsewhere in Europe.   It is therefore important that the UK has a commensurate level of influence at the European regulatory bodies and throughout the policy and legislation process.

The only way that this can be achieved is by establishing practical arrangements for the PRA and FCA at all levels to engage with the ESAs and the European Commission. . Not only will this help the UK contribute meaningfully to the debate as it arises, but it will also put those with practical expertise at the heart of the policy making process, improving legislation and financial stability over the long term.

This must work well at a senior level, as they will shape today's debate, but it is also important to get more junior staff engaged as they will be influential over the longer term.

The UK financial services industry would support proposals for practical and operational engagement by the UK regulators in Europe, including secondments.

22. Does the draft Bill contain any proposals or omissions, not covered by the questions above, which cause concern?

There are two specific elements that we believe should be raised for the attention of the Joint Committee:

- Claims management companies; and
- The future of consumer credit regulation.

Claims management companies

Claims management companies ("CMCs") frequently target the clients of financial services companies. Often they focus on areas where there have been failures in the financial sector, targeting customers who may have valid claims on regulated firms and they sometimes provide customers with recommendations which relate to financial products. However they rarely give good value.

If CMCs are to be active in relation to financial products we believe that they should be brought within the regulatory perimeter. There is otherwise a risk that they recommend their clients to take certain actions in relation to the regulated products that they own, for example redeem a bond or insurance product. This could result in client detriment.

The future of consumer credit regulation

It has been proposed that consumer credit is brought within the financial regulatory framework, although it is at an early stage of consultation. This proposal has advantages and disadvantages but if it is to proceed, it is important that the regulatory architecture and approach is appropriate for the large number and wide range of consumer credit firms.

Although these firms would naturally fall into a framework of rules that had been designed for them specifically, broader elements of the regulatory framework that is currently the subject of consultation may be extended to them, for example regulatory objectives, principles and powers. If this is to be the case, the appropriateness of the framework for consumer credit firms should be considered at an early stage.

September 2011

Consumer Credit Association (CCA) – written evidence

We represent a sub-set of the UK's unsecured credit industry[90]. Our members range from large listed companies to several hundred small family businesses. Our members are not banks and so are only regulated by the Office of Fair Trading[91].

There is no appreciable systemic risk from unsecured credit because this type of lending is intrinsically constrained by what borrowers can afford. Also - from the consumer perspective - if an unsecured lender goes bankrupt, his customers suffer no real detriment.

So although we welcome prevention of future crises as an objective, we operate in a market that has not traditionally been prudentially regulated. This means we are not qualified to comment on the design of the stability and prudential structures under discussion.

Scrutinizing an overlooked issue

Instead, our central concern is the idea that unsecured credit should transfer from OFT to FCA. This proposal is not driven by macro-stability concerns but rather by perceptions that this would improve aspects such as coherence, oversight, flexibility and efficiency[92] (a case that we do not believe has been made).

HMT/BIS are treating this issue very much as separate and distinct[93]. In one sense, they are right to do this, because this sector is so different. **But this also means that the debate on the new structures risks overlooking the implications for the very large unsecured sector.**

If the UK gets regulation of unsecured credit wrong, there will be significant economic and societal implications. UK unsecured consumer credit balances at the end of 2009 totalled £227bn. During 2009, unsecured gross advances (flow) were £171bn (c.12% of GDP). The number of UK unsecured credit accounts is also very large. There are, for example, c70m credit cards in issue[94], c.55m current accounts[95], c.10m agency mail order users and c.3m home credit users.

Yet despite the size of these figures, these are remarkably stable markets. They did not, for instance, experience the very rapid growth that occurred in mortgages. Indeed, gross advances (flow) into the UK unsecured market began to fall in 2004, well before the crisis. Adjusting for inflation, flow in 2009 was in fact back down to 1998 levels:

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[90] Meaning credit not secured on real property. Unsecured credit therefore includes personal loans, credit cards, hire purchase, conditional sale, agency mail order, home collected credit, pawn broking, payday lending etc. Our trade body, CCA, represents the home collected credit sector (shortened 'to home credit'). Our members make small cash loans (typically c.£500) over contract terms typically in the range of 26 to 52 weeks. An agent (usually a woman) will visit her customers in the home each week to collect repayments and, where requested, issue further credit. Over the course of a year, the sector will serve between 2.5 and 3 million customers.

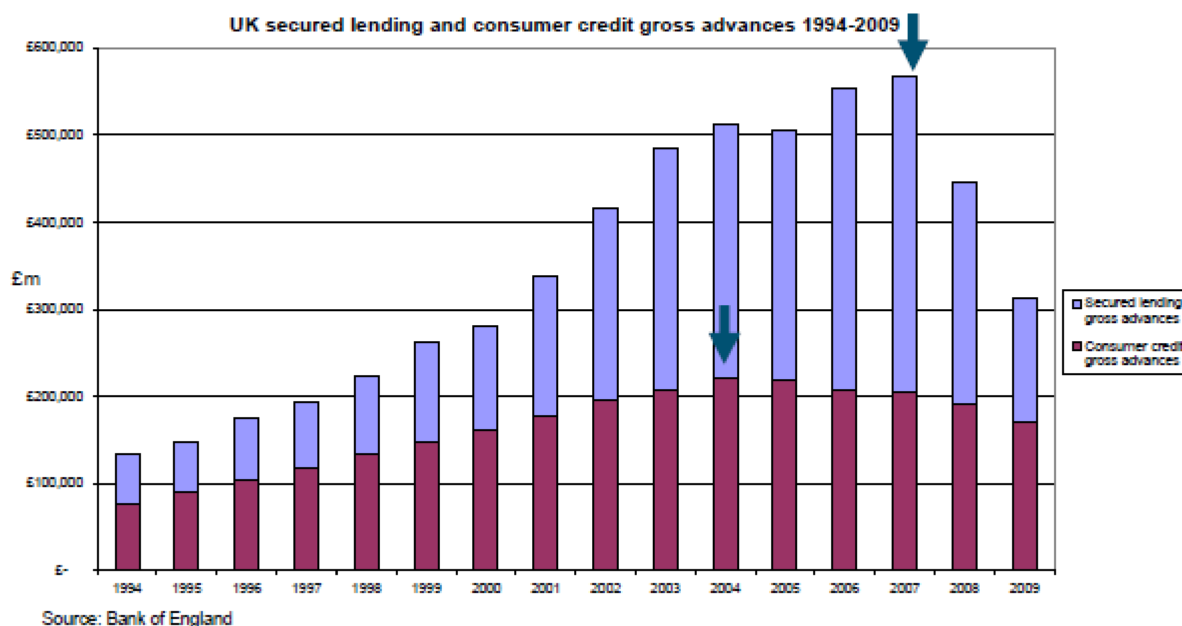
[91] Although one or two do operate deposit-taking businesses that are FSA-regulated.

[92] See *'Consultation on reforming the consumer credit regime'*, H M Treasury/BIS, December 2010.

[93] With its own separate consultation exercise: see*'Consultation on reforming the consumer credit regime'*, ibid.

[94] Although only a proportion of card holders (probably less than half) use the credit facility on the card.

[95] Again, only a proportion of current account holders will be using the overdraft facility on the account.



At the same time, there have been criticisms that the unsecured market has become less competitive, with players exiting.

Against this backdrop, sectors such as ours, with its many small traders, represent an important source of new competition.

This all creates a dilemma in terms of how the Bill should be scrutinized.

The risk is that new structures are discussed, developed and finalized and that unsecured credit is then bolted on almost as an afterthought

If the transfer to FCA does in the end go ahead, we are intensely interested in some parts of the draft Bill. If the transfer does not go ahead, the Bill is largely irrelevant to our sector

Implications of move of unsecured credit from OFT to FCA

Our main worry is that a move to FCA would very significantly increase the regulatory cost/load of running a credit business in the UK (probably by at least a factor of five). The two regimes (FSA and OFT) operate at quite different cost levels. FSA spends c.£500 million per year to regulate c.25,000 firms. OFT spends c.£20m-£30m per year supervising c.96,000 traders.

In its June 2011 paper, *'Approach to regulation'*, the FSA infers that - as FCA - its regime will be even more intrusive and costly going forward.

We believe these cost/load differentials dwarf all other considerations. There is serious potential for a high-cost/high-load FCA system to inflict deep economic damage on unsecured credit markets.

In particular, we could foresee market exit (especially by small traders), upward pressure on prices, reduced supply of credit and increased financial exclusion.

Unsecured credit contrasted with other financial products

For the products FSA currently regulates, we are neutral on the proposed approach. **Instead, our case is that unsecured credit differs in almost all respects from those products.** In fact, the most natural regulatory 'fit' for unsecured credit is with the goods and services it is used to purchase[96].

So on top of the cost/load problems for traders, moving credit to FCA would also risk fracturing important regulatory linkages which are part of this natural 'fit'. These include the essential interface with trading standards.

This table highlights the ways in which unsecured credit differs from other financial services:

	Unsecured credit	**Investment, insurance, mortgage credit**
Credence goods?	**No**	**Yes**
Complexity (product plus legal rules)	**Low**	**Moderate-high to very high**
Risk to consumer	**Low to moderate (*per* loan size)**	**Very high to moderate-high**
Risk flow	**Lender at risk**	**Consumer at risk**
Small trader fee cost (OFT v FSA)	**c.£1000 for five years (OFT)**	**c.£1000 for one year (FSA)**
Mass market?	**Generally, yes**	**Generally, no**
Extant authorizations	**c.96,000 (including brokers)**	**c.25,000**

No clear detriment justifying a move to FCA

If the UK's unsecured markets were dysfunctional or the existing system had manifestly failed, that might justify a move to higher-intensity regulation under FCA. However, the statistically-robust data instead reveals that these are stable markets which, on the whole, work well for the consumers who use them:

> *'It is often assumed that the huge increase in the volume of consumer credit over the past ten years or so must have been accompanied by an increase in indebtedness. In fact there is so little information about the extent of debt that is difficult either to substantiate or contradict this conclusion.'*
> Professor Elaine Kempson, 1992
>
> *'And I am interested because overindebtedness is a subject that frequently receives a great deal of press coverage reflecting anxieties about the level of consumer credit spending and the potential impact this may have on many households in society - not just the particularly vulnerable consumers…*

[96] For instance, 95% of the c.96,000 OFT credit licence holders do not lend in their own right. Most of that 95% are likely to be retailers of some type. See *'Consultation on reforming the consumer credit regime'*, ibid at §3.2.

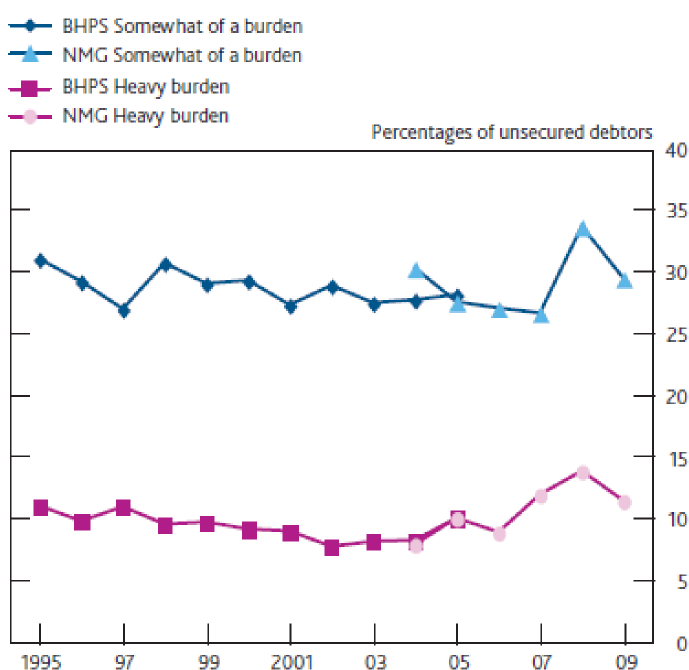
However, - despite the increase in amounts owed - the MORI research found that most households used credit modestly. The majority have only one or two credit commitments. They owe modest amounts and pay less than a tenth of their gross income on credit repayments…

…The MORI household survey provides us with a very balanced view and offers perspective on the use of credit. On the one hand, it shows us that, contrary to recent speculation, despite both the increase in available credit facilities and the increase in amounts owed, the majority of UK consumers use credit modestly. It is worth stressing again, that only a minority are heavy credit users.'
Melanie Johnson MP, Consumer Minister[97]

'The survey provides evidence that the number of individuals taking on a high level of debt service has increased over the past two years, reflecting the strong growth in consumer borrowing. However, the evidence also suggests that this increasing debt service is not causing significant problems at present. The number of individuals who consider their household's borrowing to be a heavy burden is low and has remained constant over the past two years. The proportion of individuals in arrears on repayments on credit or domestic bills is also low.'

Over-indebtedness in Britain: A DTI report on the MORI Financial Services survey 2004

Bank of England surveys suggest that consumers are able to cope with their credit obligations. Again, the picture has remained remarkably stable. This is from a 2009 Bank of England bulletin. The Bank's commentary says that the sudden spike in utility costs caused the blip in 2008:



Finally, most debt problems are caused by unexpected life events. No amount of regulation can prevent these from occurring.

[97] Comments at the launch on 27 November 2002 of *'Over-indebtedness in Britain: a report to the DTI'* Kempson [2002]

Treasury Committee comments

In its 3 February 2011 report, the Treasury Committee identifies two aspects with which we strongly agree.

First, under the heading *'It's not all about banking'* it makes the broad point that we make above, namely that:

> *'Inappropriate regulation of non-banking sectors could cause serious and unintended damage to companies within those sectors, and to the UK more widely.'*

Secondly, it presses strongly for competition to be a primary objective of the FCA. We think that this is essential. FSA comments in its June 2011 paper, *'Approach to regulation'* infer this is something that, until now, it has not taken much into account:

> *'The FCA will need a sound economic understanding of the way relevant markets operate in order that its regulatory interventions will promote competition and will effectively address the problems identified. This requires an approach to financial services markets that is significantly different to that of the FSA, both analytically and culturally.'*

Legislative method of dealing with transfer of credit from OFT to FCA

At present, the draft Financial Services Bill does not deal with consumer credit. If, however, the decision was taken to transfer unsecured credit from OFT to FCA, this would, we think, involve amendment of the Consumer Credit Acts 1974 and 2006. We assume this would be achieved through amendment of the draft Financial Services Bill and therefore hope the Committee will consider these issues as part of its deliberations.

September 2011

Council of Mortgage Lenders (CML) – written evidence

Introduction

1.
The CML is the representative trade body for the first charge residential mortgage lending industry, which includes banks, building societies and specialist lenders. Our 109 members currently hold around 94% of the assets of the UK mortgage market. In addition to lending for home-ownership, the CML's members also lend to support the social housing and private rental markets.

2.
The CML welcomes the opportunity to provide evidence to the Joint Committee. The CML has submitted responses to both of the HMT consultations on the proposed regulatory structures in July 2010 and February 2011, as well as the Financial Services Authority's (FSA) discussion paper DP 11/1 on product intervention and its approach document for the Financial Conduct Authority (FCA). We are also preparing a response to HMT's latest consultation, published in June 2011.

3.
As with those responses, our views outlined below are based on discussions with members and our experiences with the FSA, in particular our engagement in the Mortgage Market Review (MMR) and in negotiations on specific issues, including Mortgage Payment Protection Insurance and Mortgage Exit Administration Fees. As such, we have only covered issues that are of most significance to our members' mortgage lending and administration activities.

Executive summary

4.
We are encouraged that government has recognised a number of the issues we raised in our response to the '*Building a stronger system*' consultation earlier this year. However, we still have a number of reservations where we think that the proposals need to be further amended if the effectiveness of the new regulators and the markets they are designed to serve is not to be compromised.

5.
The extent of the Financial Policy Committee's (FPC) risk appetite and how it will be determined remains unclear. This will be a driving force in the FPC's policy decisions and, as a result, the day-to-day work of the regulators. But the process by which the FPC will come to its conclusions should be further explained, in particular what checks and balances will be applied. If this is not properly resolved, the FPC could effectively be left in a vacuum, to determine for example what constitutes an 'adverse impact' and how the 'short term' should be defined. This in turn could undermine competitiveness in the mortgage market and stifle innovation.

6.

We welcome the amendments to the Prudential Regulation Authority's (PRA) objectives and scope, but continue to have reservations with the practical application of an environment in which there are dual regulators. The white paper does not explicitly outline how the FCA will prudentially regulate firms in its ambit and how arbitrary differences within markets, which may well arise when different prudential regulators assess different firms undertaking the same activity, will be managed.

7.
We maintain that the current Panel structure should be strengthened across not only the FCA but also the PRA to ensure practical adherence to the memorandum of understanding on cooperation.

8.
We support the FCA's proposed single statutory objective and the enhanced approach to both the promotion of efficiency and choice and the requirement to discharge its functions in a way that promotes competition. We also welcome the inclusion of regulatory principles as well as the proposed controls for product intervention.

9.
But we continue to have concerns with how the new conduct regulator will practically apply its powers. There is a risk of scope creep if the FCA becomes too involved in product pricing and there is still not enough recognition on the face of the Bill of the broad spectrum of retail consumers and the different levels of protection that they require.

10.
We would urge the government to give full consideration to the detailed interactions between regulators, their new powers and respective day-to-day duties to avoid unintended detriment to consumers, firms and the mortgage market as a whole; and to make its conclusions clear during passage of the legislation.

Question 1: Is the separation of prudential and conduct regulation into a "twin peaks" system the right approach?

11.
We support the transition to a twin-peaks model of regulation, but remain concerned about how the PRA and the FCA will work together in practice. We welcome some of the details outlined in chapter six of the white paper, but the risk that regulators take divergent approaches remains. As far as is possible, the regulators must seek to minimise such risks and avoid presenting firms with a dilemma in the event that divergent requirements conflict.

12.
This is particularly pertinent given that prudential regulation measures can have a profound impact on conduct outcomes and vice versa. For example, in 2009 there were conflicting conduct and prudential issues connected to mortgages tracking the historically low Bank of England base rate. It is possible that similar concerns will arise from the FSA's guidance consultation on forbearance and impairment provisioning. This risk is exacerbated as both the PRA and the FCA will be proactive, judgement-led regulators that seek to intervene earlier in the process, to avoid detriment crystallising.

13.

Furthermore, the indication in the HMT's white paper and draft Bill states that where firms are dual regulated, the PRA will be the lead regulator and can, in certain circumstances, veto actions of the FCA. This could have an impact on firms where they are faced with conflicting regulation from the two regulators.

14.
The draft Bill creates a statutory duty for the FCA and PRA to cooperate, the details of which will be published in a memorandum of understanding (MoU). The MoU must be clear on how the regulators will resolve conflicting positions and regulation. We believe that, in the interests of transparency, where such conflicts are in the public domain the agreement between the PRA and FCA as to how this will be resolved should be published. It is vital that firms are given regulatory certainty to reduce risks of non-compliance and improve customer outcomes.

Question 4: Are the accountability and governance arrangements for the Bank of England, FPC, PRA and FCA satisfactory?

15.
For reasons stated in our response to questions 5 and 6, below, we think that there needs to be more checks and balances on the FPC. In particular, the statute should spell out how the FPC is to determine and communicate its definition of the key terms such as improved and clearer definitions around what constitutes risk and what is its risk appetite, as well as how it will differentiate between the 'short term', medium and long term and to what extent the FCA can sacrifice the contribution of the financial sector to economic growth.

16.
We have been consistent in pushing for safeguards that not only aid coordination and cooperation between the PRA and FCA, but also to make the regulators more transparent.

17.
We welcome the move to extend the current consultation requirements in FSMA to the PRA and to include a statutory duty for the regulator to put in place arrangements for engaging with practitioners. However, the lack of specificity on the detail of these arrangements is a significant concern. Section 2J subparagraph 1 of the draft Bill provides the PRA with broad scope to determine which practitioners it consults, when and in what form. At the very least, we continue to believe that the PRA should have a statutory duty to establish and maintain a practitioner panel.

18.
It would be significantly more beneficial if the FCA practitioner panel performed the same standing function for the PRA. This consistency of approach is particularly important given the potential for conflicting regulation of firms, to monitor the MoU on co-operation and comment on the efficient use of recourses. Having a shared standing committee of this nature, will not be a sign of 'regulatory capture' by the industry, it would merely ensure that practitioners have a formal role in the oversight and accountability arrangements of the regulator. It would also be a route by which practitioners could flag whether the two bodies were inadvertently taking different approaches and thus creating the sort of difficulty to which we refer in the preceding paragraphs.

19.

Save for these concerns, we believe that the proposed governance, accountability and transparency arrangements for the FCA, as set out in the white paper, are broadly appropriate.

20.
We strongly support proposals to enhance the FCA's accountability to government and parliament. There may be a case for looking at further ways to enhance accountability of the regulator.

21.
The current proposals seek to ensure accountability via appointments to the FCA's board, reports to HMT on regulatory failures and for an independent review of the regulator's efficiency and effectiveness. Given that the FCA's actions can directly impact on broader government policies, (for example restrictions on mortgage lending could have a dramatic impact on the government's housing policy), we believe that it is appropriate for the FCA to have to consider the potential impacts of its actions on all aspects of government policy and to set out the outcome of that consideration.

22.
This accountability could be limited to rule changes, or other actions, that would have sectoral or market wide impact.

Question 5: Are the FPC's objectives the right ones? Is the concept of financial stability adequately understood for the FPC to be able to perform against its objectives? Question 6: Should the FPC be limited in the actions it can take which might affect the growth of the financial sector?

23.
In our responses to the two HMT consultations in July 2010 and February 2011, we confirmed our support for the broad objectives and functions of the FPC. The clarification around the requirement for the FPC to balance its objective of financial stability in a way which is likely to avoid significant adverse effects on the capacity of the financial sector to contribute to the economy is also welcome.

24.
However, we do have some continuing concern about how the FPC will determine and communicate what its risk appetite is likely to be, particularly if this is established without due regard to macro-prudential regulators in other jurisdictions. The extent of this risk appetite will clearly drive how and when the FPC deploys the powers proposed in the white paper and draft Bill; and will be a crucial determinant in what effect the policy of the Committee will have on the mortgage market.

25.
The two risks outlined in section 9C subparagraph 3 of the draft Bill (systematic risks and unsuitable leverage) will ultimately be determined by the FPC's risk appetite and it will be important for those affected to understand the rationale behind it and be able to make their views known. Otherwise the Committee will have a significant and unchecked power which will have serious consequences for the operation and structure of financial markets, either through stifling competitiveness or inadvertently moving to a 'zero failure' approach.

26.
In section 9C subparagraph 4 of the draft Bill it states that the FPC's power can only be exercised in a way that does not have an adverse impact on the financial sector's ability to contribute to economic growth in the *medium* and *long* term. But there is no reference to the short term; or the impact which actions in the short term could have on the medium and long term.

27.
Consequently, we think that there needs to be more checks and balances on the FPC. In particular, the statute should spell out how the FPC is to determine and communicate its definition of the key terms such as improved and clearer definitions around what constitutes risk and what is its risk appetite, as well as how it will differentiate between the 'short term', medium and long term and to what extent the FCA can sacrifice the contribution of the financial sector to economic growth.

Question 11: Are the PRA's objectives clear and appropriate?

28. We generally support the objectives and scope of the PRA and welcome the amendments that HMT has made following responses to the February consultation. We maintain that both the PRA and FCA should have a competitiveness objective to ensure that the financial stability objective is discharged proportionately and without harmful consequences. But we still have concerns regarding some of the more detailed elements of the PRA's approach, particularly around cooperation and coordination – these are picked up in our answer to question 20 below.

Question 12: Are there any risks in the Government's proposed 'judgement-based' regulation?
Question 14: Given that the PRA and the FCA will inherit FSA staff does the draft Bill do enough to ensure a new regulatory culture and a more proactive approach to regulation? Will these two new bodies have staff with the appropriate skill and expertise?

29.
The concept of a judgment-led approach is a sound one, provided that it is evidence based, independent and not subject to external political and media pressures. It will also be necessary for judgements to be consistent, albeit not precedent setting, and undertaken by sufficiently senior and knowledgeable staff with appropriate governance oversight. Given how ill-considered proactive intervention could undermine consumer and market confidence, we would prefer these judgement-led decisions to be based on a tightly managed scorecard of influential factors.

30.
If a regulator is to intervene earlier in the process as part its judgement-based approach, it must be transparent in order to ensure that stakeholders understand its actions, even if they do not always agree with them.

Question 15: Are the FCA's primary objectives appropriate? Is significant emphasis given to the promotion of competition?

Question 17: Does the draft Bill strike the right balance between the responsibilities of consumers and firms? Are the FCA's new powers in the area of consumer protection appropriate?

31.
We welcome the clarifications in the white paper and draft Bill and support the single statutory objective of the FCA. Equally, we broadly support the three operational objectives. We would, however, echo the comments in our response to the February consultation paper, that the regulator should have an appropriate degree of protection for consumers should reflect a differential approach both between market and retail consumers, but critically between different types of consumer within the retail market also.

32.
In developing the MMR, the FSA has stated that it is not seeking to create a one-size-fits-all approach to mortgage regulation, recognising the differing needs, circumstances and financial capability of consumers. We strongly support this approach and believe that the FCA should apply a differentiated approach between retail consumers wherever possible and should be specifically allowed to do this on the face of the Bill.

33.
The enhanced approach to both the promotion of efficiency and choice and the requirement to discharge its functions in a way that promotes competition are positive changes as they will encourage a better understanding of the market dynamics that will be essential to inform the pro-active approach to the FCA (including its new product intervention powers). We also think that it is appropriate that the FCA should be able to make referrals to the OFT, where it believes that there are structural competition issues that are causing consumer detriment.

34.
In order to achieve this, the FCA will be required to look at product pricing to determine if there are any competition issues that it needs to address. But price regulation is not the government's intention for the FCA, nor should examination of product pricing be at the expense of considering other influential factors such as service, innovation and quality.

35.
Therefore we strongly believe that the draft Bill should be amended to reflect the government's intention in order to provide clarity around the scope of any new price intervention powers that may be necessary. Once the powers are framed in the legislation, the FCA should provide a clear view to stakeholders when and how the powers could be employed.

36. The inclusion of the regulatory principles is welcomed; in particular the acknowledgement of consumers being ultimately responsible for their actions. This is an important legal acknowledgement of an essential feature of an efficient market- but one which is lacking from the current framework.

Question 18: Are the prudential regulatory responsibilities of the FCA towards FCA-only regulated firms given sufficient emphasis and detail?

37.
In the context of supervising financial groups, there also needs to be clarity on whether financial groups will have a single prudential regulator. It may cause some confusion if subsidiaries are prudentially regulated by the FCA, whereas the core elements of the group are under the auspices of the PRA. We think that it should be determined by the treasury processes within groups. As most will have a single treasury function, they should have a single prudential regulator.

Question 19: Will the new regulatory arrangements reduce the risk and cost of dealing with mis-selling of financial products?

38.
It is important to recognise that systemic mis-selling in financial services markets is not widespread. The CML has regular meetings with the Financial Ombudsman Service where trends in new and upheld complaints are discussed. It is clear from these discussions that mis-selling is not a significant issue in the mortgage market.

39.
Aside from the specific issue of mis-selling, the FCA will have product intervention powers to mitigate the risk of consumer detriment before it crystallises. The CML's response to the FSA's discussion paper on product intervention (DP 11/1) outlined our views. The key points in the response relate to the uncertainty that product intervention powers can create in the market and the brake on innovation. We suggested that the FSA (and FCA) should review its current regulatory tools to determine if it can achieve the same outputs without requiring specific product intervention powers.

40.
In our view the most appropriate tools are the enhanced supervision of firms and some consolidated guidance or rules on what the regulator would consider appropriate management structures to govern the product development process.

41.
However, we accept that the FCA will have product intervention powers and we welcome the controls that the draft Bill will place on the use of these powers, requiring the regulator to consult on and publish a policy governing the circumstances in which it may make temporary product intervention rules and setting the maximum period of 12 months.

Question 20: Are the proposals for co-ordination between the PRA and FCA clear and adequate? What would be the advantages and disadvantages of having a Single Point of Contact and/or a joint rule book for dual-regulated firms?

42.
If the twin peaks approach is to prove successful, we believe that the ethos of cooperation must be ingrained in the regulators' day-to-day workings, with effective safeguards to prevent overlaps and/or conflicts. In our previous responses on this issue, we have highlighted the potential for firms to be placed in a position where they either breach conduct or prudential regulation. While this is a worst case scenario, there are likely to be situations where this will occur, and it may happen relatively frequently as the statutory objectives of the PRA and FCA will take them in different directions.

43.
The draft Bill creates a statutory duty for the FCA and PRA to cooperate, the details of which will be published in a memorandum of understanding (MoU). The MoU must be clear on how the regulators will resolve conflicting positions and regulation. We believe that, in the interests of transparency, where such conflicts are in the public domain the agreement between the PRA and FCA as to how this will be resolved should be published. It is vital that firms are given regulatory certainty to reduce risks of non-compliance and improve customer outcomes.

44.
We agree with HMT, that beyond the primary function of authorisations, it would be very difficult for the legislation to prescribe how the regulators co-ordinate. Consequently, the requirements for both regulators to agree to a memorandum of understanding outlining how they will co-ordinate and to report on how the MoU is working, at least annually, is the most appropriate tool.

45.
There may be other means within the broader accountability tools created in the draft Bill that could encourage better cooperation and coordination. As outlined in our answer to question 4, part of the function of the practitioner panel (currently only proposed for the FCA) could be to review the effectiveness of the MoU in delivering co-operation between the regulators and how that is benefiting firms. This, in our view, is a further good reason for a single practitioner panel that spans both the FCA and the PRA.

46.
We broadly welcome the amendments and clarifications in the white paper following HMT's February consultation. Before we respond to the detail of the FCA's objectives, we believe that that the FCA is likely to be seen as ultimately subordinate to the PRA because of the prudential regulator's right to veto FCA actions. As outlined above, and in paragraph 9 of the explanatory notes it states that 'the draft Bill establishes the PRA as lead regulator where firms are regulated by both the PRA and the FCA…'

47.
This is caveated by stating that the PRA can veto action by the FCA only where it is likely to lead to a disorderly failure of a firm. While these may seem like limited circumstances, they may occur more frequently then anticipated. If firms are aware that ultimate regulatory responsibility lies with the prudential body, their approaches to conduct of business are likely to be influenced as a result.

48.
Where firms are faced with conflicting regulatory requirements, it is likely that the PRA's regulation will take priority. This is primarily because the PRA will be the lead regulator where firms are dual regulated. The PRA's status is confirmed in paragraph 9 of section 4 of the Bill.

49.
This could create arbitrary differences within markets, where some firms are prudentially regulated by the PRA and others by the FCA. For example, non-bank lenders in the mortgage market will be regulated by the FCA for prudential matters and not the PRA. The different objectives of the regulators might well result in different approaches to prudential

regulation, given that the purpose of the purpose of the PRA is to promote the safety and soundness of firms (e.g. to ensure business is carried on prudently and to seek to minimise the adverse effect of a failure on the stability of the UK financial system), where as the FCA is to protect consumers and the market (e.g. failure of firms will not result in consumer detriment). This will ultimately impact on the products and process on offer and how they interact with consumers.

50.
Looking at more specific areas, we strongly support the need for the PRA and the FCA to coordinate when drafting rules to ensure that compliance with one regulator's rules does not result in non-compliance with the other's, as outlined in paragraph 2.169 of the white paper. This must be a central tenet of the MoU between the regulators, and should be subject to monitoring by HMT and the practitioner panel.

51.
We also agree that there needs to be close cooperation between the FCA and the PRA when supervising financial groups. Equally, as there are many different products and processes captured by the FCA, there must be clear lines of communication within the regulator to ensure a consistent approach to supervision. This is particularly important, given the new proactive approach of the regulator.

Question 21: How do the proposals in the draft Bill fit within the new European regulatory regime? What freedoms and constraints will the UK have to operate within that regime?

52.
The CML and our members have had significant exposure to proposed changes to European legislation, which would impact mortgage lending and administration in the UK. It is vital that the UK has, and continues to have, a coherent, consistent UK voice in international discussions. We would also welcome assurances that both regulators will give due consideration to impending European or international developments 'in the rear-view mirror', prior to consulting on and implementing UK regulation.

53. It is difficult to envisage under what circumstances both prudential and conduct regulation representation or engagement would not be required, considering the far-reaching consequences of international financial regulation reform.

54.
The FPC will also need to ensure that any macro-prudential tools it wishes to deploy are aligned with regulators in other jurisdictions if UK firms' global competitiveness is not to be undermined.

Question 22: Does the draft Bill contain any proposals or omissions, not covered by the questions above, which cause concern?

55.
We agree that enforcement should continue to be an active deterrent to firms and welcome the confirmation that although the PRA will have the same powers as the FCA, they are

likely to be used only rarely. We think that this is the correct approach for the prudential regulator.

56.
But we are disappointed that HMT is proposing to continue to give the FCA powers to disclose that a Warning Notice has been issued to a firm to support a more open and transparent regulatory approach. Paragraph 2.108 of the white paper recognises our concerns that the publication of notices could serve to undermine confidence in financial services, and that it **expects** the FCA to take this into account in setting its policy. Paragraph 2.188 of the white paper and section 24 (6) of schedule 8 of the draft Bill already include restrictions on publishing notices that could undermine consumer interests or market stability, this should be expanded to include confidence in the UK financial system (the FCA's statutory objective).

57.
We strongly agree that the Financial Ombudsman Service (FOS) should focus on processing individual complaints on a case-by-case and in doing so it should not seek to set legal precedent or change regulation. The same principles must apply to the formalisation of the wider implications referral process.

58.
We agree that the FOS should be able to make referrals to the FCA where it has evidence of large scale detriment with common underlying issues relating to a specific product and/or sales process. The FCA should be required to consult on, and then publish, the circumstances when the FOS can make referrals. Within this control there should be a clear understanding of what constitutes 'large scale detriment'.

59.
We would caution against the extension of the power to make referrals to the FCA to include consumer groups. The major concern we have is that such referrals are likely to be based on a partial or incomplete picture of a subset of consumers that have made contact with a specific group. Such referrals, in a worst case scenario, could be reactionary in response to speculative media coverage. The role of the consumer panel within the FCA structure, has been, and should continue to be, adequate in highlighting consumer issues that are of concern. The experience of the OFT with super-complaints will be relevant; and there should be a formal assessment of how that power has been exercised and the value which it has delivered before this power is granted.

60.
Finally, given the increasingly significant role of complaints management companies (CMCs) in the market, there is a strong possibility that the move to early intervention more broadly, as well as FOS referrals to the FCA, could create a self-fulfilling process. The actions could trigger the CMCs to cultivate complaints, thereby creating escalating the exact issue that the FCA is trying to avoid.

2 September 2011

Consumer Focus – written evidence

Executive summary

1. The impetus for this legislation is not only the financial crisis and its attendant affects, but also the waves of misselling by financial institutions which have caused hardship and wasted the money of so many consumers. Financial products are essential to society. We need people to save and invest, to use credit wisely and to take out insurance so they and their families are protected if things go wrong. To do all these things consumers need to know that their money is safe and that the products they buy are useful and offer good value for money. This then is crucial legislation and Parliament has a once in a generation opportunity to get it right.

2. Since the Financial Services and Markets Act 2000 (FSMA) was enacted we have experienced pensions misselling; endowment mortgage misselling; the failure of Equitable Life; split capital investment trust misselling; unfair credit card terms; unfair unauthorised overdraft charges; policy protection insurance misselling; and a major banking crisis. The new regime must be more effective at 'upstream' prevention. The Financial Services Authority (FSA) itself has learnt many lessons since FSMA was passed and strengthening the regime would benefit both consumers and the financial services sector.

3. The Financial Conduct Authority (FCA) will have a wide range of responsibilities and, if the consumer credit regime moves from the Office of Fair Trading (OFT), a huge number of firms to regulate. The challenges are significant.

4. 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. We argue for more transparency and accountability of the new regulatory bodies and against a veto by the Prudential Regulation Authority (PRA) on the actions of the FCA.

5. Regulatory frameworks in other sectors place consumer interests at the heart of their regimes. We consider there to be a strong case for the consumer interest in the new framework to be strengthened if we are to avoid further crises and damage to confidence and a sustainable financial system. We make the case for a change to the definition of the consumer so that it is clear who the FCA is protecting.

6. While stability is an important overall objective, it is surely not the only one for any public body. There must also be a concern for access to, and value of, financial services as they provide the oil on which the engine of the economy runs. It must be recognised that stability has an 'opportunity cost'. If a regulator only looks at stability it can too easily place restrictions on the supply, and cost of, credit to the wider economy. This could reduce access to essential financial services and push up prices. We are concerned that there is nothing in the statutory framework to limit the Bank or the FPC's discretion in this regard.

7. In light of these tensions we recommend changes to the objectives and 'have regards' of the FCA to make it focus on the outcomes that will benefit consumers and recognise their behaviour. In particular we challenge the arguments behind the concept of consumer responsibility in financial services.

8. We also feel strongly that promoting effective competition needs to be more central in the new regime. Competition will be more effective at delivering many consumer benefits, in the longer term, than regulation.

9. We welcome the work of the Joint Committee and look forward to a thorough scrutiny of the draft legislation before its introduction to Parliament.

Introduction

10. Consumer Focus welcomes the draft Bill and Government's commitment to improve the regulatory framework for financial services to prevent many of the financial and consumer crises we have seen in recent times.

11. It is critical that the statutory objectives set by Parliament for each body within the new regulatory architecture are well defined and understood, and that the institutions have the right mix of over-arching objectives, duties and powers to provide them with the tools and capacity to deliver. The relationship between the new bodies and the Treasury also needs to be clear.

12. **We have only answered those questions that have a direct bearing on the interests of consumers**, and have focused especially on questions 15, 17 and 19. We also have wider concerns about issues not specifically raised by the list of questions, which we have covered in our response to question 22.

13. The numbering of sections in the rest of this document follows the numbering set out in the Joint Committee's Call for Evidence.

Our evidence

1. The twin peaks system of regulation

14. There is some evidence from countries such as the Netherlands and Australia that the twin peaks approach can improve the focus of regulation and thereby its effectiveness. But this potential improvement will only be achieved if the right mix of statutory objectives, duties and powers is set out in the framing legislation for the new regulatory bodies and if they are then successful in delivering an appropriate culture within their organisations.

15. Achieving the right regulatory culture in the new bodies – the FCA, the PRA and the FPC – will largely depend on the effectiveness of their governance and accountability frameworks. But it will equally be heavily influenced by their appetite for risk, and the extent to which it is understood and accepted that there are significant risks and trade-offs in regulation. How these risks and trade-offs are managed should be openly debated and consulted on 'ex ante'[98]. This would help achieve as wide a public understanding as possible about the relative trade-offs between the different public policy objectives. These include increased stability; enhanced confidence in UK markets; stronger consumer protection; more effective competition; access to affordable loans, mortgages and other financial products; and so on.

[98] Before the event

3. The use of amending legislation

16. While the use of amending legislation may be more convenient for draftsmen and help ensure continuity and an easier transition, it makes it less easy to consider financial services from a first principles perspective. Much of FSMA was itself a revision of the earlier Financial Services legislation of the late 1980s and did not therefore represent a fundamental overhaul of the regulatory framework. This is why, for example, the definition of 'consumer' in financial services legislation is so out of step with legislation in other markets (we suggest changes to this definition below).

17. In our view it would have been preferable to start out again from first principles and produce new legislation. This would also have made it easier for stakeholders to engage with the consultation process in what is highly technical material, further confused by the process of amendment. We recognise however that this could have lengthened the legislative process, that transitional problems could be greater and that there could be a higher risk of inadvertently losing some good features of the old regime.

18. Once passage has been completed, we suggest that the Law Commission be asked to prepare a consolidated text.

4 and 8. Accountability and Governance arrangements

19. We do not believe the accountability arrangements set out in the draft Bill are adequate, particularly for the Bank of England Group. The new Bank of England (BoE) and its constituent parts will have an unprecedented suite of policy responsibilities and powers: monetary policy; financial stability; prudential regulation of banks and other credit institutions, insurers and major investment firms; resolution authority for banks and other major institutions; oversight of payments and clearing systems; and provider of special liquidity including lender of last resort.

20. The way in which the Bank and its subordinate bodies choose to discharge this cluster of important functions could have significant implications for the UK economy and the welfare of citizens and consumers, but there is no inbuilt public accountability mechanism for the Bank overall nor for large parts of its activity, other than retrospective reporting.

21. In terms of the FPC, there will need to be open and public debate about the extent to which greater stability on the one hand and economic growth and jobs on the other should be balanced. Ultimately democratically elected Ministers should be accountable for such trade-offs, yet the draft Bill leaves too much discretion in the hands of the FPC. The FPC currently has no obligation in the draft Bill to consult on its plans – reflecting the culture of central bank history where business is typically conducted behind closed doors. We believe that the FPC must become more transparent and accountable than is set out in the draft Bill. This should include being required to consult publicly on how it plans to exercise its powers and the criteria and analysis upon which it will base its decisions to act.

22. The constitution of the FPC is not acceptable, with inadequate independent public interest representation (as proposed it comprises the governor, five senior bank executives, four independent directors and the FCA CEO). At least one of the FPC members should have relevant expertise in representing the consumer interest, and there should be a majority of independent directors with relevant expertise.

23. In terms of the PRA and the FPC, we are very disappointed to note that while the good 'process disciplines' imposed by Parliament on the FSA under FSMA have by and large been carried through into the new regime for the FCA, a number are singularly 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, on its general policy approach to the discharge of its functions.

24. 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. To this end we are very concerned by the proposed PRA veto power over the FPC. Whether this is used or not, it shifts the power balance in the new system and will affect regulatory culture and status. It could also lead to the FPC not acting effectively in the interests of consumers. We do not believe it is necessary in view of the other safeguards built into the new system to ensure co-ordination and appropriate stability.

25. The FCA's own strategic objective – protecting and enhancing confidence in the UK's financial system – means the FCA could be 'ultra vires'[99] if it takes action that threatens confidence in UK markets or major UK institutions or threatens their stability.

26. There are also provisions in place to ensure effective consultation between the PRA and the FCA before key decisions are made.

5 and 11. FPC and PRA objectives

27. We do not believe the PRA or FPC's objectives are satisfactory. While both the PRA and FPC's primary objective should clearly be appropriate stability, there is nothing in the draft Bill that ensures they take into account the consumer interest – or indeed the fair and efficient functioning of the market as a whole – when making decisions. In particular, the PRA has no duty to have regard to the FCA objectives, most notably on consumer protection and promoting competition. The formulation of the Bank and the FPC's stability goal is silent on these issues.

28. Stability and competition are seen by some to fit poorly together. There may be an 'opportunity cost' to a focus solely on stability. We fear stability in the financial service markets will be pursued at the cost of genuine consumer-led competition and choice. Pursuit of effective competition may in occasional circumstances make maintaining stability a harder challenge. Yet from the consumer (and wider economic) perspective, effective and meaningful competition brings large efficiency gains, innovation, and better value products.

29. Excessive capital and liquidity requirements to make banks 'safe' serve to decrease the availability and increase the price of credit for consumers and small businesses. In addition, the takeover of HBOS by Lloyds TSB at the height of the banking crisis was allowed on financial stability grounds despite breaching normal competition law requirements. Both these examples demonstrate how policies to ensure stability may lead to consumer detriment. The potential tension between the policy goals of competition and stability needs to be recognised and resolved in the new regime.

[99] Acting without proper authority or rules.

12. Risks in 'judgement based' regulation

30. We agree with the '*judgement based*' regulatory approach as set out in the White Paper, and as set out in greater detail by the FSA in its '*FCA: Approach to Regulation* document. The FCA paper sets out a clear case why stronger, more pro-active regulation is needed and its intention to intervene earlier, stronger and more robustly. Fundamentally, it recognises financial markets are inherently poor at guaranteeing consumer value even where there is strong competition since behavioural biases mean firms may be incentivised to produce complex and misleading products.

31. Financial services regulators, whether PRA or FCA will need to have the level of skills and experience necessary to move away from a 'box ticking' reactive approach to a more proactive preventative modus operandi. This will require higher level skills, analysis, stakeholder engagement and sound judgement.

32. Quite clearly however, 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.

33. The FCA has the opportunity to instil a culture that is less excessively risk averse when challenging unfair practices than has previously been the case[100].

34. Conduct regulation is not, and can never be, a risk free activity, and it is important that the over-arching framework does not discourage necessary actions in support of consumer protection even where there may be some scope for successful challenge.

14. Regulatory staff and culture

35. 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.

36. The culture of an organisation tends to be led from the top and we applaud the Consumer Protection Strategy that has been initiated at the FSA since March 2010. 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, in the PRA and FPC as well of course as the FCA.

37. A key early task for the new Boards should be to set the organisation's appetite for risk. We agree the new regime should not be a zero failure regime. Mistakes are always made and avoiding a blame culture will encourage regulatory staff to take responsibility and exercise their powers fully rather than holding back. But this needs careful stakeholder engagement and handling skills.

15. FCA's primary objectives

What is a consumer?

38. We have a number of significant concerns over the general framework of objectives and principles for the FCA that is embodied in the current version of the Bill. But before

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100 Consumer Focus, *Rating Regulators, 2009*

discussing these concerns it is necessary to determine who the FCA is there to protect. The draft Bill falls into the same trap as 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.

39. We believe the definition of consumer in 1 (c)(3) of Clause 5 is far too broad. We see no reason why the definition of a consumer in financial services legislation should differ from those widely used in other UK legislation for example, as under Ofgem or Ofcom's remit. A potential definition of a consumer could be drawn from the current draft of the European Commission's Consumer Rights Directive where consumer means 'any natural person who [in purchasing financial products and services] is acting for purposes which are outside his trade, business, craft or profession'.

40. 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. As the FCA Approach document makes clear there is an ambitious remit for the new body.

Objectives

41. First, the wording of the single strategic objective is not strong enough to give the new FCA appropriate guidance as to its regulatory approach. We would like the FCA's strategic objective in 1B (2) to be:

42. 'protecting and enhancing *sustained* confidence in the UK financial system'.

43. 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. Adding the word 'sustained' will ensure the regulator never has the imperative to hide problems in the face of a drain of confidence. Sustained confidence also places equal weight to distant events thus reinforcing the importance of '*horizon scanning*'. The addition of *sustained* will ensure unambiguously that the regulator must think longer term and ensure it sees off problems before they become serious and that it is never tempted to hide problems to ensure confidence in the present.

Have regards to

44. Second, there is a need for additional 'have regards to'. 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.

45. 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.

46. We favour a strong competition objective for the FCA for reasons set out earlier in this response. We recommend clause 1B (4) of the Bill be amended however to read

47. 'The FCA must, so far as is *reasonably* compatible with its strategic and operational objectives, discharge its general functions in a way which promotes *effective* competition'.

48. Addition of the word 'reasonably' provides the FCA with more discretion about how to trade-off its various objectives. 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 the demand side as well as the supply side of the market needs 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, and where these problems persist then regulatory interventions beyond enhancing competition to protect consumers will remain necessary.

The new regime must adequately protect all consumers

49. Consumers are not homogenous in their needs for products and services nor 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.

50. 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.

51. We strongly believe that there is a need for the FCA to have an additional 'have regard to' to take account of the differences between consumers. We suggest that parts of OFCOM's objectives would be suitable for this purpose:

52. *'OFCOM must also have regard, in performing those duties, to such of the following as appear to them to be relevant in the circumstances –*

53. *(h) the vulnerability [of those] whose circumstances appear to OFCOM to put them in need of special protection*

54. *(i) the needs of persons with disabilities, of the elderly and of those on low incomes*

55. *(l) the different interests of persons in the different parts of the United Kingdom, of the different ethnic communities within the United Kingdom and of persons living in rural and in urban areas'*

17. Balance between responsibilities of consumers and firms

56. We are concerned about the way in which the draft Bill seeks to strike a balance between the responsibility of firms and consumers. In general, we believe the emphasis is still 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.

Are we savvy consumers?

57. It is too easy, in this context, to make unrealistic assumptions about consumers' level of knowledge and financial sophistication. Consumers in 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[101]. Meanwhile levels of financial capability, functional literacy and numeracy remain extremely poor. It is estimated that over 5.2 million UK adults lack the basic day to day competencies of functional literacy and 6.8 million lack functional numeracy. More than 20 per cent of adults, asked to choose between receiving £30 or 10 per cent of £350, opt for the lower figure. A recent FSA survey asked the question: 'if the inflation rate is 5 per cent and the interest rate you get on your savings is 3 per cent, will your savings be worth as much in a year's time?' – one in five gave the wrong answer[102].

58. Compounding this lack of basic understanding is the complex nature of many financial product contracts despite years of effort by regulators to improve disclosure. For example, the consumer document 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. It takes 55 minutes to read a standard consumer credit agreement, let alone understand it.[103]

59. 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

60. 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.

61. 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.

62. 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.

63. In our opinion there are strong arguments for the deletion from the bill of:

64. *'the general principle that consumers should take responsibility for their decisions'.*

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[101] http://bit.ly/oq0eOZ
[102] http://bit.ly/r3Ydnc
[103] *Warning: Too Much Information Can Harm*, Better Regulation Executive/NCC http://bit.ly/oUP3lj

65. 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*'.

17. Consumer protection powers for the FCA

66. 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.

67. But we think the proposed powers could, and should, be enhanced further still.

Ruling on what is fair

68. We believe the FCA should also have full powers to exercise consumer protection rules of fairness under Consumer Protection Legislation. The FCA should have clear powers to deal with generic product terms and pricing that it deems unfair. This would allow the FCA to tackle such issues as ancillary charges in current accounts.

Competition issues

69. We would like greater clarity on the face of the Bill about the boundary between the regulatory scope of the FCA and that of the OFT or new CMA. The FCA should have a statutory duty placed upon it to require it to investigate and respond to super-complaints from designated consumer bodies about practices causing consumer detriment in financial services markets. It should have clear powers to undertake market studies where it does not believe markets are functioning in the consumer interest or where effective competition could be improved. Just as it has the 'duty' under the proposed legislation to promote competition, so the FCA should have the powers to act quickly, decisively and effectively if there are barriers preventing competition from being effective 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

70. We believe more needs to be done to ensure the regulatory principles on openness and disclosure and transparency are achieved. The regulatory principles applied to PRA and FCA 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

71. The disclosure is still limited and it is unusual for principles to be qualified by 'as appropriate' and 'as possible'. S.348 limits the regulator's ability to publish firm specific information in their regulatory duties without the consent of the firm affected. The current

S.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 S.348 remains it is unlikely that the interpretation will change.

72. 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, a presumption that a warning notice will be published and finally earlier publication of decision notices *once* the decision has been made rather than after all appeals have been exhausted. The proposed changes stop short of this, are qualified, and are likely to be subject to the same legal arguments from industry. We call for amendments to S.348 and the definition of '*confidential information'* to allow the new regulatory principles to empower the regulator to use transparency as a regulatory tool.

Why we need greater transparency

73. 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 Ofgem, OFCOM and the ASA, to publish the initiation of enforcement proceedings. This would allow it to demonstrate it is delivering on its statutory duty on 'enhancing *sustained* confidence in the UK financial system'.

74. In energy markets, Ofgem announces on its website when it is investigating firms for breaches to the licence.[104] It also openly reports after nine months what has happened to the investigation. Equally, the Advertising Standards Authority (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.

75. 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'*.

76. 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.

77. Parliament must give the future FCA the regulatory tools to enable enforcement action to be quicker, less costly and less onerous on regulatory resources. We are aware of the difficulty the FSA has experienced – even with key techniques such as mystery shopping – in gathering sufficient evidence of a robust enough nature to proceed with enforcement action. To support the FCA's new intensive supervisory approach, we favour a change to place financial services enforcement action within a civil rather than a criminal regime, and subject to a balance of probabilities test. This should allow the FCA to accept wider notions of

[104] Ofgem, *Enforcement Guidelines on Complaints and Investigations*, 232/07

evidence than in the past, and allow enforcement action to be quicker with a lower threshold to prove regulatory breaches. It would be a strong incentive for firms to avoid consumer detriment and 'gaming' the regulator and its enforcement procedure if future enforcement action was quicker, more robust and made public.

Transparency can help fuel competition

78. 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.

19. Impact of new regulatory arrangements on the risk and cost of misselling

79. We hope the enhanced powers proposed in the Bill, alongside the revised FCA approach of which we strongly support, will go some way to preventing detriment. But for the reasons stated elsewhere in our response there are real concerns about whether the powers, tools and objectives in the draft Bill are sufficient to prevent the many forms of detriment consumers have suffered in financial services markets.

80. 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

81. In terms of consumer detriment, we believe it is vital that the current arrangements under the 2002 Enterprise Act for super-complaints are extended to give designated consumer bodies the powers to refer super-complaints about financial services direct to the FCA rather than to the OFT as at present. The FCA would have a commensurate statutory responsibility to investigate and respond to the super-complaint in a timely fashion. Super-complaints have proved an effective policing and influencing tool for the retail market as organisations such as ourselves, Which? and Citizens Advice have been able to raise cases of significant detriment with the OFT for priority action. We strongly urge these powers to be clear on the face of the Bill. At the moment the draft Bill only refers to '*referral powers'*, including from other bodies funded from the levy (MAS and FOS).

82. Our super-complaint on cash ISAs, which resulted in the maximum time of transfer being cut to 15 days from 23 days and interest should be paid on every day of the transfer is estimated to have saved consumers up to £14.5 million.[2] Equally, it was a super-complaint from Citizens Advice that eventually lead to PPI compensation. The ability to refer such

super-complaints direct to the FCA with its detailed knowledge of the market and its wide range of powers to take any necessary action would improve regulatory efficiency and effectiveness.

83. 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.

22. Other areas of concern

Scope

84. 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 workprogramme 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.

85. 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.

Oversight of payment systems

The BoE 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, recognising the crucial need to maintain the integrity of payment systems in the event of failure of a major bank or other institution. 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.

September 2011

Consumer Focus; Reserve Bank of Australia; Which?; Citizens Advice Bureau; moneysavingexpert.com; Mr Paul Lewis; Financial Services Compensation Scheme; Financial Ombudsman Service and Money Advice Service – oral evidence (QQ 99-206)

THURSDAY 15 SEPTEMBER 2011

Evidence heard in Public　　　　Questions 99 - 206

Members present:

Mr Peter Lilley (Chairman)
Mr Nicholas Brown
Baroness Drake
Mr David Laws
Lord Maples
Lord McFall of Alcluith
David Mowat
Mr George Mudie
Lord Newby
Mr David Ruffley
Lord Skidelsky
Baroness Wheatcroft

Examination of Witness

Witness: **Dr Malcolm Edey,** Assistant Governor (Financial System) of the Reserve Bank of Australia, examined.

[This evidence was taken by video conference.]

Chairman: Dr Edey, thank you very much indeed for joining us from Australia. We are grateful to you and are very interested to hear the experience of your country.

Q99 Baroness Drake: Dr Edey, Australia weathered the global financial crisis well compared with the UK. That certainly seems to be the common view. To what extent in your view was this due to proactive regulation in Australia, and to what extent was it due to the particular characteristics of the Australian financial markets?

Dr Edey: It is true that Australia did well during the financial crisis. We did not have a recession, bank failures or the need for public funds to be injected into the banking system. I am often asked for the explanation for it. My usual answer is that it was a mixture of good luck and good management. The good luck side of it is that Australia is fortunate to be closely integrated with the Asian economies which performed better than the United States and Europe over recent years. We have been benefiting from a commodities boom here, and that has been very important to our performance. Certainly, that has not been the sole driver. I think we have been well served by our prudential regulatory system. As you probably know, Australia has a regulatory model quite similar to the UK's, so we have a prudential regulator separate from the central bank. I think our prudential regulator served us well. They had a fairly tough-minded approach to setting standards in a number of respects. They set tougher capital standards than were applied to banks globally, and I think they also had a more proactive approach in using their discretion to resist unsound practices.

There are other factors behind Australia's performance. I think the fiscal position of the Government coming into the global crisis was very strong and allowed plenty of scope for the Government to engage in a counter-cyclical fiscal policy to cushion the effects of the crisis. The Reserve Bank was fairly proactive in keeping up the level of interest rates in the boom times heading into the crisis, which meant we had a lot of room to manoeuvre in cutting rates when the global economy turned down. A whole series of things contributed to the overall performance.

Q100 Baroness Drake: Did the agreement between the banks not to take each other over have a significant behavioural effect on them?

Dr Edey: I am not sure what you mean by the agreement not to take each other over.

Q101 Baroness Drake: I may be wrong, but my briefing said there was an understanding between the banks, not necessarily enshrined in law, that they would not take each other over or take predatory action against each other. Is that not correct?

Dr Edey: We have a policy here which we refer to as the four pillars policy. Australia has four major banks which together have about three quarters of the market in banking services in Australia. The Government's policy for some time has been not to allow takeovers to occur among that group of four, which would further concentrate the system. I think that is what you are referring to. Would you repeat the second part of the question?

Baroness Drake: To what extent did the existence of that policy have a significant impact on the behaviour of the banks—

Q102 Chairman: —in reducing their incentive to compete with each other by over-lending, operating on lower capital requirements and so on? Was there less incentive than there might have been had they been trying to ramp up their share prices and profitability to take each other over, or avoid being taken over?

Dr Edey: Yes. There is probably something in that. I would not say that our system was completely uncompetitive, but some commentators have made the case that the Australian banks were not as aggressive in competing for market share, for example by lowering their lending standards, as was the case in some other countries. I think there is something in that argument.

Q103 Chairman: Perhaps I may add a follow-up to Baroness Drake's first point about the underlying causes of your greater stability. In America, the UK and some parts of Europe the banking crisis was related very much to a prior lending boom in housing, driving up housing prices. When the house price bubble collapsed it led to problems for the banks. Was there a similar housing bubble in Australia? Were efforts made to puncture or moderate that bubble earlier than in Britain and America? Can you tell us a little about that aspect of the situation?

Dr Edey: We had our housing boom in about 2002-03. If you look at a graph of Australian and UK house prices they look very similar during that period, but, unlike the UK, we really did not have a follow-up boom during 2006-07. In Australia during 2002-03 the regulators saw that as a source of risk to the financial system and the economy. We took some steps to try to rein that in. Probably the main thing the Reserve Bank did was to make public statements to try to warn people of the risks, but it was also a period when we were raising the policy interest rate. That also played a role in helping to take some of the heat out of the market. At that time APRA was also aware of the risks in that area and of using the powers available to them to discourage banks from excessive expansion. That was one of the reasons why a few years later we did not get into so much difficulty during the global downturn because the main boom in house prices in Australia was further in the past and there was not so much overstretch left over by the time we got to 2007-08.

Q104 Lord Newby: Dr Edey, you described how good management played a significant role in avoiding some of the worst problems that we had here in the banking crisis. How much do you think that was due to the regulatory structure itself and how much to the ethos and wisdom of the people operating it?

Dr Edey: My feeling is that it is more the second one of those. I do not want to say we have better people than other countries, but the regulatory culture in Australia may have been different from the one that prevailed in other countries. In financial regulation, particularly prudential policy, there are laws that stipulate what banks can and cannot do, but there is also a lot of soft power available to the regulators to influence the way the institutions that they regulate will behave. Some regulatory cultures are more comfortable than others with making use of those softer powers.

In Australia APRA would describe itself as being towards the end of the spectrum; that is, it would be more comfortable with using its persuasive powers and ability to put pressure on institutions to try to influence the way they behave. It is important for prudential regulators to be able to ask tough questions of institutions about the risks that they take and not take too mechanistic and legalistic an approach to the way they regulate. APRA was probably more towards the end of the spectrum that was comfortable in taking that sort of approach.

You might ask why APRA has that characteristic. One reason for it is that very early in APRA's history we had a significant failure of an insurance company called HIH, which was one of the major insurers in Australia. There was subsequently a royal commission into what

went wrong and all the various ways in which the institution itself got into difficulties, and how the regulator missed seeing that until quite late in the process. APRA took a good look at its regulatory procedures in the aftermath and learnt the lesson from that episode that it was very important to take a proactive approach in the way you prudentially regulate institutions.

Q105 Lord Newby: As you have looked around the world from the relative security of Australia in this respect, have you drawn the same conclusion as you have watched what has been happening elsewhere, namely that although the structures vary from country to country—some have twin peaks, some do not—the way in which the regulators have chosen to interpret and exercise their mandate has had a greater influence than the actual structures in which they have been operating?

Dr Edey: Possibly we will talk a little more about this as we go on. I can see advantages and disadvantages to the twin peaks model. Both the twin peaks and unified central bank regulator models can be made to work. The most important thing is how the regulators go about their task in the way I described when I talked about how APRA did their job. I do not want to comment on the jobs done by specific regulators because I just do not know enough about exactly what has happened in every individual country, but I think that has been an important factor for Australia.

Q106 Lord Skidelsky: In Australia the micro-prudential regulator is separate from the central bank. Would there be any advantage in the micro-regulator coming under the central bank, as is proposed in the UK, and do you have any such regulatory change in mind?

Dr Edey: There is no proposal to do that in Australia at the moment. It is not really on the agenda because, given that our system came through the crisis in good shape, nobody is really advocating that we change the current regulatory model. You may be aware that we used to have bank supervision inside the Reserve Bank. The current structure was created in the late 1990s following the Wallis inquiry in Australia when bank supervision was taken out of the RBA and combined with the insurance regulator and the regulator of smaller deposit-takers to create APRA. Therefore, we had some experience of both models in Australia. The advantage usually claimed for bringing all of that inside the central bank is that it would ensure co-ordination among the central banking, monetary policy and the regulatory functions. You do need that sort of co-ordination. The disadvantage of doing it is that prudential supervision is a very big job. When we had bank supervision inside the central bank we found that for most of the time outside a period of crisis nothing was happening in the regulatory sphere, so central banks tend to focus most of their energies at the very senior level on the monetary policy function. I think there can be a case for separating out and specialising the institution that does regulation so it is more focused just on that task, but if you are to do that you need good co-ordination mechanisms between the two.

Q107 Lord Skidelsky: We have been concerned with the question of how you manage a potential conflict among micro-prudential and macro-prudential policies, financial stability and fiscal liability, financial stability and growth and monetary and macro-prudential policies. Do those conflicts arise? Have you experienced them? How do you deal with them?

Dr Edey: I do not think we have experienced any serious conflicts between those things. When we talk about macro and micro-prudential supervision, the boundary line between those is not always distinct. The way I think of it is that most of the instruments for prudential regulation are really micro-instruments to do with capital ratios and controls on what individual banks can and cannot do with their balance sheets. To my mind, macro-prudential policy really means using those instruments with the objective of stabilising the system as a whole rather than just the individual institutions. In a way, what we are talking about is using the same instruments but with a broader objective. It is system-wide rather than institution specific.

In Australia APRA is the micro-prudential supervisor and most of the time they are looking after the safety of individual institutions. The Reserve Bank has a macro-financial stability mandate. We are given the task of overseeing the stability of the system as a whole, but APRA has most of the instruments you need if you want to take regulatory action in relation to financial institutions. Therefore, you need co-ordination. We co-ordinate that through a group called the Council of Financial Regulators which consists of APRA, the Reserve Bank, the Australian Treasury and the Australian securities regulator. But we have never found any conflicting objectives or perspectives on policy within that. When you think about how micro-prudential supervision works, the safety of an individual bank is closely tied to the stability of the system as a whole. Those two things are very much interrelated rather than being in conflict.

Q108 Lord Skidelsky: To be clear, are you saying that the central bank has two mandates: one is presumably price stability, or an inflation target, and the second is to maintain financial stability?

Dr Edey: Yes, that is right. Under the Reserve Bank Act, which is our governing legislation, we have a very broad mandate which covers price, currency stability, full employment and the general prosperity and welfare of the people of Australia. Potentially it covers anything that can come under any of those three headings. In more recent times, the Government have sought to clarify the mandate and make it more specific. Therefore, we have a specific price stability mandate that is agreed with the Government. We also have a financial stability mandate. That is the more modern redefinition of the mandate specified under the Act, but the Reserve Bank Act itself gives us a very broad mandate.

Q109 Mr Mudie: You answered one of my questions in your previous answer. Just on the point you have made, we have a target for inflation. Do you have different or additional targets on the stability front? You mentioned employment and welfare. Do you have specific targets in those fields, like unemployment and growth?

Dr Edey: We have only one numerical target and that is for inflation. Our target is 2% to 3% on average over the medium term. That corresponds to the Bank of England's target of 1% to 3% inflation. We have objectives to pursue full employment, financial stability and the general welfare of the people of Australia. Those things are not converted into numerical targets in the same way as the inflation target is.

Q110 Mr Mudie: When we had our crisis the big question was: who was in charge? On the macro-prudential side, what powers does the central bank have? Is it just a power of persuasion? The Council of Financial Regulators does not seem to have any statutory power. Is it just persuasion, or does it have any statutory powers over the regulator?

Dr Edey: The council has no statutory powers, so it is simply a body which co-ordinates the individual powers of the four agencies that comprise it. The powers of the Reserve Bank as you have said are those of persuasion. The Reserve Bank also has power to engage in transactions in the financial markets. Like a lot of central banks, we are active in foreign exchange and money markets, providing liquidity to the banking system. The second of those powers is very important in a crisis, because often you get self-fulfilling panics. People become reluctant to lend because of uncertainty. People become short of funds simply because of that self-fulfilling uncertainty, and in those circumstances central banks have an important role to play in providing liquidity to the system. Therefore, we play that role. Other than that, our role is, as you said, mainly persuasive. The Governor of the Reserve Bank is the chair of the Council of Financial Regulators, so we have a leadership role in that regard. We have done a lot of work with the other financial regulators, including APRA, to think through the procedures we need to follow in crises and stress situations to try to work out exactly how we will deal with them in co-operation with one another, but that relies very much on the individual powers of the institutions, not any overarching power of the council.

Q111 Lord McFall of Alcluith: During a crisis what is the channel to the politicians regarding the Council of Financial Regulators; in other words, when the money has to be given out how is that managed with the Reserve Bank and others?

Dr Edey: The Reserve Bank has only power to lend or buy and sell financial instruments in the market, so we do not see ourselves as being an institution which would bail out insolvent banks. In the recent crisis banks did not need any bail-out funds anyway, so the question did not arise, but the position of the Reserve Bank is that we do not hand out any funds.

Q112 Lord McFall of Alcluith: My question relates to the management process between the Reserve Bank and others and the Government itself. When the crisis struck in the UK we had a tripartite authority and the Chancellor of the Exchequer was an integral part of that. What is the equivalent of that in Australia?

Dr Edey: I do not know enough about how the tripartite authority works, but it sounds as though it would be playing a co-ordinating role similar to that played by the Council of Financial Regulators here. The council plays an important role in advising the Government. If we felt some action needed to be taken in an emergency we would be advising the Government that they needed to do that. If funds from the fiscal authority needed to be handed out for some reason that would be a decision for the Government, but the council would see itself as being available to provide advice on that.

Q113 Mr Laws: We have already had some discussion about macro-prudential regulation in Australia over the last few years. Can you run through the major tools that have been

used since 2001 and indicate how effective you think they have been in securing the outcomes you described earlier?

Dr Edey: The main prudential tools that APRA has at its disposal are to do with the capital and liquidity standards for the banks. A lot of that is written into rules about certain ratios and standards that banks have to meet, but APRA also plays a role in going through the way banks provision for loan losses and calculate their exposures to various forms of risk. Therefore, they have a significant influence over the amount of risks that banks can take just by the way they go through those calculations with the banks. APRA also talk to the banks behind the scenes. If they see that banks are systematically taking too much risk in some area they will talk to a bank privately about that. That sort of conversation can have a lot of influence over the way a bank behaves.

Q114 Mr Laws: Are you considering bringing in any new tools in relation to macro-prudential regulation in Australia, or do you feel you have more or less what you need?

Dr Edey: I think the main one that would be under consideration is what is known as the counter-cyclical capital buffer. That is a tool which has been designed specifically by the Basel Committee for inclusion in the Basel III framework internationally. The way that buffer works is that a prudential supervisor would make an assessment as to whether or not credit expansion by the banking system was excessive, and various tests would be applied to determine whether that was the case. If it were the case, the prudential regulator would impose an additional capital surcharge on the banking system as a whole. That would build up capital buffers and have the effect of making it more difficult for banks to expand their lending, and it would also create a buffer that you could release in the event banks get into difficulties later on. That has been proposed internationally. APRA is considering it in Australia, but to have a good sense of how it would work is some way off because it has not been used in the past.

Q115 Mr Laws: Would it be fair for us to read your evidence as suggesting that people in Australia are pretty happy about the way the regulatory system works and responsibility is divided up or, in the same way that we are considering throwing things up in the air a bit in the UK, has the financial crisis prompted any re-evaluation in Australia about how the regulatory system is functioning, or should function in the future?

Dr Edey: People are pretty happy about the outcomes here. I do not want to sound complacent about that. It has been a mixture of good luck and good management. I know we do not want to be complacent about that. There is a global effort going on to tighten up regulatory standards further and we will be taking that on board in Australia. I think that either of the two regulatory models can be made to work. I can understand why, if you feel there has been a problem of co-ordination, you may want to change the system and try to get better co-ordination in a different way. In Australia I think the attitude is that the system has worked well in the latest period and so we do not see a need to change it.

Q116 Baroness Wheatcroft: I would like to ask you a little about those who are regulated rather than the regulators. There is a suggestion here that we should ring fence the retail side of banks. I would be fascinated to hear whether you think that is a good and

workable idea or that the issue is more one of the governance and ownership of banks. Can you also say a little about how Australian banks are owned and governed?

Dr Edey: The issue of ring fencing really has not come up in Australia simply because Australian banks do not have very large investment banking activities. The big four Australian banks that comprise a large part of the banking market here really do most of their business in core deposit-taking and lending rather than investment banking activities. The idea of ring fencing really has not come up. Looking round internationally, there have been cases where banking systems have got into difficulties through international contagion, where you had very large banking systems in relation to the size of the domestic economy and very large international banking activities. There were a number of cases where that became a source of international contagion. That is really the issue which has given impetus to the question of whether you want to ring fence the core domestic operations of the banks in cases like that. It is well worth thinking about. I would not claim to be able to give you expert advice on it, but it is well worth thinking about ways you can limit the capacity for international contagion of that type. The sort of ring fencing proposal that the ICB is talking about is one way of addressing that. Another way of addressing it is by looking at subsidiarisation structures for international operations. Again, I cannot claim to give you expert advice on that, but I think it is well worth looking at.

Q117 Baroness Wheatcroft: One of the reasons the banks went from retail banking into investment banking was in a search for higher and higher returns on capital. Can you say a little bit, as I suggested, about the ownership and governance of Australia's banks and whether that might explain why they did not go in search of the same sort of returns, at least this time round?

Dr Edey: There are different views on that here. One view, which I think has some truth to it, is that during the period leading up to the crisis the Australian system was still adjusting to an earlier period of deregulation and an adjustment to low inflation and low interest rates. Therefore, there was a big domestic expansion of the Australian financial system already under way and plenty of growth opportunities, within what you might say is the traditional domestic market, allowed banks to be highly profitable, even without pursuing these other more international or newer market areas. I think that in the post-crisis environment it is important for banks to have realistic expectations about the sort of profit growth and balance sheet growth that is achievable, because one of the potential sources of risk is that if banks set themselves unrealistic expectations they expand into areas where they need to take on more risk, or risks that they do not understand. That can expose a financial system to problems further down the track. We have been actively trying to get that message out in Australia, and I think it is becoming well understood what the growth opportunities were. I think it is important for banks worldwide to have realistic expectations about how quickly they can grow their businesses.

Q118 Baroness Wheatcroft: To a certain extent my final question relates to what you have just been talking about. There are four major banks in Australia. The situation here is not so different. How do you ensure that there is a competitive environment for consumers?

Dr Edey: This issue has been the subject of quite a bit of discussion in Australia recently. One of the consequences of the crisis was that the big four banks gained some market share. One of the reasons for that was that the markets that fund banks and other lenders in Australia became more cautious, so it became harder for some of the smaller institutions to fund growth of their balance sheets in the post-crisis environment.

There is a lot of debate in Australia about how competitive the system really is. In the pre-crisis environment it was pretty competitive on the lending side. Post-crisis, it has become more competitive on the deposits side. Because of the issue of funding that I just mentioned lenders have been competing harder in the deposit market to get the funds to enable them to continue expanding their lending. The Government have focused on the issue of competition in Australia. A package of measures was taken recently to try to address that. It included things like account switching procedures to make it easier for people to switch banks and promote competition in that way. It is something on which we have been focused, but I do not know whether there is any magic solution to it.

Chairman: Dr Edey, thank you very much indeed for your evidence. It has been extremely clear and helpful and it has got us off to a very good start to our day's proceedings. We are very grateful to you for staying on late and getting us up early and off to such a good start.

Dr Edey: Thank you very much. It's been a pleasure.

Examination of Witnesses

Witnesses: **Christine Farnish,** Chair, Consumer Focus, **Peter Vicary-Smith,** Chief Executive, Which?, **Gillian Guy**, Chief Executive, Citizens Advice, **Martin Lewis,** moneysavingexpert.com, and **Paul Lewis,** freelance financial journalist, examined.

Q119 Chairman: Thank you very much indeed for coming to us today and the evidence you have already submitted. We are very grateful to have a very distinguished panel of witnesses. It is going to be slightly difficult because, obviously, we do not want five replies to every question. On the other hand, we want to draw on all your experience and expertise. Perhaps I may start the ball rolling by putting a general question—but please do not feel that all of you are obliged to answer it—about the application of regulation to ensure we do not have future crises without, in the process of preventing them, restricting consumers' access to financial products. Would anybody like to give us some observations on that?

Christine Farnish: I would be very happy to kick off, if I may. Obviously, it is very important we strengthen and seek to improve the UK's regulatory regime in the wake of the recent crisis. The danger will be that we lurch too far in one direction in pursuit of a single objective. As we all know, the world is a lot more complicated than that. We have quite

serious concerns about the fact that very significant powers are being given to the new Bank of England group. The FPC will be able to direct the new regulatory bodies, both the PRA and the FCA. The PRA will have a veto over the FCA. We do not think the balance is right yet in this draft bill; it is too one-sided. If you go too far in terms of financial stability obviously you will not deliver what is required for both the UK consumers and businesses in this country. It is a balancing act, and we think the strategic objectives are not yet sufficiently balanced.

Q120 Chairman: Is that a general view?

Martin Lewis: When I went through it I had to read it again and again until I started to understand how the system began to work. Even once I started to understand what the FPC, PRA and FCA did—frankly, there are more acronyms than the driving licence authority—I realised that it did not include competition and credit, which are what people think finance is about—making sure it is competitive and there is credit out there. As an overarching starting point, even trying to work out what everybody does is incredibly difficult for an experienced personal finance journalist. How the hell the public will ever grasp and have confidence in this form of regulation I do not know, because it is way too complicated. The names are far too complicated. We are using acronyms already which just do not help anybody. The names are not descriptive. When you look at where consumers are in this—it is the third body that cannot look at competition and does not really deal with credit, which is what I tend to have most problems with because debt is really what it is all about. Then you may have some consumer representation on the consumer panel, but the other two big and important bodies do not. Therefore, when a decision is made that we need to curtail the amount of lending done by the FPC because it is impacting the economy, and suddenly realise that effectively you trap people in their existing high-rate mortgages so they cannot remortgage and leave them stuck at that level, we have a real problem about the limited extent to which consumers are being thought about in the system. More importantly, we cannot have faith in a system we do not understand.

Paul Lewis: The FCA, as Martin Lewis has said, is the only one that has any obligation towards consumers, and it has to provide the appropriate degree of consumer protection. We really need an agency that provides consumer protection, full stop. The kind of dilemma it will have, which is exactly the one I pointed out to the FSA over many years, is that if the FCA knows a bank, building society or financial body is in trouble, to protect consumers it should tell everyone. To preserve the market it should keep its secret. Dealing with that conflict is, I am sure, going to come down on the side against consumers and they will be left in the dark. The degree of interplay between them is not clear, and consumers should be much more at the heart of at least the FCA because they are nowhere else.

Q121 Baroness Wheatcroft: You can look after the interests of consumers only if you are doing so within a stable financial environment. Would it not be fair to say that part of what went wrong with our previous regulatory system was that the FSA, albeit it did not do it terribly well, focused far too much on the consumer side of things while nobody was actually looking after the overall financial environment?

Paul Lewis: I would not say it did look after consumers very well. It has changed recently but that has been since the crisis in 2007-08. Before that, it did not do enough for consumers.

Martin Lewis: I am absolutely flabbergasted. You must live in a totally different world from me. The FSA has done bugger all for consumers over a long period of time and left them completely in the dark. I first wrote about PPI in 2001. There was a super complaint in 2005. There was an 80% uphold rate by the ombudsman and £6 billion being paid out. We nagged the FSA and it did nothing. It did nothing over bank charges. I do not know what world you live in, but I certainly do not think the FSA did very much for consumers. People do not think the FSA did very much for them. When I asked people what they wanted me to say here, everybody said, "What does the FSA do? It's done nothing to help us." You must have a different period of reflection. I agree that overarching stability of the system must be fundamentally important, but hopefully that crisis comes once in a generation and we need to have the right structure. The day-to-day problems of real people are about their interaction with financial services that are far too powerful and tend to operate in ways that they do not understand. We are a financially illiterate nation being held at the mercy of banks and big financial institutions. I think the regulator has had the power but not the will or institutional idea behind it to look after consumers, so we come from a very different perspective.

Q122 Baroness Wheatcroft: Mr Lewis, I said they may not have done it effectively. Nevertheless, with initiatives like treating customers fairly I contend that the focus of the FSA was far too much on the consumer side of things and nobody was looking at the macro side. Christine Farnish is probably in a better position than I to address this point.

Paul Lewis: I absolutely disagree with that, as Martin Lewis has said.

Gillian Guy: Perhaps I may put a different perspective. In Citizens Advice we are dealing with over 2 million consumers every year. We are talking to them about the issues they confront and do not expect legislation necessarily to be crystal clear to everybody at First Reading. It is a job we all need to engage in to make it clear to people what the Bill will do and try to simplify and strengthen the regime. As Christine Farnish has said, it must be a question of balance between prudential regulation and conduct. From our perspective, it is very important that it is not just about how the organisations are set up but their culture and whether they are likely to be champions for consumers through the FCA. For us, all consumers are not just a homogenous mass; some are much more vulnerable. There are issues of equality where people need particular consideration, and that impact needs to be considered in the prudential area. We also need to think about strengthening the "have regards" in the FCA and be proactive in preventing consumer detriment and minimising that for vulnerable consumers. We will probably want to say something about strengthening the objectives to make sure there are outcomes attached for consumers so we can then explain what difference this will make, as opposed to exactly what it will do.

As to the culture itself, we would like a super complaint attached to the FCA so we can see, as we did at Citizens Advice through PPI, that action will be taken and it will not just be words on paper, which is important in explaining the position to the consumer. We would also ask for credit control probably to go in that direction and to have a rules-based system so we can ensure it is not just enforcement after the event but rather heavier regulation of

what goes on in the credit arena. At the moment too many people slip under the bar, get through the threshold and become registered. There are many rogue companies out there and a lot of consumers are suffering, and it is always the vulnerable ones who suffer most.

We can see some benefit in strengthening the current system. In that regard we would also want to keep the CCA—the Consumer Credit Act, for those who do not like acronyms—but strengthen and build on it in order to have a rules-based system through the FCA.

Peter Vicary-Smith: This cannot be an either or. We cannot say either we want to do good prudential regulation or good consumer regulation. The truth is that we need both done well. The FSA did not do either well. We should not be getting into trade-offs. We need bodies that can handle both sides, because if the prudential regulation fails the market is messed up for everybody. If the consumer regulation fails, then consumers will not have trust and purchase. Both have to be done well.

Martin Lewis: To go back to my initial point about the complexity of the system, if it is so complex you do not understand how you are being protected you do not have confidence in it. If consumers do not have confidence that is a prudential macro issue, because they do not want to deal with banks. People—thankfully, not many—talk about putting money back under the mattress again. None of us wants that. Your home insurance is not anywhere near as good as the FSCS. What we want is to make sure there is confidence in this complex system. If I may echo what Gillian said, and this has been the position for years, the fact that a bank account is regulated by the FSA when in credit but probably by the OFT when it is overdrawn because it is consumer credit is just nonsense. People do not understand why financial regulation doesn't include debt and credit. There should be one body. A bank is one body and it needs to be regulated in one place, and competition and credit need to be part of this. To have a regulator that cannot look at competition means you have neutered it from the start.

Q123 Baroness Wheatcroft: Are you uncomfortable with it all being taken under the wing of the Bank of England and with the governance of the Bank of England itself?

Martin Lewis: To be absolutely honest with you, that is above and beyond my pay grade looking at a macro level. I want a body that works and has a culture that looks after and helps consumers. We have not had that. If the august ladies and gentlemen in this room will forgive me, you can come up with whatever system of regulation you like, but unless you change the culture of the organisation to protect individuals it is not worth the paper it is written on. They have had many of the powers we have wanted for a long time but they have not been used. If I were doing this I would have people in a room of that organisation whose brief was to read social message boards, listen to what consumers were saying, read the newspapers and say, "Well, that's an interesting issue. Should we be looking at that to make sure there isn't a problem about to happen?" so they are ahead of it, instead of waiting for people. We had over one million template letters on payment protection insurance downloaded before the FSA started looking at this. That is just not good enough.

Christine Farnish: Perhaps I may comment on the question raised by Baroness Wheatcroft about the Bank of England, which is a very important issue. The Bank of England group going forward will have an unprecedented suite of powers. It will be responsible for monetary policy, financial stability, what is known in the jargon as macro-prudential regulation and

micro-prudential regulation, which we have just been talking about. It will have the function of lender of last resort and the provision of liquidity to the financial system; and it will be overseer and regulator of the payments systems. In addition, it will be a special resolution authority if a major institution goes belly up. That is an enormous suite of very wide and significant powers which potentially will have a huge impact on everyone's daily lives, the availability of credit, the way in which the financial system is working and the economic welfare of this country. To us it is very surprising that that suite of powers is being granted to a body that has no formal accountability to Parliament or the general public. There is a lot of work to do in the way in which the accountability and governance arrangements in this Bill are formulated to strengthen those arrangements.

Peter Vicary-Smith: One very good illustration of the lack of awareness on the prudential side about the consumer impact of this set-up is the PRA objective with regard to insurance. It is argued that it should have to contribute to securing a degree of protection for consumers, yet this is the sole body responsible for regulation of with profits funds of £330 billion, with 25 million individual holders, and yet the regulator has only to contribute to securing a degree of protection. That has to change, because that's where the buck stops if there are continuing problems related to with profit funds, which we have all been arguing about for years. At the moment the consumer dimension seems to be an afterthought in the PRA.

Paul Lewis: Perhaps I may give an example of where the law needs changing. You are talking about a Bill, but the existing law is very damaging in this way. It is about the FSA and what it can reveal. In 2006 it did a mystery shopping exercise about pension churning, basically taking one person out of one pension and putting him into another. In that it found that a third of the firms looked at were mis-selling pensions. It was only two years later in 2008 that it took any action against some of them. When it first did so I said to the FSA, "Tell us who the third are; or, if you don't want to do that, at least tell us who are the two thirds doing it well." It would not do so. On that and other occasions in this kind of secrecy I have been to the Information Commissioner. One case even went to court eventually. There is a section in the Act—I am sorry I cannot quote it this morning—that stops the FSA revealing information during the course of its activities.

Peter Vicary-Smith: Section 348.

Paul Lewis: Thank you. If that persists in the new Act the FSA, whatever it might want to do and however you might change its objectives, will not be able to tell us. I would say to people from the FSA who are on my programme, "Look, you know the firms that were mis-selling; I don't, and as we speak people are going to them for advice and being mis-sold." They said, "We can't tell you; it's against the law." I have to say they are quite right about that, so that is a bit that needs changing.

Q124 Chairman: That is a very important point. I am told it persists in the Bill, so we are grateful for that point being made.

Martin Lewis: There are very few bad products. In all the years I have been doing this I have seen very few products that are not suitable for somebody. The problem is that we tend to look at a product and say that it is treating customers fairly because they have all the correct forms. That does not mean they are treating them fairly; it just means they have dotted all

the i's and crossed all the t's of the documentation they need to provide. That was my greatest problem with treating customers fairly. It is not about fairness but about whether you have passed the bureaucracy test. It does not help financial companies and has not helped consumers.

There are very few bad products, so what has been going wrong? Why do we have so many mis-selling cases, so many consumers who are disenchanted and no longer trust the institutions? It is because the products are sold badly and the marketing information that goes with them is poor. Of course, products are not a one-stop shop. We tend to forget that when somebody has signed up for one, whether it is a pension, annuity or insurance product, they are ongoing products, so the ongoing treatment of the customer is important. We have to stop looking at the product and look at it in the holistic way an individual deals with it if we are to be able to regulate it properly. Paul was exactly right. The mis-selling of a product is often seen to be considered secondary to the product itself. In my experience, cash back credit cards—let's take them as an example—are wonderful if you pay off in full every month. If you do not, they are a horrible experience. It is not about the product but how you interact with it. That is the bit which tends to get ignored, and we need to make them look at that.

Gillian Guy: We are saying that all of these matters are a question of balance. I agree with Peter that both sides of this need to be dealt with but each needs to look at the other and consider what impact it is having over the fence. I slightly disagree in that some of the products are bad in terms of the business plan to roll them out and the way in which it is planned to administer them, not necessarily the conduct; for example, payments up front but that don't deliver the goods later on. That does not deal with the culture, but that business plans are looked at is an important tool.

We also seem to concentrate very much on the powers given to these organisations. Perhaps we can look more at duties and responsibilities for those organisations that ought to go alongside the powers. As far as concerns the PRA, it ought to have a duty to pay regard to the impact on all consumers, which is my earlier point about financial inclusion and exclusion, and also minimise hardship. A prudential measure can, by its implementation, mean hardship for people if it is taken out of time and people's circumstances are changed without an understanding of their glide path to that change and it being managed appropriately.

As far as concerns the FCA, there ought to be a duty to investigate where there is evidence of mis-dealings, mis-selling or any of those things that give rise to consumer detriment. That is why we think the super complaint on top of that will make sure the culture shift is one about consumer protection.

Q125 Chairman: This has been a very interesting start to our discussion, not least because collectively I think you are making a point which echoes what we have been hearing in discussing macro-prudential regulation: it is not simply a question of structure but culture. That culture is partly determined by your powers, the objectives you are set and the accountability within which you operate. Perhaps we can focus on those three things. Simply on the powers, the Government are considering the transfer of the consumer credit regulation to the FCA. Do you think that is appropriate; if not, how should it be changed?

Paul Lewis: As Martin said, it is daft to have two different regulators for what is in effect one set of financial products. If you have a bank account it is regulated by the FCA; if you become overdrawn it is regulated by the Consumer Credit Regulations, so it is absolutely daft. The simple answer is yes, and I cannot imagine why anybody would think anything else. A slightly more detailed question is whether it should transfer as the Consumer Credit Act or it should be completely rewritten under FSA's complex rules; that is, ICOBs, or the Insurance Conduct of Business Rules, whatever it is called. I do not have an answer to that. One set of rules is probably better. That is the debate we should be having, not whether it moves to the FCA, because I think the answer, plainly, is that it should.

Q126 Baroness Drake: I want to develop your point that culture is influenced by objectives. I would be particularly interested to hear a response from Which? and Consumer Focus. We know that the proposed FCA's strategic objectives are to protect and enhance confidence in the UK financial system. I would be interested in hearing your view on whether the FCA should have that as a strategic objective. From your point of view, is it the right objective from the perspective of consumer protection and fairness outcomes?

Peter Vicary-Smith: It is absolutely the wrong objective. If there is one message I want to leave in all the evidence we are giving it is that this is the most important thing to sort out. I would argue that the current strategic objective sends a message that regulators should be more concerned about the perception of confidence than the reality of protection. To my mind, trust and confidence are an outcome of a fair and transparent market. If you make it an input you put upon the regulator the burden of not revealing things, so the best way to have trust and confidence in the financial services industry is never to tell anybody when there is a problem. That kind of tension is quite entwined within the FSA, and we have seen that over the years how to manage trust and confidence while protecting consumers has given it real problems. It has led to a refusal to give information, laggardly behaviour and it wanting to do everything behind closed doors and in agreement. We argue strongly that the primary and strategic objective should be to maintain a fair and transparent market for financial services. If you want to put the word "confidence" in there then it can be "a fair and transparent market which leads to justified confidence in it", but trust and confidence must be an outcome, not an input. Otherwise, the regulator will be bedevilled by what it does in any particular real situation.

Christine Farnish: I have worked for the FSA and I know how important the objectives are in terms of driving culture. If we do not get right the formal statutory objectives of these new bodies in the legislation this time they will drive pretty well everything. Everything comes back to them, so they are extremely powerful and critically important. I agree with Peter. I worry about confidence being the overriding single objective. I can see the attraction of having a single objective. Obviously, that gives a much clearer focus. However, I am not sure it is quite as simple as that. If you just have confidence there the regulator could be held back from intervening early in an emerging problem, which may or may not blow up into something quite serious for consumers and another mis-selling crisis, because they do not want to disturb confidence. We should remind ourselves that consumers were totally confident in institutions like Northern Rock until the day before they looked at their television screens. I am not sure that confidence is the right overriding objective. It is very important that consumer interest is at the heart of this new regime in the FCA and that it has a proper statutory objective on competition as recommended by Sir John Vickers earlier this week. My understanding of the formulation in the Bill is that it does not have the status

required to allow the FCA to draft rules to promote competition, and that is a very serious weakness.

Gillian Guy: Perhaps I may build on what Peter said about the objective of confidence. I agree that confidence ought to be a bi-product of having got it right in the first place. To get it right in the first place, if the objective is about making the market work for all consumers, but also to have a credible system of deterrence and redress, that begins to build a package and an objective with outcomes for consumers that will probably start building confidence.

I also want to pick up Christine's point about competition. Our concern is that competition is seen as the magic bullet that sorts out all of this, remembering that competition works for some consumers and against others. Sometimes they are left out of that competitive market. For example, when we have free-in-credit offers those who are not in credit suffer and subsidise those offers. We have to make sure that when we are looking at competition we consider the impact it will have on all consumers. If we had an objective that was clearly about working well for all consumers and having deterrence and redress, we would scotch some of that at the same time.

Peter Vicary-Smith: The ICB puts that competition point very well in its paragraph 6.5: "The underlying problem in such cases is not competition but the frameworks, including consumer protection and financial regulation in which competition takes place. To blame competition would be to misdiagnose the problem." To paraphrase it, in short a distinction is needed between good competition to serve customers well and bad competition that exploits consumer awareness or creates a race to the bottom. Therefore, it is not as simple as competition; you need to define competition more particularly. It is not a silver bullet.

Paul Lewis: I think openness assists confidence. The FSA has a namesake in the Foods Standards Agency. Let me refer to its bulletin I printed off last night: Stella Artois Cidre has been withdrawn; Asda has recalled six Chosen By You drinks due to possible choking hazard; Waitrose has recalled own-branded meat products due to listeria contamination; and Kettle Foods has withdrawn kettle chips. Those have just happened. Do we have any less confidence in Waitrose, Asda or Kettle Foods because we know they have withdrawn food that is dangerous? No. It increases our confidence, and yet if you talk to the FSA at present they will not tell you what products they have discussed or have had withdrawn. They should be publishing every day a list of things they have found wrong and who has withdrawn them. Then I would say, "Prudential is a good insurance company. Look; it's taken its product off the market because it doesn't do any good."

Q127 Baroness Drake: To put a follow-through question, I am picking up a tension between confidence and consumer interest and transparency and the way that is operated. You have both articulated the problems on both the demand and supply sides. In essence, what would be the kind of effective competition that in your view would reduce the need for monitoring firms' behaviour and produce the better consumer outcomes that you would like to see?

Peter Vicary-Smith: It is not about competition reducing the need for interventions. Consumers have a variety of needs and financial service companies should be genuinely innovating, not changing the headline rate or name, to meet those needs. They should be doing that in different ways, each of which is trying to address the consumer need better

than another. The consequence is that if alongside it there is clear communication to consumers about the benefits of each offer, and a regulator who makes sure toxic products do not get to the market in the first place, you have a more transparent market in which consumers will start to have more confidence. I think competition is one of the vehicles. We think that dimension is handled well within the objectives. It is one of the second-tier objectives alongside consumer protection, and they sit alongside each other. We think that is a good place for them to be. It is just that the strategic objective is wrong.

Q128 Lord Maples: I want to move into the area of competition from a slightly different direction. We all know the virtues of competition in promoting efficiency, choice, innovation, reducing costs and price tension, but if you protect consumers too much they lose what responsibility they have. Obviously, there is a balance to be struck. Since we are spending a lot of time looking at banking regulation here, one of the areas where this seems to have happened is in banks taking deposits. You mentioned Northern Rock. I was staggered by the number of people who had put their money in Northern Rock for an extra 0.25% or 0.5% compared with what they could have got in HSBC, Barclays or whatever without apparently any consciousness of the risk. Since that happened we have altered the deposit protection scheme to give 100% guarantee up to £85,000. If you are a consumer you are taking absolutely no risk at all. You know you have a Treasury guarantee up to £85,000 in any bank.

Martin Lewis: That is not correct. You do not have a guarantee up to £85,000 in any bank. You have a guarantee of up to £85,000 in any financial institution. RBS and NatWest are one conglomerate—

Q129 Lord Maples: I recognise that.

Martin Lewis: But you made the point that consumers should be aware of this. My point is that RBS and NatWest are one conglomerate and have separate institutional protection. Halifax and Bank of Scotland are another conglomerate. They have a joined institution. Try to look this up on the FSCS or FSA websites.

Q130 Lord Maples: I had some difficulty finding it myself.

Martin Lewis: There is a lot more complexity, so where do you trust? We do not understand that.

Q131 Lord Maples: I am trying to make a slightly different point. I do not know what percentage of deposits are under £85,000, but I would guess the vast majority of the kind of consumers whom we feel need protection are probably under that. Do we not now have a position where the consumer has no responsibility at all in making this deposit? Therefore, we are encouraging them to choose the more risky institution. Does this present a prudential hazard for the whole banking system? Within 48 hours of the collapse of Northern Rock the Chancellor of the Exchequer had effectively guaranteed all the liabilities of the British banking system because one relatively small regional mortgage bank had got into difficulties. As it turned out, it was both insolvent and illiquid, but we did not know it

was insolvent at the time. Where do you see that balance? Do you think that particularly in competition for deposits we have created a risk-free environment for consumers, which therefore creates a very risky environment for the taxpayer?

Paul Lewis: I really do not agree, Lord Maples. Yes, you won't lose £85,000, but if you try to work out the best place for your money it is immensely complicated. There are terms and conditions about when you can take it out and how long the interest rate lasts for. It will disappear in a year in many cases. Do you have to give three months' notice? If you take money out of Nationwide, for example, I think you lose all or almost all the interest in that month. It is immensely complicated. You have choices to make. The example I often give is that if I buy a motorcar I am not allowed the choice of having window glass in the windscreen, which will save a few pounds, or reinforced glass. I must have reinforced glass because I am allowed to be sold only a safe motorcar. I can choose all the interesting stuff. I think that is exactly where we are with deposits now. You choose the interesting stuff but safety is a given, and so it should be.

Martin Lewis: I agree. We want people to save. I would agree with your thesis had the teaching of financial education in schools been compulsory, as it should be, from the age of five so people had the tools in their mental arsenal to understand and make these decisions. You need to accept in this room that most of the public are financially illiterate and scared. People do not look at their bills because they do not understand them. It is about financial education from an early age. It must be compulsory. Every time I sit here and talk about these types of issues I say that if you want the cheapest way to fix it make sure people understand how the system works. Your argument does not hold water until the majority of the public are not financially illiterate. Until that point, the most important thing we have done with deposits is to make sure people understand that if they save in them they are safe. ING DIRECT is an account very widely advertised on the television. It does not have to tell the public that if, in the very unlikely event—thankfully, it is a big, safe bank—it went bust they would not be protected by the UK Government that they vote for, because they would be reliant on the Dutch Government to protect them under the passport system. There are still many problems, and it is worth addressing those more than talking about the moral hazard of protecting all savings. We want people to save for their future and to have trust in the system. It is good that we have now put up the limit to £85,000. I just wish we could solve the remaining complexities.

Peter Vicary-Smith: Consumer responsibilities are already well established under common law, so the principles of reasonableness, good faith and disclosure and action are already there as responsibilities that lie upon consumers. The problem that we fear this Bill creates is that if you go into Tesco to buy a ready meal you look at the price and consider whether you will like the taste of it. You do not have to worry about whether it will poison you; that is Tesco's job. But the way the Bill is currently drafted places far too much responsibility on the consumer to work out whether or not something is safe. That is a real problem and will reduce confidence and trust, because people will work that out and won't buy.

Paul Lewis: It is something that the Bank of England could not do, incidentally.

Peter Vicary-Smith: One body we consulted upon this Bill said, "It's as if the Bill's draftsmen were at pains to ensure that consumers should only have themselves to blame. There is an utter imbalance at the moment within the Bill between the responsibilities lying on consumers and the responsibilities lying on financial institutions." I know you are not saying

this, but I think it's a bit rich for bankers to complain about risk-free deposits by consumers at their banks considering that the entire cataclysmically risky lending of banks was all underwritten by the consumers as well, so they had a pretty good taxpayer guarantee too.

Christine Farnish: Perhaps I may comment on a point of consumer responsibility. We see in two places in this draft Bill the general principle that consumers should take responsibility for their decisions, which is copied from the Financial Services and Markets Act. We have great difficulty with the inclusion of that clause as part of the consumer protection objective. The problem is bigger because this is very strange legislation in consumer terms because it defines the consumer as anyone from my mum to a hedge fund manager. No other legislation which talks about consumer interests and protection in other parts of regulated markets would have such an astonishingly broad definition of "consumer". It makes it very difficult for the regulator to focus on where protection is really needed because of that broad definition. Of course you need consumers and hedge fund managers to take responsibility for their dealings. There is a difference here between sophisticated market participants, who have knowledge and should take responsibility, and consumers who do not do this by way of business and are, generally speaking, vulnerable. I would define myself as a vulnerable financial services consumer, yet I have spent the last 15 years working in financial services, if I am buying many complex products. There is a real issue here.

Gillian Guy: That is a really important point about all consumers. That does not mean all consumers are the same. It means looking at a differentiation of what the consumer market is like. My feeling about its inclusion in the Bill is that it ought to be about putting consumers in a position where they could take responsibility. They cannot do that at the moment because the environment is not safe for them to do so.

Q132 Chairman: Is it because the environment is not safe or they do not have the transparent information?

Gillian Guy: They do not have the information and knowledge and necessarily the confidence that other people are looking after that safety for them. I would echo the point about education and putting people in a position where they are capable of taking decisions. At the moment the Government are considering whether to continue funding to make sure people get that kind of education. That is really important in the whole atmosphere of allowing people to take responsibility.

Martin Lewis: As a very important point of information, we have become a culture where we demand that financial services institutions provide all the appropriate information about their product, although there are still areas lacking, such as they cannot quite tell you what interest you are earning on your savings account, even though they can tell you the specific interest you have earned. I have never quite understood why that is so difficult for them, but they have my sympathy.

The real problem here is that we have said we will provide information. Take a credit card summary box which tells me there is a 56-day interest-free period on my credit card. How many people know that does not mean it is interest free but that you must pay off in full by the end of the month or you will be charged interest? It explains the repayment hierarchy on my credit card. How many people understand that? We have become a tick-box information-based system whereby to treat customers fairly you must give them all the

information. You do not have to make sure that information is understandable or explained. We cannot underestimate our financially illiterate society. Most people are given the information and ignore it because they do not understand it and there is no way for it to be explained. We are trying to assign too much responsibility in a market that is often driven and run by confusion marketing. The system is designed to confuse to stop churn and so people look at the headlines and do not understand the real problems. The information is out there so that the companies can justify their actions, but there is no explanation or understanding by everyday consumers. In some ways, it is very good. I have made a living out of providing that information to people, so it helps me but I would far prefer that you put me out of a job and gave better information and explanation in the first place, to be honest with you.

Chairman: We will do our best.

Q133 Mr Laws: I think we are getting the message that there is probably a consensus among the five witnesses that to assume consumers are responsible for their decisions puts too much weight on them, but that brings us to the very difficult issue of how you regulate in a world where the reality is one of financial illiteracy, or lack of knowledge. Reflecting on products like shared appreciation mortgages, or perhaps the mortgages now being advertised that appear to have very attractive rates but are linked in future to base rates plus 4% or 5% so it can get people into potentially quite big problems, how the hell do we regulate that? I would be quite confident that Christine is not quite as inexperienced and naïve as she says; I think she can manage her way. I think Lord Skidelsky would be fine in deciding whether he wants to buy those products, but I am not sure all of my constituents would be. That creates a very tough situation where regulators have to consider consumer protection that differs for different consumers. Starting with Paul—the other witnesses can say whether they disagree with him in any way—how do you regulate for that type of risk?

Paul Lewis: Consumers have to take responsibility but they should do so only among products that are broadly safe. They must make the decisions which suit them, but they must not be encouraged to invest in or save in something that is inherently dangerous, only if that is explained to them in huge red capital letters. Over the weekend I had an argument with the independent financial advice community about what is called trail commission: the annual charge on a pension or investment. I was saying it was a secret; they said it was not and it was in every document they gave to people. In the one that I saw it was on page 16 and was expressed as 0.5%. You do not really understand it. More than half the people with pensions did not know it was paid. If you look at the broader population, the percentage is higher than that. Although you can give information it is where and how you give it.

Q134 Mr Laws: We might agree on things like that, but when we look at products like shared appreciation mortgages, or mortgages linked in future to base rates plus *x, y* or *z*, those are not simple in a world of financial illiteracy but are not completely beyond consumers taking some responsibility either. With those particular products in mind, do they fall into your dangerous category?

Paul Lewis: Yes. There are things I would have banned at the start, endowment mortgages for one.

Q135 Mr Laws: What about my two specific examples?

Paul Lewis: Shared appreciation mortgages. Yes. They are too dangerous. Your house is too important to let it rely on stock market performance.

Q136 Mr Laws: You would not even allow Lord Skidelsky or Christine to buy a shared appreciation mortgage; you would ban it from the market?

Paul Lewis: I would, and I would do so simply because some things are risks that people should not be allowed to take.

Q137 Mr Laws: That is quite draconian. Are the other witnesses in that category?

Paul Lewis: You should have regulations so that some products are not allowed. I am sure many of my colleagues will not agree, but I take a hard line on that.

Martin Lewis: I would go the other way. Shared appreciation mortgages were a clever product with a very high risk for people who understood that effectively they may get a cheaper deal depending on what happened to house prices. There are a couple of things. We have a mortgage ticking time bomb because people think they have cheap mortgages and, once interest rates come back up, they will be phenomenally expensive. We will cause ourselves all heaps of hell because of that. Someone should be acting on that now, never mind sitting in this room looking at long-scale regulation.

When we start to talk about regulating price, which in many ways is what we do, we are delving into a territory where we have never been before. I do not believe this is as difficult as you think it is, because it is the type of thing that Paul and I do every day. When new products come out myself and my team go through them and write a list. We write a big article that explains, "This is where it may work well; this is where it may work badly; this is what you do right and this is what you do wrong." These days I have 36 staff and about 15 of us work on editorials looking at this. That is not a very big team. I suspect the FCA may be slightly better budgeted than my internal staff. What has been relied on is the ability to make a super complaint, which is fantastic. The FCA should absolutely be allowed to take super complaints; it is ridiculous that it won't. Just by looking at what is being said in the marketplace and reading the newspapers, you tend to see the dangers here. I do not believe it is beyond the wit and wisdom of a regulator to be monitoring what is coming out and have sophisticated individuals on product teams who are experts. It does not take many people to cast an eye over what is coming, spot the dangers and then make sure the dangers are being communicated correctly.

Q138 Mr Laws: I am sorry to come back to the same example but it crystallises things very clearly. You say that you would not be as draconian on shared appreciation mortgages. It is obviously still an issue for many consumers. Paul is willing to be quite draconian and say

they are far too risky. You would acknowledge there are some people who understood the gamble they took in what looked like a cheap mortgage?

Martin Lewis: I am trying to remember shared appreciation mortgages. They were there before I started but, if they are what I think they are, one of the biggest problems is that the examples given in the material did not include the fact that we might have a house price boom. People got caught by how much they would have to give back.

Q139 Mr Laws: The banks would say they did not include a house price bust either.

Martin Lewis: They should have included both. There should have been big warnings in font 140 saying what would happen if there were a house price boom or house price crash. It is not that difficult to do these types of things. Baroness Wheatcroft, when you write articles, you investigate something and gives the pros and cons. If banks spin their products to best advantage a regulator needs to make sure people understand the real level of risk they are taking. It is not that difficult.

Q140 Mr Laws: Are you saying that ultimately you are satisfied with consumers taking responsibility, even for some quite risky products, provided the warnings are "clangingly" obvious?

Martin Lewis: And there is an explanation, questions are answered and it is done properly. It should be done on the basis of what we would say if you or I were selling it to someone to discuss with them whether it was good or bad.

Paul Lewis: The point is that if you did do that with shared appreciation mortgages nobody would have taken one out. It has to be upfront with big warnings.

Peter Vicary-Smith: I have a relatively simple approach to this. There is a company called TP Activity Toys which makes climbing frames. It has a rule that a climbing frame cannot go out until the marketing department can assemble it, on the grounds that if the marketing department can do it any customer can do it. It is a bit like that with some of these products. So often we find that a product is developed and the banks or financial institutions themselves say, "Not all of our sales force will sell it because they will probably not sell it properly." If that is the case, you should be selling it only with advice so the consumer has that interpretation and there is a duty placed upon the advisers. By and large, I am relaxed about the products existing, but they should be sold with advice so the adviser has a responsibility. It should not be sold just through the normal branch sales network.

Christine Farnish: The interesting thing about the whole debate about product regulation is that in many respects it is in both the wider consumer interest and the interest of the industry to try and get a better settlement than we have had over the last 10 or 15 years where the focus has been very much on disclosure, more information, and abiding by the FSA rule book. You tick all the boxes, but as long as you do all those things pretty well anything goes. If something blows up you go off to the ombudsman. That is a very expensive, inefficient system that really imposes a lot of cost which consumers ultimately bear, and does not even deliver the right outcomes. I think there is a genuine common interest to get a better way through. In this legislation we need enough enabling power for the regulator to facilitate and encourage that process.

Q141 Chairman: As I understand it, there are new powers in the Bill on product intervention, financial promotion and early publication of disciplinary actions. Are those powers sufficient or do they need to go further; and, if so, how?

Christine Farnish: They are certainly an improvement on what we have at the moment, but the will to act is the critical thing. That is where regulatory culture will be so important.

Q142 Chairman: We take that point on board.

Martin Lewis: Perhaps I may raise one of my pet points that I wanted to say when we came in. I refer to the ridiculous disjunction between the ombudsman and the regulator. Year after year we see systemic mis-selling where the ombudsman is awarding in over 50% of cases in an industry and nothing is done about it year after year. There has to be some join-up in this Bill between the complaints consumers are making, which are being upheld by the independent arbiter, the ombudsman, and the regulator acting on them. If an industry has a complaint rate of over 50% it should be an automatic super complaint which must be responded to within six months by the regulator. PPI is a wonderful example. A secondary point you must understand—I know you are going to talk to the ombudsman later, who I am sure will echo this—is that companies deliberately reject cases they know the ombudsman will uphold because it puts off consumers. Only 10% of consumers then go on to the ombudsman. We have had uphold rates in PPI—it has changed since the ruling—of 90% to 99%. Exactly the same case is made by one consumer, is rejected by the bank and it goes to the ombudsman. The ombudsman upholds it. Another person comes along with the same thing and they reject it. Rejection of complaints has been used as a tactic to pay out less. If I were writing a Bill the one thing I would put into it is that there should be a fine if you use rejection as a tactic. It clogs up the system and the ombudsman.

Chairman: I am sorry to cut you off. It is an important point; we have got it, but we have very little time and do not want to cut out other important points.

Q143 Lord McFall of Alcluith: I am interested in financial inclusion. We have made quite a bit of progress in the past few years. What do you see in this Bill which will foster more financial inclusion?

Christine Farnish: Very little. Possibly there is something missing from the consumer protection objective or the "have regard to" list for the Financial Conduct Authority. It would be quite easy to look across at other regulatory regimes, whether it is energy, communications or any of the other major services that are so important to daily lives, and see their formulation and what would be appropriate in this Bill. To us, it is very important that the new Financial Conduct Authority has full regard to the needs of vulnerable consumers, particularly those who may be disadvantaged in various ways. That is missing at the moment.

Consumer Focus; Reserve Bank of Australia; Which?; Citizens Advice Bureau; moneysavingexpert.com; Mr Paul Lewis; Financial Services Compensation Scheme; Financial Ombudsman Service and Money Advice Service – oral evidence (QQ 99-206)

Q144 Lord McFall of Alcluith: Do you think financial inclusion should be an objective of the FCA?

Christine Farnish: Or a qualifier to the consumer protection objective would probably be right.

Q145 Lord McFall of Alcluith: I am thinking of, say, the Royal Bank of Scotland which made an announcement a few weeks ago that it would withdraw the facility for basic bank accounts with their ATMs. We have a free ATM network, but what that will do in my opinion eventually will interfere with the interchange fee. Therefore, there will be a structural issue there and the whole system can come down with others following that. What do we do with those systems?

Paul Lewis: I think you could say it was anti-competitive, and it is appalling. I believe Lloyds do it too. They do not allow basic bank account customers to use other banks' ATMs. They have to use only the ATMs of that bank. I think it is anti-competitive. If you were being really cynical you might say it was because they do not really want basic bank account customers, so let them go to another bank. Competition is fine. There are people who use websites, churn their stuff and move from one to another. We are all quite well served, but those who do not have easy access to the web and the credit rating to move their debt or current account all the time must also be protected. It is more about protection than financial inclusion.

Q146 Lord McFall of Alcluith: So, what do we do with this legislation?

Martin Lewis: We talk about most people being financially illiterate. You then have those at the very bottom who will never be capable of understanding the product. The statistics show that 44% of individuals, or their partners, who have had mental health issues have had debt crises compared with 9% of the rest of the population. To me, that is a shocking statistic. You are five times more likely to have debt crises if you have mental health issues. The job of banks is to make money from you so you have to be responsible for yourself, but we must protect those who are not capable of being responsible for themselves either temporarily or over a longer period, whether it is due to mental health or mental capacity. Gillian uses the phrase "all consumers", so we are not talking just about competition; we are talking of the bottom end. That must be included in the Bill so people are protected in future.

As to basic bank accounts, we need to take it back to the bigger step. Banks do not want basic bank accounts. If you apply for a bank account and tell them you have a poor credit file they give you a current account form. If you are rejected they do not have to give you the basic bank account; they say, "Sorry; you've been rejected." I would impose an obligation that if you are rejected they must offer you a basic bank account. In this country we have one million people without bank accounts. It would be relatively easy to put in that regulation to fix it. We should mandate the FCA to look at that, changing small regulations that help people by financial inclusion.

Q147 Lord McFall of Alcluith: Gillian, would you agree with that given all the problems you have at local level?

Gillian Guy: The cost of financial exclusion goes way beyond financial institutions and what we are talking about here, because it also takes us into the social costs of housing, education, health and all those things. We have spent a long time at Citizens Advice trying to persuade the banks to give basic bank accounts to undischarged bankrupts, because they cannot get back into the system at all. If they get work they cannot have their pay put into an account anywhere because everyone pays through banks. We also find it enormously difficult to get that acceptance through the BBA. We think that this is an opportunity to put in a mandate to say that financial inclusion must be an objective and is clearly within the legislation and regulatory framework.

Q148 Lord McFall of Alcluith: On the issue of competition, I note this week that in the Vickers report there are quite good proposals on switching but an absence of current account portability number. Without that I do not think much will happen with it. Is there something we should be doing here?

Christine Farnish: The difficulty here is that you are talking about changing some of the biggest IT systems in this country, if not the biggest, and that cannot be done in a short time scale. It is perfectly reasonable to set that as a longer-term objective and probably demand it.

Q149 Lord McFall of Alcluith: With the objective of 2019 like the rest of it?

Christine Farnish: It is certainly worth studying the cost benefit of setting some sort of target like that.

Peter Vicary-Smith: Mobile phone switching took off in this country only when numbers became portable. All the way through it the industry said it could not do it because of the problems. The regulator said they had to do it anyway. I cannot remember the number of years. They said that when they next upgraded their systems they would impose upon them an obligation to include that. That is where we should go. They are changing all the time. HSBC is in the middle of a large changeover now. Lay it upon them that next time there is an obligation on them so that in 10 or 15 years' time, whatever it is, it is there for future consumers.

Paul Lewis: The work that Vickers suggested is supposed to happen within two years, September 2013. If you leave it for another six years until 2019, surely they could have portability. Portability is the mechanism, but you also must have an understanding of the terms on offer. Where I do think Vickers has got it wrong is to say that the interest you are losing is bank rate minus whatever they pay you. That is nonsense. They do not lend money at bank rate but at LIBOR. It should be a lot more than that if you are to see what you are really losing from having a balance in a current account.

Q150 Mr Brown: We have in part touched on the issue of redress. Rather than invite you to repeat what you have already said, how easy is it to get redress for consumers who have

been wronged by the system? Can you say anything to us about the structures through which you have to work? You mentioned the ombudsman earlier.

Martin Lewis: The funny thing is that the ombudsman tends to be much better at looking at the wish and the will of consumers than the regulator. The problem with the ombudsman is that there has been an explosion of work in recent years and it is struggling with staffing, especially PPI. There is a two-part system set up. First, you must first go to the bank and then the ombudsman. The problem is that the banks traditionally have seen that as an opportunity to do everything they can to stop the consumer going further. I have read those letters. They are beautifully drafted to ensure that they fulfil the requirement of telling you about the ombudsman but give you no hope whatsoever that you will actually succeed. It is an overly-litigious form written by a clever lawyer to tell you how you go forward. People cannot even write letters.

Q151 Mr Brown: My question is: what would you ask us to do about it?

Martin Lewis: I would have the ability to complain much more quickly and banks must have an obligation upon them to solve complaints effectively and efficiently without going to the ombudsman taking into account prior ombudsman's decisions. That would be the way that I would solve the issue. Therefore, if they do not do that the ombudsman becomes an appeal court, but it is effectively setting precedent and the judgments of the ombudsman are publicised, which we tend not to see at the moment. Again, there is no transparency. Why can't we find out how the ombudsman makes these decisions? It is a quasi-judicial process, but it is a much better and more efficient system. The problem is that redress is very complicated; people do not know how to do it. Very limited help is available. We can publish template letters, but the ombudsman tends not to like them. People are very bad at writing letters to their banks. They get very scared.

Q152 Chairman: The question was: what should we be doing about it?

Martin Lewis: You should be making sure that when a complaint is made to a company it must look at redress with a view to what the ombudsman has decided in the past so there is some precedent as to how a decision is made. There should be redress on those lines, not on its own views.

Chairman: That is very helpful.

Peter Vicary-Smith: I would add two specific points. One is about resisting industry pressure to water down the powers of the ombudsman. There is a concerted campaign now going on to make the ombudsman less effective. We always need to resist that, because it is a hugely valuable tool for consumers. The second thing is that I would like to see all financial institutions do what some already have done, namely that the bonuses of the senior management team include an element for customer complaint reduction, not to be passed on to the ombudsman but to drive down customer complaints. Some have done that already. Then you will start to see far more attention being paid to customer complaint levels if it hits their pockets.

Paul Lewis: It is trying to change the culture so they want to resolve them. If somebody from the Money Box team or myself rings up a bank the problem is solved like that, yet somebody might have been waiting six weeks to get it solved. It is the culture in the complaints department that must be changed, so give them bonuses for the number of people they pay out rather than the number of complaints they block. Something must be done. I am not clear about the legislative procedure, but something should be done to change that culture.

Gillian Guy: Perhaps I may sound a note of caution on the number of complaints resolved being the determinant of bonuses, incentives and the like. If organisations encourage complaints and therefore want to see a volume of them in order to resolve them that gives rise to consumer care, if you like. I also stress that part of the FCA's objective should be about deterrence and redress so it is part of the conduct and regulatory framework to make sure the obligation is articulated, as opposed to it being just left to the companies themselves. Indeed, it is one of the reasons why we would like to see consumer credit transferred to the FCA, because at the moment there is no power of redress.

Chairman: We have already dealt with that issue. I am sorry to cut you off but we are already overrunning, which is why I am having to be rather rude in this way.

Q153 Mr Mudie: I am sorry to take you back to it, but I am disappointed that the four of you have not picked up on Consumer Focus's strong paper on accountability. It is inevitable; you do not get much opportunity to speak for the consumer in public before Parliament. What Consumer Focus is saying is that this Bill gives unelected individuals unprecedented powers with accountability reduced to retrospective reporting. These powers will affect employment and growth and will have great social consequences. It is not even accountability. The only way to influence them has been taken away because it is retrospective. The governor will come here and tell us what he has done and why. He will not say, "Do you think I should be doing something different?"

To give an example, in the case of RDR when we had Hector Sants of the FSA in front of us—it was something that caused real upset in the country—the Committee gave him a really hard time and he did not give very adequate answers. When we said publicly, "Will you have second thoughts about this? Will you review your decision?" he said, "No. I have the power." But we said, "We're democratically elected; we represent the people and we're asking you to do it." He said, "If you give me evidence I will consider it." That is operating now. This pushes it much further. Consumer Focus has spelt out the dangers. Do you not understand, or would you comment on it?

Peter Vicary-Smith: There are a couple of things. I absolutely agree. Our failure to come to it yet was not that we saw it as unimportant by any means. There are really two intertwining things: accountability and governance. We absolutely agree on accountability. Indeed, the FSA had woefully inadequate accountability to Parliament. One of the things we have talked about in the past is that really only the Treasury Select Committee seemed to be holding the FSA to account. We have said that publicly. Therefore, accountability to Parliament is really important. To be accountable the strategic objective needs to be right so Parliament knows what to hold it accountable to.

The other dimension is about the governance and interventions before then. We want to make sure that the decisions have those inputs from outside the group. For years we have gone on about the FSA having at one point 10 of the 12 members of the board being from the industry, including the chief executive of HBOS sitting on the board at the same time as his firm is being regulated by the FSA. That sort of nonsense is helpfully going away, but it could still be there within the Prudential Regulatory Authority. It has no requirement about representation on the board of the PRA, or indeed about having a consumer panel that can give these inputs. There are three dimensions: get the objectives right; ensure accountability to Parliament is strengthened, as has been talked about, and get the governance arrangements right in both of these major bodies so there is less to worry about downstream.

Q154 Mr Ruffley: All of you seem to be saying in your powerful evidence that safety should be a given, like people who sell food or cars. We have got that. Is there any foreign country with a regime of product regulation that delivers that safety as a given in financial services products? Are there any models abroad at which this Committee could look?

Paul Lewis: Not that I am aware of. The answer is that I just do not know, but what you have to consider is whether there is any foreign country that has a financial services industry like ours. The answer to that is probably no.

Martin Lewis: I think they are incredibly dominant in this country. We have a large number of complex products.

Q155 Chairman: Are there any foreign examples?

Martin Lewis: Not that I can think of, even in the States.

Christine Farnish: Certainly, in the States there are measures for consumer credit products which have been introduced relatively recently, from which we might be able to learn. In some European countries there are some quite strong product regulatory regimes. They are different from us in a number of respects, but we could also look at other sectors. The energy regulator is looking very closely at the confusion of tariffs and all the rest of it in energy markets, and is thinking now about how to move towards more common or minimum standards and greater clarity and simplicity for consumers. I think regulators need to get together on this issue and learn from each other. There is valid experience out there.

Paul Lewis: The States introduced a new regulation system after the crisis. As I recall, their equivalent of what we will call the Financial Conduct Authority is for consumers and nothing else. I think that would be a model worth looking at, though I cannot tell you the detail here.

Peter Vicary-Smith: Some work has been done on this by Consumers International. I cannot bring it to mind, but perhaps I may write to the Committee subsequently.

Chairman: That would be very helpful indeed. Thank you all very much indeed. This has been an immensely valuable session. When prior to our public sessions we started to consider how we should focus our attention we diagnosed that there had been a problem in

the public debate. The focus on preventing another banking crisis was in danger of crowding out the important aspect of consumer regulation in the Financial Conduct Authority. We resolved that we would not make that mistake. Even if we had not, you would have prevented us from doing so. We are very grateful to you for the powerful evidence you have given, both orally and in writing.

Examination of Witnesses

Witnesses: **Mark Neale**, Chief Executive, Financial Services Compensation Scheme, **Natalie Ceeney**, Chief Executive and Chief Ombudsman, Financial Ombudsman Service, and **Tony Hobman**, Chief Executive, Money Advice Service, examined.

Chairman: Thank you very much indeed for coming today and your prior evidence to the Committee. I am sorry we overran the previous session which means we will have rather less time than we hoped to talk to you. I hope, therefore, that questions can be pithy and that, to the extent it is possible, answers can also be kept brief.

Q156 Lord Newby: Under the proposals two regulators, the PRA and FCA, will have responsibility for rule-making powers over the FSCS. How do you think you will deal with the issues of co-ordination between those two bodies?

Mark Neale: I think accountability to both PRA and the FCA makes very good sense because it reflects the important role we play in the resolution arrangements for the failure of major banks, building societies or other systemically important financial institutions. Equally, we will have important accountabilities to the FCA for the protection of consumers when other financial businesses fail. Therefore, accountability to both bodies looks right to us. I see no great problem with making those relationships work. We have good relationships now with both the Bank of England and the FCA, and I would expect the memorandum of understanding that will be put in place to underpin a continuation of those good working relationships.

Q157 Lord Newby: So, you think your working relationships with them will continue to be good and you are not concerned, as some people have been, that the relationships between the PRA and FCA might cause problems?

Mark Neale: Clearly, it will be very important that the PRA and FCA work effectively together. Again, the legislation provides for the existence of memoranda of understanding to underpin that relationship, but at the end of the day the working relationships are what actually matter and I would expect them to be close and effective.

Q158 Mr Mudie: I have a question about your charging. The compensation scheme was set up hurriedly and it was going to be reviewed. There is general unhappiness. I am not sure the review has taken place. Do you intend to change it to meet the genuine complaints made, because it is a disparate market, is it not?

Mark Neale: You are absolutely right. There are concerns within the industry about our funding arrangements prompted by the heavy demands we have had to make on the industry to finance compensation for the key data failure and also PPI failures. We are very conscious of that. Clearly, it is important that the industry funds us, but it is also important that the funding arrangements themselves command maximum support within the industry. There is a review in place led by the Financial Services Authority, but, quite rightly, the FSA put it into suspense until we were clear how European Union legislation on deposit protection would come out. It is quite likely that the European Union legislative process will complete in the second half of this year. I would very much hope that the review will be able to start up again and we can see whether we can move to arrangements that command wider support within the industry.

Q159 Mr Mudie: That is helpful. You say that they have been making these complaints, justifiably, for a considerable time. These are dire times for firms, especially the smaller ones. You are waiting for the legislation and then you will do a further review. First, can you give any assurances that that review will be quicker than the last one? Second, I worry about your terms of reference "command maximum support". Firms in some of the smaller niches are being hammered by this. There is a need for sensitive compensation scheme charging that reflects the different sizes and finances of the firms involved. Is that going to be a prerogative, rather than just commanding maximum support and the minority can lump it?

Mark Neale: No. I think you are absolutely right. It is very important that the arrangements are fair to smaller businesses. Certainly, those businesses would argue that they would like to see the funding arrangements better reflect the risks that particular sectors of the industry impose. In answer to your first question, once we are clear on the European legislation, which essentially will determine whether we have pre-funding for deposits, there is a general view that we should move as quickly as we possibly can. That would certainly be my view.

Q160 Lord Maples: One of the suggestions made by Vickers, if I understand it correctly, is that insured deposits should have priority in a liquidation. Presumably, it would mean that, unless the bank was so insolvent that it did not have enough money to meet that, which seems unlikely, with the loss buffer of about 20% that Vickers is talking about these losses will no longer have to be spread around the banking system, they will fall on the shareholders and other creditors of the bank. Does that solve the problem?

Mark Neale: I do not think it solves the problem. You are absolutely right that it will facilitate our role in recovering the costs of compensation from the estate of the failed bank or building society. Clearly, there are time lags in the insolvency process. We are committed to paying out the great majority of depositors within seven days of a failure, so although deposits are a priority—it will help us maximise the recovery we make from the estate of the failed business—inevitably there will be a lag.

Q161 Lord Maples: As I understand it, you do that at the moment. You would finance that immediate payment by borrowing the money from the Treasury?

Mark Neale: Not necessarily. We certainly did borrow from the Treasury during the 2008 crisis because of the scale of the compensation costs we were being asked to meet, which rose to about £18 billion. For much smaller failures we would expect to make a levy on the deposit-taking sector immediately.

Q162 Lord Maples: But the deposit-taking sector would presumably much prefer the arrangement proposed by Vickers than the one it has at the moment, because it would solve the problem about which Mr Mudie has just asked and which I experienced as a constituency MP, namely that small, conservative and well-run building societies feel that they are bailing out the irresponsible and more risky organisations?

Mark Neale: I am not sure it would immediately solve their problem, because for small and medium size failures we would certainly raise a levy in the first instance in order to meet the compensation.

Q163 Lord Maples: But they would get their money back?

Mark Neale: Yes.

Q164 Lord Maples: The deposit protection scheme used to pay the first £2,000 and then 10% of the next whatever it was. I have forgotten what it was. It was £38,000 or something like that. It is now 100% of the first £85,000?

Mark Neale: Correct.

Q165 Lord Maples: In the context of competition, have we now given an unfair advantage to the risky organisation, the Northern Rock, where people can take the slightly higher interest rate than they might have got from, say, Nationwide or Barclays, and are financing a much riskier organisation but are not bearing any of the risks at all; it is all borne by the Financial Services Compensation Scheme?

Mark Neale: Arguably, you have pointed to what economists would call a "moral hazard" problem.

Q166 Lord Maples: I am being told not to use jargon in this Committee.

Mark Neale: I would make two points in response to that. First, financial stability is very important and if consumers feel they have any money at stake that is likely to lead to the kind of scenes we saw when Northern Rock was in trouble, which in turn added to the financial instability of the period. Second, I question whether consumers are in a strong position to make judgments about the creditworthiness of banks and building societies.

Q167 Mr Brown: When you make a finding, how easy is it to get a remedy for the people whose cases you have upheld? In your relationship with the regulator how responsive is the regulator to your findings? In particular, people who come to see their MPs always say they are not doing it for themselves but to make sure it never happens again. How responsive is the regulator on the "it will not happen again" point?

Natalie Ceeney: Let me start with the firms and then move on to the regulator. We see complaints only when the firm has already had a period to get things right. We often take a very black and white view of firms. I see very good and abysmal firms. As to the very good firms, best practice would be that for any complaint coming to the ombudsman the firm has already considered it at board level. Frankly, we tend to find in their favour in the majority of cases because they have done it properly. We also have some firms where we find against them virtually on every occasion. To give an example, there is one major firm that I will not name in which, for three weeks, we have not even found someone to answer the phone because it has carried out some staffing changes. As a result, we have found no one to talk to. Therefore, we do see the abysmal.

As to our relationship with the regulator, things are now changing, but we have had a period when we have seen it very slow to get action. Payment protection insurance is a classic example where we started to see very high volumes of cases about five years ago, and we became increasingly vocal about it. It was only very recently that we obtained clear guidance on what to do. We are beginning to see that change, but for us one of the biggest issues is that when we see systemic issues—not much of what we see is a systemic issue—we want early intervention.

Q168 Mr Brown: And the regulator?

Natalie Ceeney: That is really in relation to the regulator.

Q169 Mr Brown: My question is: do you get it?

Natalie Ceeney: The honest answer is that it varies. Over the last five years we have had quite big problems. If I may talk briefly about PPI, it has been 20% of our work in our 10-year history.

Q170 Mr Brown: I was struck by the volume of work you are carrying out in a year. I had not realised that until I received your briefing.

Natalie Ceeney: It is quite staggering. In our 10-year history just three issues have accounted for half of our work: complaints about the mis-selling of mortgage endowments, complaints about mis-selling of payment protection insurance and bank and credit card charges. For five years we flagged that we had seen increasing volumes of PPI complaints and that in our view it had gone beyond individual complaints to a systemic issue. The regulator was very slow to act. To be fair, some of the banks also put every obstacle in the way to act. That has been a concern. In individual cases where it is really about talking to the firm to get a remedy, that is what we do. Where there is a systemic issue we rely on the regulator to take early action. It has not been a strong point with the FSA for the last five years, but I am starting to see that culture change within the FSA.

Q171 Mr Brown: The point about culture is made to us a lot. Should we be looking to strengthen your hand with the regulator or the regulator's hand with the regulated?

Natalie Ceeney: Both. I think the big gap over the last five years has been to do with our starting to see issues. Our role is simply to decide individual complaints. We are not a regulator, and I do not want to stray into that space. But when we start to see the same issue again and again we want a regulator to say, "There's an issue and we'll step in." On PPI there was a big gap. We would be looking for far earlier intervention by the regulator.

The regulator got some new powers under section 404 in the last 12 months to be able to do industry-wide redress schemes. They have used those powers three times. We really welcome that. There are instances where an industry-wide redress scheme is the right answer rather than everything coming to the ombudsman. One other issue is whether there have been enough consequences for firms in getting complaint handling wrong. One issue that I know the consumer groups have just raised is transparency. We are very pleased with the provision in the draft legislation which will allow us to publish ombudsman determinations. We think that to make transparent what we are seeing will help raise the stakes and help people to take complaints seriously. We also think it is quite important that the issue of a super complaint is debated to allow consumer groups and others to raise where they see a systemic issue and get it more firmly on the regulator's agenda earlier.

Q172 Mr Brown: These published findings will not be anonymised?

Natalie Ceeney: After consultation with the Treasury—it is out for consultation now; in fact it went out last Friday—we are asking for the views of consumer groups and industry alike on what should be redacted. Our view is that we should not publish the names of consumers, because they come for a solution and we would not want to disadvantage them, but it would be wholly impractical to redact the names of firms. You would end up blanking out half the decision. But we really are taking views over the next few months, so that at the point the Bill is introduced we can inform Parliament about the views of industry and consumer groups alike and then you can take a view on that.

Chairman: I want to ask about a point that came up in the previous session. I do not know whether you heard it or were out in the corridor.

Natalie Ceeney: I did. I heard it.

Q173 Chairman: It was said that redress procedures took too long and that consumers should be allowed to approach you earlier in the process than is currently the case. Could you comment on that?

Natalie Ceeney: It is important that consumers can get their problems sorted out by their firms first. To give you a slightly shocking statistic, at the moment the big banks have eight weeks to resolve a consumer's dispute. Of the cases that are referred to us, over half of the consumers have not received a final response within that period. Therefore, if we could solve one thing it would be to get better complaint handling by firms. It is better for the

firms and consumers that they can raise an issue quickly and have it dealt with quickly. In a way, we were set up to be a back stop, and that is what we think we should be. We already offer a service where consumers can phone us, even if they have not complained to their firm. What we will do is talk through with them how to complain to their firm and often explain to them how the process works. We are not seeking earlier intervention powers. I would like firms to handle complaints properly.

Q174 Chairman: How can that be brought about if they are supposed to do it within eight weeks at present but half of them do not?

Natalie Ceeney: Quite a lot has happened over the last couple of years which might give an indication. As we have started to publish data, the media has paid more attention and we have seen more and more senior people within firms get interested in complaint handling. There is more transparency about what we are finding and the data about complaint handling. As to data about firm behaviour—for example, we talk about banks as if they are all the same—in the case of one large banking group, at the moment we find against it in two thirds of cases. In the case of another large group, they win in two thirds of cases. They are not all the same. The more that is apparent the more it will help firms improve.

There is more that the regulator can do. They have started to fine banks for poor complaint-handling behaviour. We would welcome more transparency from the regulator about findings and, frankly, more consequences for getting it wrong, but the focus must be improving the way firms handle this themselves. I stress that there are some very good ones and others where the performance is, frankly, abysmal.

Q175 Lord Newby: Do you publish the relevant statistics?

Natalie Ceeney: We do. Every six months we publish both the volume by firm and what we call uphold rates by firms, ie win/lose rates. They are quite telling. Within any product area you will find firms that, frankly, do very well and those that do very badly.

Q176 Chairman: So, you publish which firm loses two thirds and which firm gains?

Natalie Ceeney: It is in the public record, yes.

Q177 Chairman: In that case, can you tell us the names?

Natalie Ceeney: I can. In the last published data of the big banks, Lloyds Banking Group lost two thirds of the cases they referred to us in that period and HSBC lost only a third, but I stress that, if you look at our data, building societies as a group lost only 22% of cases, and some firms lost every case they sent to us. It varies significantly by firm.

Q178 Mr Brown: That rather reinforces the point that has been made to us throughout the morning about the culture in individual institutions being as important as structures.

Natalie Ceeney: Absolutely.

Q179 Mr Brown: Is it possible that a bank would reject cases almost as a tactic and hope that the customer did not then appeal?

Natalie Ceeney: Unfortunately, yes. If I may talk about one instance in the public domain. One large banking group was selling a very risky investment product to unsophisticated deposit account-holders. We had to see complaint after complaint, and it was only when a group of those customers approached Parliament and the media got interested that that big bank started to settle complaints. We had 500 of those cases and we found consistently in the same way. I was having conversations with the retail chief executive saying, "Nothing's going to change; we'll keep finding that selling this highly sophisticated product to unsophisticated investors is, frankly, wrong." It took media intervention to resolve it. Unfortunately, we see that quite often.

Q180 Baroness Drake: Natalie, your submission expresses optimism that the proposals in the Bill and other changes will strengthen the early identification of issues prior to intervention, and the range of regulatory powers will reduce mis-selling. Your submission uses the word "optimistic", but we know from other submissions that there will be unhappiness among firms on two particular matters: first, that they cannot appeal the decisions of the ombudsman, whereas the consumer has a choice between accepting it and going to court; second, if it is clear that they have complied with the FCA and guidance they should not have what they consider to be inconsistent redress imposed upon them because that is making the ombudsman in effect a semi-regulator. Given that we will probably meet those comments how would you rebut, or even sympathise with them?

Natalie Ceeney: I talk to industry a lot. Those views are not held by the majority. There is a segment of industry that would quite like to weaken the role of the ombudsman, so it has to be looked at in that context. We have an appeals process. The ombudsman has a two-stage process. 80% of our disputes are resolved at the first stage. If anyone is unhappy they can go to the second stage, so there is an inbuilt appeals process. We can then be judicially reviewed. That is something that is used. We have about 20 judicial reviews a year. It is a power that is actively used. Parliament set us up to be an alternative to the courts, so if what happened was simply after the ombudsman things went back into the bottom of the courts system we would not be an alternative to courts; we would be a piece of bureaucracy added to the court system. In our view there is an inbuilt appeals system.

Q181 Baroness Drake: You said that judicial review is a process that is actively used. Can you give us any quantitative statistics to illustrate that point?

Natalie Ceeney: In any one year we are judicially reviewed up to 20 times. The most recent high-profile example was the BBA's judicial review against us and the FSA on PPI. The High Court judge found in our favour and the FSA's on all counts. We have a good track record of winning judicial reviews, which I think should give the system confidence that we do our job pretty well.

To address the second point, we are very keen to give industry confidence and transparency on what the ombudsman will find. We have done a lot of work over the last few years to make our approach very public. Lord Hunt reviewed us three years ago. One of his

recommendations was that we should put on our website pretty much all the internal guidance we use derived from case law to judge cases. We do that, so that is out there. He also recommended that we publish data, which was the birth of the data we now publish. We run a helpline for firms. If any firm is confused about what we might do in a case it can call. I actively talk to industry about any confusion. I am very keen that industry does not misunderstand about what we do.

Neither the FSA nor any regulator can lay down absolutely every scenario in the rules. That was the issue in the recent High Court case, in that firms said, "Where in the rules did it say we couldn't sell PPI?" The High Court judge essentially decided that the FSA rightly had principles about treating customers fairly as well as rules and firms had to follow principles as well as rules. If firms follow the law, the FSA's principles and rules it is extremely unlikely we will ever find against them. For example, nowhere in the FSA's rules does it say you cannot swear at or punch a customer, but if I have a case where a member of staff at a branch had sworn and punched a customer you have a pretty clear indication of which way I will find in that case, and the defence "Where in the rules does it say I can't do it?" will not hold a lot of sway.

Q182 Mr Ruffley: I have a question for the chief executive of the Money Advisory Service. What percentage of the public know of your existence and what you do as an organisation?

Tony Hobman: Relatively few at the moment. We were born out of the 2010 Act with the prosaic title of the Consumer Financial Education Body. We had the task, in which we are still engaged, of transforming ourselves into something that would resonate with the public in terms of what it is we say we are doing, hence the new title, and also having a rather more effective suite of products and services than was the case before. We have embarked on that journey only having been relaunched as the Money Advice Service since June of this year with our financial health check. We probably have brand awareness of about 10% of the market at the moment.

Q183 Mr Ruffley: You have been badged with doing something slightly different. What percentage of the great British publish do you reach? Presumably, you put out opinion surveys because you are a public-facing organisation; indeed, I read from the submission that you give advice to members of the public. Will you do any work to find out who knows about you, and what progress you are making?

Tony Hobman: Yes, absolutely. We have just started the journey, but it is clear to us, without being over-critical of what went on before—much of what was done was under the so-called Delivering Change strategy, which was really the umbrella for financial capability under the FSA up to last year—a lot of information was produced and leaflets and booklets were handed out, but there was not necessarily action and change in behaviour on the back of that. It is a very new model. What will be important to us, which we will measure going forward, is not just the amount of reach we achieve—we have to reach many more millions of people than was the case before—but what they do as a result of having contact with us.

Q184 Mr Ruffley: How are you as chief executive going to measure the success of your organisation in the next 12 months?

Tony Hobman: I already have some clear targets within the context of this year which are about the numbers of people who are reached with our new health check. We hope to reach 500,000 by next March. We also have a wider inherited impact measure that, of those who have some contact with us, at least 8% will go on and do something as a result. We would expect to set targets going forward—we have not done it yet; we are in the process of working them out—that are much more significant than that. For example, Delivering Change probably reached of the order of 10 million people.

Q185 Mr Ruffley: How do you define "reached"?

Tony Hobman: I do it by my earlier rather weak definition.

Q186 Mr Ruffley: They have heard of you?

Tony Hobman: Yes, or they have been given something by us. I would expect in the medium term—maybe the very few years ahead—to be reaching that number of people in any one year, which is a quantum factor looking ahead, and also significantly to improve our impact. We have not measured it yet, but we need to have a longitudinal study of how much people's confidence, understanding and ability to manage their finances is growing. That is about measuring a change in a social norm in a sense, but that is something we can do.

Q187 Mr Ruffley: So, it is a matter of a social norm and qualitative analysis?

Tony Hobman: It will be quantitative as well. It absolutely would be quantitative. I think you can ask questions. Indeed, there was a very large-scale baseline study done by the FSA at the beginning of the process which said, "These are the questions you can ask people which seem to indicate the degree to which they have financial capability or confidence", and you can go back over time and ask those questions of a population that has had contact with us and a wider population as a sort of control to see what difference we have made.

Q188 Mr Ruffley: In the interests of transparency, I take it you will be publishing your targets and your progress against them?

Tony Hobman: Indeed we will, yes.

Q189 Mr Ruffley: I read in your submissions that you want to become a more advice-oriented service, so education and information is a given. Can you describe what you mean by "more advice-oriented"? Subsequent to that, if advice is being given what can you tell the Committee about the quality of the personnel dispensing the advice in your organisation? Who are they? From where are they recruited?

Tony Hobman: The important distinction I would make is that we do not seek to provide regulated advice, so we are not advising people which company's product they should be purchasing, although through our comparison tables they could eventually find their way to those products. We are providing more directive advice than simply saying, "Look, here's the information. Make of it what you will." We will be prepared to talk to people about

whether and how they could budget more adequately than they have, what risks are inherent in certain types of products and indeed whether they might want to think of getting more specialist advice. We also hand on a lot of those who contact us to the fee-charging advisory community. I am very clear that we can do more than simply provide information under the umbrella of the term "advice" which is not a regulatory term but one that ordinary folk understand.

On your question about standards, within the context of not giving regulated advice we have very clear and strict protocols for those people who man our phones or give face to face advice. Of course, the material that goes on our website is monitored and has to meet a standard, which is regularly checked.

Q190 Mr Ruffley: If someone rang your advertised telephone number and said, "I don't understand my American Express monthly statement and why I'm being charged this rate of interest for an uncleared balance, or portion of a balance", your staff would get into that?

Tony Hobman: Yes, they would. Clearly, a huge number of queries of that nature, which are more or less complex, could be answered by them or they could direct the person to someone else who could. In many cases the inquiries will relate to debt, for example, where people are better served currently by going to specialist debt advisers.

Q191 Mr Ruffley: Some people in the industry have indicated to the Committee that there are organisations other than yours that already provide website price comparison services. Is there any degree to which you are reinventing the wheel and duplicating efforts better done by other existing price comparison services?

Tony Hobman: I do not believe so.

Q192 Mr Ruffley: Why so?

Tony Hobman: I will explain. First, we know from the research we have done that to reach the number of people we intend we must have their trust; they must want to relate to us, and the aspects of our service established by the Government, being free and not relying on a commercial model for our income, are important to them. It is important that we have a suite of products branded as the Money Advice Service which they know are ours.

The other point I make is that there is enough room for us all. We know from research done last year that only 11% of people look at savings account comparison tables, for example, which you have mentioned. That tells me there is a job for us to do and for others too. A lot of potential has not been met in the market. I think there is room for all of us.

Q193 Mr Ruffley: There is reference to co-ordination agreements with the FCA, which will be the subject of a memorandum of understanding. Can you describe what that will cover?

Tony Hobman: We have an MOU currently with the FSA which talks about the way in which and the frequency with which we will talk to each other and the topics on which we

would expect to liaise. I would hope to take forward the core of that. One thing that is different about the world ahead, and therefore characterises our relationship with the FCA, is that because of the relationship with this very large number of people we will have a unique and important body of consumer feedback on the things that are issues to them. That will be pre-detriment in a sense; that is the missing part of the jigsaw at the moment. It is not when things have gone wrong but the things that people are talking and asking about which suggest they already have issues. I would expect that within any memorandum of understanding with the FCA it is important we project that information to them and they listen to it.

Q194 Mr Ruffley: I put one sneaky question to the financial ombudsman and chief executive. You may or may not have heard the evidence of Martin Lewis earlier. He said it would be hugely in the interests of consumers if when a complaint was made against a company for that financial service firm to be aware of previous rulings by your service and take account of the precedents established by your service when determining an intra-company complaint. That seems a bit of a no-brainer. Is there any mechanism you can see in this legislation that will deliver that objective?

Natalie Ceeney: In many ways that is already there. The FSA rules already say that firms ought to have regard to previous rulings. Of course, firms see the individual rulings, so in many ways that should have been happening and has not.

Q195 Mr Ruffley: But Mr Lewis was quite clear that it was not happening and you can infer it is not happening from quite a few of the statistics.

Natalie Ceeney: There are certainly some firms that are not paying regard to what we have done in the past. I think it is more to do with culture than rules. One thing that will help is inclusion in the Bill of an obligation on us to publish all ombudsman decisions. One issue is that firms should learn from themselves, but it would also be good for the financial services sector if they all learned from one another's mistakes. We really welcome that inclusion. Going back to some earlier comments, greater transparency can rebuild and not reduce confidence.

Q196 Lord Maples: On this point, Martin Lewis went a bit further. He said that if a firm had been found against by you and continued to reject the same complaint from other customers you or somebody should have power to fine them or impose a sanction against them. Is that feasible?

Natalie Ceeney: To some degree, the FSA have been able to do that and started to do it. In the last 10 years they have levied £10 million of fines on financial services firms for poor complaint handling. We do need to keep upping the stakes on bad complaint handling because there need to be more consequences for getting it wrong. Fines help, but my view is that the more transparent we are and the more publicity is given to it potentially it will have an even greater impact.

Q197 Baroness Wheatcroft: However hard the industry tries, inevitably there is an asymmetry of information between financial services providers and clients. There is a power under the new regime to ban certain products, but I wonder how extensively you would like to see that used and where the balance between caveat emptor and the provider should be. For instance, Paul Lewis was adamant that endowment mortgages were so dangerous they should never have been sold to anybody. There are people who would take a very different view and did very well out of endowment mortgages. Where do you see the balance?

Natalie Ceeney: A lot of products sold are suitable for some people but not all. The sorts of issues I see are those where products designed for sophisticated investors are sold to the unsophisticated in an inappropriate way. Tackling the sales end and the sales culture is in many cases more appropriate than necessarily looking at products, because well-designed products can be sold to the wrong people. There are other leading indicators. If you look at mortgage endowments, one of the big issues was that it became the dominant product sold. I agree with you that it was very suitable for some people and highly unsuitable for others, but when it becomes almost the only show in town and everybody pushes it you start to worry. The same trend occurred in PPI. It was pretty hard to buy a loan without somebody saying, "Of course you need PPI." The other indicator is that I have heard a leading insurer say that when you start seeing margins of 90% on a product alarm bells should ring. Most products are suitable for some people. Take the issue raised earlier about some of the complex mortgages that are in the market at the moment. When we look at complaints in those cases often our view is that they are fine as long as they are sold with advice and suitability is very carefully assessed. When that is not done we start to have concerns.

Q198 Baroness Wheatcroft: It sounds as if you would hope that a product ban would be quite a rare thing.

Natalie Ceeney: Yes. To take PPI again, in the end mis-selling was happening so widely that there was a ban on the sale of single premium PPI. I think that was the right decision because so much history had happened to make it the right decision. It also comes back to another theme of this debate. We have to get the culture right so it is not constantly stopping things after the event but these things do not happen in the first place because the prevailing culture in financial services is that customers should be treated fairly.

Q199 Baroness Drake: In response to the question about advice, you said there were circumstances in which you handed on those who raised queries to the fee-paying community. How do you do that?

Tony Hobman: If they were speaking to us on the phone or face to face we would conceivably signpost them there and then, but it is more likely we would put them in contact with someone like unbiased.co.uk which is an umbrella organisation for IFAs so they could find an IFA where they lived.

Q200 Baroness Drake: Do you run a panel or list of IFAs? Do you get engaged in preference?

Tony Hobman: We use IFAs in the development of our material.

Q201 Baroness Drake: But when you are handing over the people.

Tony Hobman: If you went to our website and, as a result of using that information, it was clear that it was something you might want to explore, we would have a gateway into the advisory community, but we would not list every single one. This may be a point about recycling some of the other materials available in the commercial world. There are several good portals into the advisory community.

Q202 Baroness Drake: What I am trying to get at is: can you be certain that IFAs do not get preferential access?

Tony Hobman: If that is your point, absolutely not. We do not recommend one IFA above any others.

Q203 Lord McFall of Alcluith: Mr Hobman, what is your budget for the current year, and what is the projection for the next three years?

Tony Hobman: Our current budget is £47 million. We are absolutely in the middle of setting our budget for next year. I cannot give you a definitive figure yet, but I would expect it to be of the same order of magnitude for the preventative work we are doing. There is another task, and therefore cost, on the horizon. The Government have asked us to take over the co-ordination of debt advice. Currently, the face to face contracts, which were run by BIS through Citizens Advice, are of the order of £27 million. There is a clear indication that if we took those on a somewhat greater amount would be needed.

Q204 Lord McFall of Alcluith: Are you content that with a combined budget you will be able to carry out the task?

Tony Hobman: Yes. To go back to what I said earlier in response to Mr Ruffley's questions, without being over-critical of the past we can get a lot more bang for our buck by being smarter about what we do and how we do it.

Q205 Lord McFall of Alcluith: I had personal experience of PPI in 2005. I went into Barclays Bank and they offered it to me. I did not need it. I got eight letters after that. I reported it to people. Five or six years later they dragged it out until we got to this stage. Natalie, will this Bill help in a situation like that, or will you still be in the position where 50% of your work, as was the case over the past 10 years, is associated with these issues as such? If it is, we will not be able to move forward.

Natalie Ceeney: I am an optimist. I think we have to find ways of doing it, but part of it is power and part of it is culture. As to the things in the Bill that I think are good to prevent mis-selling, we need a regulator who will intervene earlier, which is partly to do with powers and culture. We need a mechanism whereby when systemic issues are flagged they have to be brought to the regulator's attention. Others have talked about a super complaint power, and under the present proposals that is mooted. We would welcome a formal mechanism

for issues to be brought to the regulator's attention with a time limit for resolving those, but it really comes down to the will to act. We need a willingness to act.

Q206 Chairman: There is one final question that I hope each of you can answer in two sentences at most. Is there any single power or objective not in the Bill that you would like to see included, or anything in the Bill you would like to see changed? If the answer is no, that's fine.

Tony Hobman: No, other than perhaps some clarification, which may be consulted on, to take in our debt role. For the record, our precise budget is £43.7 million.

Natalie Ceeney: The super complaint issue I raised needs clarification. At the moment it is a very tentative issue, and it is quite material to the future of the Bill. Others have already mentioned consumer credit and where that fits in. For the ombudsman it does not matter because we can work under multiple regulatory regimes, but to clarify that is key for other reasons.

Mark Neale: The Bill looks to be in good shape to us, but we are working with our colleagues in FOS and the FSA to look at the existing provisions on the exchange of information among the regulatory agencies to ensure they provide for the free flow of information.

Chairman: Thank you all very much indeed for your evidence today. It is very helpful to the Committee. You have given very clear and comprehensible answers to all of us. Thank you for that and for your prior advice.

Consumer Focus – supplementary written evidence

Thank you for the opportunity to provide oral evidence to the Joint Bill Committee. In view of the limited time available to get complex points across, I thought it might be helpful to confirm our main points in writing. We have reflected further on the issues and have four main priorities for the new legislative framework for financial services regulation. These are set out briefly below:

FCA's strategic objective

An overarching strategic objective to protect and enhance market confidence is inappropriate and 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 recommend a formulation along the lines:
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.

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.

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.
- '*The general principle that consumers take responsibility for their own affairs' in 1C(2)(f)* be deleted, for the reasons given in our submission (and also be deleted from the list of regulatory principles in Chapter 3 of the draft Bill).
- A new clause is added to the list of 'have regards' in 1C(2): *'the particular needs that low income, elderly, disabled or other vulnerable consumers of financial services may have'.*

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 **efficiency and choice objective** would then become otiose and could be deleted.

PRA Veto

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 cooperate with the Bank in the pursuit of its stability objective, the duty on both the FCA and the PRA to coordinate 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. It could provide cover for more cautious behaviour and a reluctance to act appropriately in the discharge of its statutory remit by the FCA. It could influence behaviour in a way we do not think either Parliament or voters would want. We believe the FCA should have equivalent stature and status to other parts of the new system and not be perceived to be subordinate in any way.

Bank / FPC / PRA remit

We would like to see more conditioning of the **stability remit of the Bank and the FPC**. Under the Bill as drafted, the Bank and FPC could pursue a financial stability goal at the expense of credit availability and reasonable growth in the real economy. The decisions and judgements are to be largely in the hands of a small group of senior bank officials with little or no public accountability, and with weak, largely retrospective accountability to Treasury Ministers and to Parliament.

Likewise we find the **PRA's statutory remit** to be flawed. 2B(2) states that the PRA's general objective is to promote the safety and soundness of PRA authorised persons. Promoting the safety and soundness of particular firms is a means, not an end. The end is surely to ensure continuity of financial service provision in order that business and institutional customers and consumers can get the services they need, and that their money is protected. There is no mention of the interests of end users and customers (other than policyholders) in the PRA's remit, which puzzles us. We do not have specific drafting proposals, but believe this is a point the Committee will wish to reflect upon.

I hope this letter is helpful and would be happy to provide further elaboration on any point if required.

28 September 2011

Consumer Focus – further supplementary written evidence

Financial Services Products and Consumers

Following our evidence session with your Financial Services Bill Committee, we have been thinking further about how a future regulatory regime could reduce consumer detriment and facilitate wider consumer uptake of good value products that geniunely meet consumer needs.

We have set out below the sort of model we think is required. You will note that the general direction of travel is deregulatory in that – where there is clear evidence of a reduced risk to consumers - we see scope for cutting back on detailed, intrusive conduct of business requirements where products can be guaranteed to meet specified minimum standards and have clear comparable pricing.

The current (largely process-based) regulatory approach to retail mass market business has been shown not to work. Growing product complexity, and lengthy product information disclosures which are hard to understand, have made it difficult for consumers to make informed choices. We have seen waves of mis-selling and growing mistrust in financial services products. This results in many consumers failing to buy the products they need.

We believe that partnership working between industry and consumer groups could set up the sort of machinery we describe below, with benefits to regulated firms and consumers alike. It could be achieved within the Bill by giving the FCA a new power to enable it to recognise a not for profit body corporate known as the Trusted Products Board subject to certain specified criteria.

I hope this proposal is of interest to your Committee and would be happy to discuss it further with you and your colleagues if that would be helpful.

Financial Services : Trusted Consumer Products

Proposal: Establish an independent body [the Trusted Products Board - TPB] to set common standards for a suite of mass market financial services consumer products. The TPB would be a not for profit Community Interest Company, funded by the financial services industry and with active industry participation but with a Chairman and board made up of a majority of independent public interest directors.

The TPB would be staffed by a small full time secretariat and advised by Standing Panels comprising mixed teams of industry and consumer representatives.

The FCA would have powers to recognise a TPB, subject to established criteria, and to devote resources to helping to bring it about. It could also have observer status but it would not be a member of the TPB. It would have powers to de-recognise a TPB if it was clear that established criteria were not being met.

Objectives of TPB: The TPB would agree:-

- A suite of mass market consumer products which would be defined by a set of common minimum standards – of design, governance and management
- The specific common standards for each identified product
- Common terms to describe products and define what is included in the product price, so products could be compared and consumers could shop around and compare like with like
- A logo or kitemark which providers of qualifying products could license and use for products which met the agreed minimum standards
- To monitor the market and identify and ban any emerging additional product features on products which otherwise met minimum standards if the TPB considered they could cause consumer detriment
- To keep under review changing consumer needs and the changing financial services environment and (a) add new products to the suite of trusted products as required and (b) modify or remove items from the suite of existing approved products

Relationship to FCA, MAS, and FOS:

- The FCA would agree to apply a lighter regulatory regime to the sale and marketing of Trusted Products. Provided they complied with the TPB terms they would be capable of being sold by authorised firms within an appropriate risk based set of FCA rules. Consumers would be strongly urged to undertake a money advice check via the MAS before purchase. Product providers would still retain a legal duty of care towards their customers.
- The MAS would be able to lead its clients through to a MAS comparable table of Trusted Products that were suitable following a financial health check. This should help widen the market for both the MAS service (as the gateway to buying a trusted product) and trusted product markets.
- TPB approval would be taken into account by the FOS in consumer complaint cases.

Benefits

- Greater public trust in retail financial services markets
- More effective competition by making it easier for consumers to compare products and shop around
- Better value for money through clearer price disclosure in terms consumers understand
- Wider uptake and bigger markets for retail products – greater financial inclusion
- Lighter touch regulation where products are less likely to cause detriment

- Prevention of future detriment through effective market monitoring and oversight of new products
- No need for the regulator to screen products and dampen innovation
- Greater flexibility to respond to changing consumer needs and financial market environments than is possible through the formal regulatory system
- Opportunity for open transparent debate between providers and user/public interest representatives about what kinds of products and product features genuinely meet consumer requirements

2 November 2011

Consumer Focus, Citizens Advice and Which? – written evidence

Evidence to be found under Citizens Advice

Rt Hon Alistair Darling MP; Professor Charles Goodhart CBE, Professor Emeritus of Banking and Finance, London School of Economics; Professor Eilis Ferran, Professor of Companies and Securities Law, Cambridge University; and Professor John Kay, Economist – oral evidence (QQ 207-287)

Transcript to be found under Professor Eilis Ferran

Mr TWR Davies – written evidence

All of the problems in the financial system stem from a single cause;
The ability of the commercial banking system to create money and the fact that 97% of our money now in use was created by commercial banks.

The rate of increase in the money supply as defined by M4 had reached about £177 billion a year in 2007. The need to find a home for this money led to the creation of ever more risky forms of investment which collapsed.

It would be a mistake to attempt to stem these problems only by changes in bank regulation. The answer lies in preventing banks from creating money. Banks should only be allowed to lend money they have received in the form of deposits from holders of existing money.

The only source of new money should be the Bank of England, in the form of loans made by the Bank of England or government expenditure above tax receipts.

The above ideas are amplified and justified in a short publication at www.legalforgery.com

September 2011

Deloitte LLP – written evidence

1. Is the separation of prudential and conduct regulation into a "twin peaks" system the right approach?

   It can be the right approach. However, experience of the crisis has shown that no single regulatory structure or architecture guarantees successful regulatory results. Whether "twin peaks" will in practice prove to be the right approach will depend on how it is implemented and, in particular, on effective co-ordination between the relevant bodies – particularly the Prudential Regulatory Authority (PRA), the Financial Conduct Authority (FCA) and the Financial Policy Committee (FPC). And no regulatory structure can be considered in isolation from the policy framework or the expertise and attitudes of the supervisors who implement that framework.

2. What lessons can be learnt from the approach of other countries to regulation of the financial sector?

   As noted above, the most powerful lesson is that regulatory structure is not a panacea. Some countries with integrated regulators fared well during the crisis; others such as the UK did not. Similar examples and counter-examples can be found for twin peaks regulators and for sector-specific regulators. This in turn suggests that any sensible regulatory structure can be made to work; each has its own advantages and disadvantages which need to be taken into account in implementing the structure. In addition, care must be exercised in comparing the UK with other countries given the different characteristics and market shares of the financial services industries in the various countries.

3. Is it appropriate to make such major changes to the regulatory system by way of amending legislation, rather than starting afresh?

   No response.

4. Are the accountability and governance arrangements for the Bank of England, FPC, PRA and FCA satisfactory?

   The arrangements are, in our view, broadly satisfactory, with two exceptions. First, we believe that the legislation should require the PRA to have a standing Practitioner Panel, as the FSA has now and as the FCA will have in future for the purposes of engagement and consultation with the financial services industry. The PRA has exactly the same policy-making functions as the FCA and equivalent supervisory functions. We see distinct advantage to the PRA having ready (and, if need be, immediate) access to a group of very senior practitioners drawn from the types of firm that the PRA will regulate. Such a body would be well informed of the PRA's approach and way of thinking, built up through regular engagement with its senior management (in a way that ad hoc groups would not), would provide information on the practical impacts of policy changes across all sectors of the industry, assess the combined impact of different regulatory initiatives (including across the PRA and FCA) and assist the PRA to engage actively and early with the European Supervisory Authorities (ESAs).

The second exception concerns the governance arrangements for the Bank of England, given its now very broad and diverse remit. The nature of the new structure, and the huge responsibility and workload placed on the individual who is Governor of the Bank, means that there is a real risk of bottleneck, in the absence of robust arrangements for delegations and other support for these tasks. Given the current lack of information about these arrangements, this risk remains.

5. Are the FPC's objectives the right ones? Is the concept of financial stability adequately understood for the FPC to be able to perform against its objectives?

The FPC's objective is the right one but, as the question implies, further debate is needed so as to arrive at an agreed understanding and definition of the concept. This is essential, both in its own right and also to ensure that the FPC and the Bank of England can be held to account for discharging the financial stability objective.

6. Should the FPC be limited in the actions it can take which might affect the growth of the financial sector?

It could be counterproductive to deny the FPC the ability to undertake certain actions or use certain tools in advance. A preferable approach, which the Government appears to be following, is to specify the objective in terms of its impact on economic growth and to place checks and balances around the FPC's use of its toolkit. An additional safeguard would be to require the Bank to consult publicly, each year, on how it intends to pursue its financial stability strategy.

7. How will the interaction between macro-prudential and monetary policies be handled by the FPC and the MPC?

No response.

8. Has the right balance been struck between the powers of the FPC and the powers of the Treasury?

No response.

9. Can Parliament take an informed decision about the proposals for the FPC without details of the macro-prudential tools at its disposal?

Until there is some clarity around the precise tools to be used by the FPC there will be some residual doubt about how far it is equipped to fulfill the role given to it, and about the appropriate checks and balances on its activities. However, the requirement for the FPC to set out in advance its toolkit and its proposed use of those tools is an important safeguard, as would be a requirement to report periodically (perhaps annually) on the effectiveness of any tools it had deployed.

It is also important to recognize that the FPC's influence on the day-to-day work programme of the PRA and the FCA (e.g. by asking them to collect data and carry out further investigative work into what are assessed as emerging financial stability risks) is

another "tool", whose use needs to be monitored and evaluated given that work on behalf of the FPC may displace work that would otherwise have been carried out by the micro-prudential regulators.

10. Does the draft Bill adequately deal with the risks posed by the shadow banking system?

The key powers needed to deal with the shadow banking system are that the authorities should be able to require information from entities which, while not currently regulated, pose a threat to the authorities' objectives; and if necessary, to extend the regulatory perimeter to bring those firms within its scope. These powers exist within the draft Bill.

11. Are the PRA's objectives clear and appropriate?

Yes, although it is important for there to be clarity about the relationship between the PRA's financial stability objective and its insurance (policyholder protection) objective. In almost all cases the objectives will be complementary but the possibility of a conflict cannot be ruled out. In such an event, would the financial stability objective always take priority, or would this depend on the circumstances and how would such decisions be made?

12. Are there any risks in the Government's proposed 'judgement-based' regulation?

There are two risks – one internal, the other external. The internal risk concerns the availability of senior, experienced regulatory staff able to exercise judgement in an increasingly complex financial services market in a consistent fashion. Consistency is particularly important and would, as noted earlier, be assisted by having a standing Practitioner Panel able to provide senior, well informed feedback on the exercise of judgement-led supervision. The external risk comes from the EU, and whether the combination of an increasing amount of EU legislation being in the form of Regulations and the desire for a single EU rulebook, achieved through binding technical standards issued by the ESAs, will be inimical to a judgement-led approach.

13. Is the Government's proposed approach to 'orderly' firm failure satisfactory?

The concept of "orderly firm failure" is a key component of the new framework, not only for the PRA but also for the FCA. In this context it is important to note that while the draft legislation includes an explicit "no zero failure" clause for the PRA, there is no equivalent clause for the FCA. There is no obvious reason for this asymmetry and it could be interpreted as setting the FCA up as a "zero failure" regulator, which would be an impossible task, and would seem to be contrary to the FCA's efficiency and choice objective. It is important to recognize that planning for the orderly failure of firms needs to extend beyond the banking and building society sectors if it is to become a reality for all types of firm.

14. Given that the PRA and the FCA will inherit FSA staff does the draft Bill do enough to ensure a new regulatory culture and a more proactive approach to regulation? Will these two new bodies have staff with the appropriate skill and expertise?

It is difficult for any piece of legislation to "ensure a regulatory culture". The legislation, through the objectives it confers on the new regulators, can set the new direction. But

ultimately it will be for the Boards and senior management teams of the new regulators to determine the cultures of the organization.

15. Are the FCA's primary objectives appropriate? Is significant emphasis given to the promotion of competition?

    Combined response to Questions 15 and 16. The FCA's objectives are, in our view, broadly appropriate although we believe certain aspects should be further emphasised. One of the greatest challenges for the FCA will be to secure sufficient differentiation in its regulation of retail and wholesale markets. There remains widespread concern among wholesale market participants that the FCA will find it difficult to make such a distinction and that over time the pressure on regulators to focus on retail matters will erode this distinction. One important safeguard would be to ensure, through legislative routes and otherwise, that the FCA always looks first to promote competition when dealing with wholesale market concerns before resorting to other, regulatory interventions. This would help reduce the risk of inappropriately detailed retail market regulation being read across to wholesale markets.

16. Are the responsibilities of the FCA towards the regulation of markets appropriate?

    Combined response to Questions 15 and 16.

17. Does the draft Bill strike the right balance between the responsibilities of consumers and firms? Are the FCA's new powers in the area of consumer protection appropriate?

    The draft legislation reproduces the wording of the existing Financial Services and Markets Act in that there is a "regulatory principle" that recognises that consumers should take responsibility for their decisions. This misses an opportunity for a fundamental debate in order to clarify the responsibilities of regulated firms on the one hand and consumers on the other. Such clarification is by no means straightforward, but would benefit both firms and consumers.

18. Are the prudential regulatory responsibilities of the FCA towards FCA-only regulated firms given sufficient emphasis and detail?

    No response.

19. Will the new regulatory arrangements reduce the risk and cost of dealing with mis-selling of financial products?

    No response.

20. Are the proposals for co-ordination between the PRA and FCA clear and adequate? What would be the advantages and disadvantages of having a Single Point of Contact and/or a joint rule book for dual-regulated firms?

    In principle, the co-ordination arrangements are clear. However, at present it is very difficult to judge how the arrangements will work in practice, given the absence of any real detail to underpin the very welcome high level statements about the need for effective co-ordination.

We are supportive in principle of a single rulebook for:

(a) those firms – such as certain investment firms – whose regulation, as a class, will be split across the PRA and FCA. In the absence of a single rulebook, the scope for regulatory arbitrage would increase; and
(b) those aspects of regulation for dual-regulated firms where there should be no reason for any substantive difference of expectation between the PRA and FCA. These aspects could include: probity standards for approved persons, high level systems and controls standards, governance and senior management arrangements.

21. How do the proposals in the draft Bill fit within the new European regulatory regime? What freedoms and constraints will the UK have to operate within that regime?

No response, but please see our response to Question 12 for one risk which we believe exists in relation to the EU's approach.

22. Does the draft Bill contain any proposals or omissions, not covered by the questions above, which cause concern?

No response.

September 2011

Deutsche Bank; JP Morgan and Goldman Sachs – oral evidence (QQ 848-914)

Transcript to be found under Goldman Sachs.

Charles Dumas, Lombard Street Research Ltd; Gillian Tett, Financial Times and Lord Burns – oral evidence (QQ 1-63)

Transcript to be found under Gillian Tett

Mr Andrea Enria, European Banking Authority - oral evidence (QQ 64-98)

TUESDAY 13 SEPTEMBER 2011

Heard in Public Questions 64 - 98

Members present:

Mr Peter Lilley (Chairman)
Mr Nicholas Brown
Baroness Drake
Mr David Laws
Lord Maples
Lord McFall of Alcluith
David Mowat
Mr George Mudie
Lord Newby
Mr David Ruffley
Lord Skidelsky
Baroness Wheatcroft

Examination of Witness

Witness: **Mr Andrea Enria**, Chairman, European Banking Authority, examined.

Q207 Chairman: Mr Enria, welcome. Thank you very much indeed for agreeing to come and meet the Committee and allowing us to question you a little about the relationship between regulation of the banking system and the financial system at a European and a national level. As you know, we are carrying out pre-legislative scrutiny of the proposals the Government has put forward for legislation in this country, legislation which may also be amended to incorporate some of the recommendations that were made yesterday by the Vickers Committee, of which you may have heard; indeed, if you have read the British newspapers you will have read of little else. We are very interested in how that will interact with the European level.

May I ask you at the beginning whether the 2008 banking crisis that we have been through and its subsequent unravelling were in any way exacerbated by a lack of pan-European regulation at that time? Was there regulatory arbitrage between countries and, if so, did that contribute to the problem or not?

Mr Enria: First of all, thank you very much for inviting me to this hearing. It is a privilege and an honour to have the opportunity to speak in front of you. I would say definitely, yes, it contributed. I remember I was working as Secretary General of the Committee of European Banking Supervisors here in London back in 2004-2005, and at the time we identified two major issues that were creating problems in terms of a level playing field across countries in the European Union. These two issues were the definition of capital for banks and the lack of a standardised approach to liquidity risk supervision.

If you look at the two main responses after the crisis, the focus was very much on these two topics, and the lack of a common standard has led in these two particular areas to serious cases of regulatory competition amongst jurisdictions. I remember, wearing my national supervisor's hat in Italy, that very frequently I found the banks coming to me and saying, "I should be allowed to issue this type of capital instrument. You should recognise it as top quality capital because that is what happens in the neighbouring jurisdiction, and if you do not do so I will be at a competitive disadvantage." The pressure on the national regulators was quite strong. Eventually, in most cases, this competitive process led to a deterioration in the quality of capital at the European banks, and this was very much an element of weakness when the crisis occurred.

Besides the regulatory competition issue, I would like to mention the issue of co-operation between home and host supervisors. I think a lot of effort was made in the past to improve co-operation, especially within the so-called colleges of supervisors, which gather, under the guidance of the home supervisor, all the competent authorities involved in the supervision of the different branches and subsidiaries of a cross-border group. A lot of effort has been put into stepping up co-operation there, but I think it is commonly acknowledged by all the authorities that not enough co-operation was in place, and when there have been moments of tension these co-operation mechanisms have often broken down. I remember especially the fact that a lot of work was done in the past on crisis management at the European level, drafting memoranda of understanding between authorities that were supposed to foster co-operation. Unfortunately, when the crisis occurred, we saw more retrenchment—rather naturally, I would say, but it is still questionable—to try and protect only national taxpayers and national depositors. This did not always lead to the most co-ordinated approach to the crisis and was not perhaps the most effective solution. I think these two issues of regulatory competition and co-operation are probably the two weak spots that were present in the co-operation arrangements when the crisis came, which contributed to aggravating the crisis further.

Q208 Chairman: That is very helpful indeed and very interesting. So the regulatory competition was more that the regulators responded to pressure from the banks in a downward spiral to reduce asset requirements rather than banks actually moving from one jurisdiction to another, or shifting business from one jurisdiction to another, in response to differences. I say that partly because it was somewhat of a revelation to many people in this country, once the crisis unfurled, that continental banks, we were told, had lower asset

requirements or asset holdings than in the UK, and yet we saw no evidence of UK banks shifting on to the continent to take advantage of this.

Mr Enria: This is a completely personal view. There are areas of business in which relocation in order to minimise the regulatory or tax burden occurs quite frequently. We have seen a lot of asset management business, for instance, being located in Luxembourg or Ireland because of the tax treatment. Certain components of financial business do react, especially in the wholesale part of the business, to the potential burden of regulation or taxation or other public policies, but, in general, the threat of relocation in response to some regulatory treatment, especially for banks, is not always very credible. Usually, the banks use this argument vis-à-vis their supervisors, and I think it is also a legitimate argument to use in terms of the dialogue that needs to be in place between the regulators and industry. I think it is also good to have some element of discipline on the regulators to some extent to know what their fellow regulators do in other jurisdictions. But I have never seen a lot of massive relocation across Europe due to differences in the regulatory burden, and I can tell you that there have been quite substantial differences in the regulatory burden across European countries in the last 20 years since I started my career as a supervisor.

Q209 Mr Ruffley: Good afternoon, and thank you for speaking to this Committee. I would like to ask you a question about the European Systemic Risk Board and the Capital Requirements Directive, and I would like to quote our own Mervyn King, wearing his hat as Vice-Chair of the ESRB. Mervyn King said, "Under the current proposed capital requirements regulation, maximum harmonisation would not only limit the counter-cyclical buffers that could be imposed, but would also limit the number of instruments at the ESRB's disposal. In certain situations such a toolkit could be too weak or too restricted to prevent a build-up of excessive risk and leverage. It would be peculiar if one European body inadvertently prevented another from carrying out its remit." That is what our Governor said, wearing his Vice-Chair hat. What is your response to that, and do you agree with that assessment?

Mr Enria: I also have the honour of serving as second Vice-Chair of the ESRB, so we engage in quite intensive discussions at the ESRB table on these topics. I would say, on the first point raised by Governor King, that I agree with him that having a ceiling on the possibility of raising the counter-cyclical buffers, as he mentioned, would have been a mistake, and I am glad that the Commission removed this from the proposal that they put on the table at the end of July. There was a specific letter that the ESRB wrote on this point and the Commission reacted, in my view, very positively to that.

On a more general note, I would like to make a point which I hope I am able to get across because it is not always easy. I think there is a little bit of a misconception about maximum harmonisation and maximum requirements. As a regulator, I would not favour in any way the rules imposing a ceiling on the requirements that I could put in place. Let us put aside the issue of European legislation versus national rules. For instance, you have the so-called Pillar 2 under the Basel Standards, which allows supervisors to raise the capital requirements for each single bank in such a way that the requirement is in line with the specific risks that this bank has in its portfolio. So you can have a single rule that is applied fairly across all the institutions and which allows the supervisors the flexibility to raise the capital level of a specific institution because of its specific situation.

If you move to the macro-prudential area or to the structural issues that you might have within Europe, there needs to be an acknowledgement that you need this flexibility at the national level. You might have a real estate bubble in one country while you have a depressed real estate market in another country. So it is important that you have the flexibility to manoeuvre the capital requirements, or any other requirements, with respect to real estate exposures, for instance, in such a way as to tailor the specific risks in this jurisdiction. My point is that with maximum harmonisation, in my view, this measure should occur within a single framework, so you should have a sort of European process for doing that in order to ensure that there is a level playing field across jurisdictions. This, in my view, is very important, irrespective of whether breaching common rules is downward or upward, because it is very much in terms of how the rules work in the single market.

In a nutshell, I am very much in agreement with Governor King that you do need flexibility as supervisors to raise capital requirements, or any other requirements, to fit the specific needs of a jurisdiction. I would argue, maybe in addition to what Governor King says, that it is important that this process occurs under strict European co-operation. The European Systemic Risk Board, in my view, is the most appropriate body to make sure that this type of policy interventions at the national level are discussed and shared with fellow regulators in other jurisdictions.

Q210 Mr Ruffley: That is a helpful answer. Your view is that maximum harmonisation is not such a big problem.

Mr Enria: Yes, absolutely. Actually, my view is stronger than that. Maximum harmonisation is a big step forward, in my view, in the functioning of the European markets.

Q211 Mr Ruffley: Some of the briefing we are getting from the UK Treasury is along the lines that there might be a difficulty with the most recent draft of the Capital Requirements Directive, as I understand it, in that the current draft will say there is a 7% ratio and that this might prevent, in UK law, our implementing a 10% figure, pursuant to our Vickers inquiry. Do you recognise that argument—that maximum harmonisation will not give the UK the flexibility to go up to 10% and impose a 10% requirement, rather than the 7% in the directive, the directive, of course, implementing Basel III?

Mr Enria: First of all, let me make a disclaimer. I am not in a position to give the original interpretation of the Commission's proposal. I will give you my reading of the Commission's proposal and my reading of how it should work at the European level. As it is now, the minimum requirement is actually 4.5%, but with the additional buffer it goes to 7%. There will probably be, after the implementation of the systemically important banks, standards agreed in Basel as an additional part of legislation. This is the minimum requirement. There are several tools that are laid down in the Commission's proposal which allow flexibility to raise the capital levels above this threshold. One, as I said, was Pillar 2, referring to individual institutions, which was in place before and needs to remain in place after the reform.

Then there is an interesting proposal and there is discussion also at the regulatory table whether this proposal is the right way forward, but it is an interesting proposal, in my view, to use Pillar 2 also for classes of banks. You can identify that a class of banks engaging in a

particular line of business faces a particular risk, so you might wish to have additional requirements for that class of banks.

And there is another provision, which, again, has been debated and probably will be debated at the table of the Council in the European Parliament, which is to use the flexibility given by the counter-cyclical buffer also for structural reasons, so that, if you have in your national banking sector specific structural features that raise the level of risks in that jurisdiction, you would be allowed to have additional capital set aside. In principle, in my view, the two things are not in contradiction. At the moment I do not yet see a process for having these sorts of decisions at the national level discussed within the European framework, and I hope that this process is set in place and in motion.

Q212 Mr Ruffley: A final question on this, Chairman, if I may. When an emergency situation is declared by the Council, the ESAs will have enhanced powers to co-ordinate member states' reactions and policy responses, and, as I understand it, make binding decisions on national supervisory authorities. Could you identify what classifies as an emergency situation, because I know that when Mr Barnier visited a parallel Committee to this—the Treasury Select Committee—he was not entirely clear, and I know the English parliamentarians were rather concerned that he was not able to outline what might constitute an emergency such that an ESA like your own could issue a binding instruction to the FPC in this country.

Mr Enria: I must confess I have some sympathy for Commissioner Barnier because it is very difficult, and probably it would also be, in my view, too restrictive to have a precise identification of exactly what could be a crisis.

Q213 Mr Ruffley: I am not asking for a precise definition. We need to understand, I think, in this Parliament, what the circumstances are in which your body, or one of the two other ESAs, could impose a binding instruction on a UK national supervisory authority. The list I am asking you for is not an exhaustive list; it is not a definitive list. It is merely a set of possibilities when our supervisory authority in the UK would be overridden by a European entity.

Mr Enria: First of all, let me say that I do not read the article of the regulation as an overriding article. It is an article according to which you can take joint decisions quickly. First of all, it is a joint decision that you take at the table of the Board of Supervisors of the Authority.

Q214 Mr Ruffley: I am assuming this is in a situation where there is a difference of view between the UK supervisory authority and one of the EBA.

Mr Enria: Completely, but it is important to stress the fact that we view these as a sort of extreme case that should not happen.

Mr Ruffley: Of course.

Mr Enria: To me what is important is to find, in this situation, a common view at the European table. I have seen several cases at our table, even in the short lifespan that we have had as an authority, in which we have discussed very tense and sensitive issues, having different views, voting in different ways, and then complying and applying the decision in a very co-ordinated manner. So we know that this is the rule.

Q215 Mr Ruffley: I understand that. We do not need to be worried about that. What I am worried about is situations where there is a clear disagreement that cannot be resolved in the way you have just described between the UK supervisory authority and one of the EBA.

Mr Enria: For instance, let us look backwards. In the weeks after the Lehman crisis, in my view, it would have been very likely that an emergency situation, were the current regulation in place, would have been declared, and I think it would have been very useful to co-ordinate supervisory reactions better. If I had been the Chairman of the EBA at that time, I think we should have conducted some joint work to assess the relevance of structured finance products, for instance, in the balance sheets of banks, or in issuing transparency requirements for the banks at that time, and if a jurisdiction was not in line with these, yes, probably we would have tried to activate this overriding provision which is in the regulation.

Let me also record that there are, however, safeguards to the use of these provisions. One of these is that, of course, first we have to address these recommendations to the national authority. The national authority could react and explain why they think it is not appropriate to apply this recommendation in the jurisdiction. Eventually, if it is in any case overruled, there is, especially for the emergency situations override, the so-called fiscal safeguard provision, so that, if the member state thinks that by acting in this way the European authority is impinging on the fiscal responsibilities of a member state, they can activate a process within the Council to overturn this decision. Let me also say that another important safeguard is the fact that the emergency situation is declared for one month, and if it is not renewed every month by the Council all the provisions are not in place any more. So, if the Council is unhappy with the way in which the European Banking Authority is exercising its powers in an emergency situation, the Council can basically call off the game.

Q216 Mr Laws: Can I just follow up on Mr Ruffley's question about crisis situations? I guess one crisis that people are quite worried about at the moment, looking forward rather than backwards, is a default by one of the EU nations, most probably Greece. If there was a sovereign default in the EU, obviously not country-specific, under the new regulatory structures in the EU and the UK, could you run through what you see as the role of each of the major bodies, which I would take to be your own EBA, the ESRB and, presumably, the FPC and the PRA in the UK? What role, if any, would each of those bodies have in that type of crisis, and how would the co-ordination work between them?

Mr Enria: You will allow me, I hope, not to elaborate on the likelihood or—

Mr Laws: I am not asking you for a probability.

Mr Enria: We are regulators. So we start from the assumption that what the Council is saying, which is that there is a strong commitment not to allow member states to go in default, is the starting point for our work.

Q217 Mr Laws: Are you happy with the contingency plans?

Mr Enria: It is not denied that, in any case, before going in default we have serious stress coming from the sovereign at this moment on the financial sector, and this is, of course, generating strong pressures on financial institutions, on supervisors, in some countries.

Q218 Mr Laws: My scenario is when the crisis has hit; we have not managed to prevent it, just as we did not manage to prevent many of the problems in the last financial crisis. What then becomes the role of each of those key bodies in dealing with that type of crisis?

Mr Enria: First of all, whenever there is a shock that hits the financial system, the European Systemic Risk Board and the three European Supervisory Authorities have to think whether they should activate the procedure to call the Council and ask for an emergency situation. All the institutions have the possibility of suggesting to the Council that they initiate that, and this would surely be the first step to undertake. The European Systemic Risk Board looks more at the unravelling of the potential elements of contagion throughout the system and identifying recommendations to member states, European institutions or supervisors, in order to counteract this sort of contagion. We as supervisors, of course, would have to identify which are the financial institutions which are going to be hit by such a shock and probably convene meetings of colleges of supervisors to co-ordinate the actions in advance of these events, and to undertake any possible co-ordination or policy measures at the European level to minimise the impact of the crisis on the financial sector and eventually on the safety net.

Q219 Mr Laws: Who do you see as doing the heavy lifting in such a scenario? Where would we be looking, among this list of four institutions that I have given you, two of them UK regulators and two of them essentially EU supervisors, for leadership and action in a scenario which, by any measure, would be regarded as meeting the Ruffley crisis test? A sovereign default would be pretty high up the list of crisis outcomes.

Mr Enria: I would not like to sound elusive in answering this question, but it depends very much on the nature of the crisis. If the crisis is hitting a predominantly national entity or is confined within the borders of one or two jurisdictions, probably the national authorities will have to do most of the heavy lifting.

Q220 Mr Laws: But would that not be unlikely in the case of an EU sovereign default?

Mr Enria: In the case of a new shock cutting across borders and affecting, let us say, EU, if not global, institutions, I would say definitely that the European Supervisory Authorities

would have a major role to play. Unfortunately, we are still in the building-up phase and we hope that we will have a little bit more time to equip ourselves to manage a situation like that.

Q221 Mr Laws: Hopefully. In your own organisation in such a scenario, in terms of action rather than co-ordination with the national regulators, what tools would you have at your disposal for dealing with a sovereign default?

Mr Enria: For any event having to do with the situation of sovereign defaults, we do not have a lot of tools and supervisors to deal with something like that. Sovereign issues need to be dealt with mainly at the sovereign level. What we could do is provide advice to the competent authorities, to member states, the Council, and the Commission, to try to minimise the impact that this type of crisis could have on European financial institutions.

Q222 Lord McFall of Alcluith: A Financial Stability Oversight Board has been established under Dodd-Frank. What relationship do you have with that in order to manage a global problem?

Mr Enria: You raise an important point. There are several fora for co-operation between supervisors, for sure, for example, the Basel Committee. There are fora for co-operation between, let us say, central banks. In terms of these mixed bodies in charge of macro-prudential responsibilities, there is not yet a well-established global forum for co-ordination. But, having said that, I would say also that the central banks have a prominent role in these bodies, so there are fora for central banking co-operation, such as the G10 Governors' Meetings, and the Basel meetings would surely be the key forum for ensuring close co-ordination between the two sets of bodies.

Let me also say in general that there is quite a lot of effort under way between the two sides of the Atlantic, between the newly established authorities and the US authorities, to start engaging in a dialogue. There was yesterday, I think, in Brussels a meeting of the Financial Services Committee where the US authorities were present and engaging in the so-called financial market regulatory dialogue between the US and the EU. So, several channels of communication are open. In the macro-prudential field I do not think we have yet a dedicated forum for co-operation. The Financial Stability Board, to a large extent, which encompasses finance ministries, central banks and supervisors, would probably be the most appropriate forum for this type of co-operation.

Q223 Baroness Drake: If I could go back to Mr Ruffley's questioning and revisit some of the points that he was making, Mr Enria, you said in your introduction that one of the drivers for a single rule book was that the competition and pressure in the different regulatory jurisdictions had led to deterioration of capital in European banks. But we are faced with a letter from our own Bank of England that clearly does not have confidence that the single rule book will allow them the powers they need to set more stringent rules. That is currently their thinking. When one reads the comments that Mr Barnier made in response to an interview in our *Financial Times*, referring to the Vickers Commission maybe proposing

a 10% capital requirement for retail banks, he said, "We think we have the flexibility we need", which has an air of hesitancy. It does not have an air of, "We know that we will have the flexibility." So, although there is talk of buffers, from our perspective a key question is whether the proposed European regulatory framework would allow a 10% permanent capital requirement for British retail banks to be accommodated. That is the sort of question we need to nail in understanding whether the European framework would allow that permanent capital requirement to be the case.

Mr Enria: I will try to reformulate my argument a little bit to see whether I can manage to put it clearly. In my view, the flexibility to do that is in the directive. This does not mean that each and every increase in capital requirements should be considered as possible without scrutiny at the European level. Let me try to give an example in another way. For cross-border groups there are sometimes very intense discussions between home and host authorities on the capital level and on the distribution of capital across the group, between the parent company and the subsidiaries. We know that in some cases some countries, maybe countries which are predominantly host countries, might wish to raise capital and liquidity requirements for the banks with a view to attracting more capital and liquidity in their jurisdiction to protect depositors, perhaps, or financial stability in that jurisdiction more than in other countries, and this could create a tension between the home and the host countries. My point of view is that whenever you have requirements to go higher than the European level, which are bound to create a sort of redistribution of capital liquidity or whatever else in a group, there needs to be scrutiny to make sure this does not jeopardise the single market, that it does not de facto create barriers for business across borders and does not jeopardise or hamper the integration of the financial market in Europe. There needs to be an element of scrutiny, but the flexibility is there. If there is a good motivation for doing that, I think that this is allowed in the framework.

Let me put an additional point, which I really believe in. Since we had the crisis of Banco Ambrosiano in the early 1980s and BCCI in the early 1990s, one of the key objectives of supervisors has always been to have integrated, firm-wide supervision requirements for groups, because if you do not have them there is the possibility of major risks building up in the financial sector. So we must also be very careful that a lot of fragmentation in the requirements across integrated markets does not jeopardise the integrated risk management of financial groups. I think these things need to be considered, and, again, I want to stress that this is not going against having flexibility at the national level. I think this flexibility is needed. It is at the very core of what the G20 has agreed as a response to the crisis: the possibility of tailoring the requirements to the risks. The only point I am making is that you do need to have a process at the European level to make sure that these are coherent across jurisdictions and eventually strengthen the European and global financial systems.

Q224 Baroness Drake: Any increase in capital requirements above that set in the rule book would always need European clearance. There would be no delegated margin.

Mr Enria: "Clearance" is perhaps a strong word. There needs to be a process through which these are discussed at European tables, co-ordinated with other authorities, and, yes, also subject to some sort of review.

Q225 Lord Skidelsky: You may have a common rule book, but you have a possibility, do you not, that national regulators will display different levels of diligence in supervising the rules, which may or may not be a polite way of talking about regulatory capture?

Mr Enria: Yes.

Q226 Lord Skidelsky: Do you think that is a problem? How would you tackle it?

Mr Enria: I think this is the problem and maybe one of the most important issues. Thank you for this question. I do believe that after the crisis hit at the global level a lot of efforts were made in regulatory repair in reviewing the rules, but maybe the bug in the system beforehand was more in the enforcement, the supervision, than in the rules themselves. I think that major efforts should be made to achieve stronger supervision. I will just give you an example, and this also is very relevant for the single rule book. We have had common rules, for instance, under European regulations, under the International Financial Regulatory Standards, on the consolidation of vehicles. When you had special purpose vehicles, structured finance vehicles, there was a rule that you should consolidate those vehicles if there was not a significant risk transfer. This was the wording in the rule out there in Community legislation.

The way in which this principle was enforced across European countries was very different. Some supervisors pushed the banks to consolidate these vehicles, and they were much more effective in containing the risks. There were jurisdictions where these vehicles were not consolidated, so it was considered that the risk was transferred and there was no need to consolidate it. This made a major difference. So that also adds to the level of capital requirements. The level of capital requirements is important, but we must bear in mind that there were banks, when the crisis hit, that had capital levels that, according to the regulation valid at that moment, were twice, if not more than, the minimum requirements, but still they went bust or were close to going bust because these rules were not enforced properly. So we need to pay a lot of attention to the enforcement aspect—the supervision aspect.

How do we do that? We have in the regulation in Europe a task, as the European Banking Authority, to push the convergence supervisory practices. I think this will be one of the most difficult tasks we have on our table because the supervisory traditions among our members, among the national supervisors, are the most diverse. It will be very difficult, but I hope that we will be able to identify best supervisory practices and spread them, and our presence as an authority in the supervisory colleges of the major European groups should help us in observing the different practices and trying to identify the best ones and spread them, but it is a major challenge. You are completely right on that.

Chairman: Thank you. It may be appropriate to raise the issue of the different treatment of branches and subsidiaries, which John Maples wants to raise.

Q227 Lord Maples: I want to ask you about passporting from one European Union country to another. In the crisis our Government, and I expect most Governments, found

they had to guarantee retail depositors. We had a Deposit Protection Scheme, but the Government went past that almost immediately and guaranteed all the liabilities of Northern Rock and then other institutions that came along. They concluded—I do not know what has happened in other countries—that it would have been easier if non-British banks taking deposits in Britain had been made to operate here as subsidiaries rather than branches, because they could have been, at least in part, supervised by the UK authorities, who were going to be liable for making good on any deposits that they did not make good on. However, as I understand it under European Union law at the moment, a Greek/French/Italian bank, and the same with us, is entitled to open a branch and cannot be made to turn into a subsidiary. Do you agree that it would be easier to regulate and protect against the need for Governments meeting liabilities if we were able to make the passporting arrangement one where you had to form a subsidiary, and would that require changes to European Union law to do that?

Mr Enria: The single market has been built on two main pillars: minimum harmonisation and mutual recognition, passporting, so the home country principle. These two pillars have added a third major component, which, as I mentioned at the beginning of this hearing, has probably not been as effective as it should have been, which was co-operation. The idea was that there should have been great and close co-operation between the home and the host supervisors. I think that this is still, indeed, the case, so you can have delegation of tasks and responsibilities across supervisors; you can have voluntary delegation. In the case of branches, I think that, as this eventually will be resolved under the home jurisdictions, it makes sense that there is a home competency, provided that there is strong co-operation with the host authority, especially when these branches are significant in the host jurisdictions. I would like to mention that the European legislation has been strengthened on these grounds and there is also in there, if I remember rightly, CRD4, an article which envisages additional powers. First of all, in the CRD 2there was an opening in the fact that the supervisors of the branches should also be included in the colleges of supervisors, supervising the bank and the group as a whole, so there is a first rank in your co-operation.

The second point that has been introduced now with CRD4 is a provision according to which, in an emergency, for instance, the supervisor of the branch could take emergency steps to protect depositors in the host jurisdiction. These quite strong powers are given to the host supervisor to take action on the branch, and the proposal by the Commission is that the European Banking Authority would have a mediation role, because, of course, in this case it is very likely that some conflicts between the home and the host countries would take place. We also have, and I am quite scared of it, a strict timeline of 24 hours to provide an answer on these conflicts or mediation cases. In a nutshell, I think that the home country principle can work much better than it has worked in the past crisis, and the legislation that has been put in place should strengthen the role of the supervisors of the host countries quite a lot.

Q228 Lord Maples: Let me just follow that up because we did have particular problems here with the Icelandic Landsbanki, which operated here in two ways, one with a subsidiary and one with a branch, I think, and also with the Irish banks, which ended up getting into trouble. I follow what you are saying, but the liability to the depositors rests with the host nation, does it not, rather than the home supervisor? It seems that they are liable, if it goes wrong, but they do not actually have as much power as they would need to stop it going

wrong, and you are saying you think the host supervisor does have enough power, for instance, to close the branch.

Mr Enria: In the cases you have mentioned which types of tool would you have had? Let me say first of all that the main tool in this case would be the European Systemic Risk Board stepping in much earlier in the crisis and avoiding, in certain jurisdictions, the financial sector building up to a dimension and a scale of risks which is not manageable. Hopefully, we have set in place the tools to contain those very trends that build these imbalances which make the situation unmanageable. There is a European possibility to intervene before this imbalance between the home and the host is generated and detonates conflicts between the home and the host authorities.

The second point is that the host supervisors now have a say in the supervision of the bank and in the branches' jurisdiction by participating in the college. So, if the host supervisor has serious concerns that risks are being built up in that institution which are putting in jeopardy the depositors in their jurisdiction, they have a channel by which to intervene through the college of supervisors. If there is a conflict of views between the home and the host supervisors, the host supervisors can trigger a mediation process at the European Banking Authority. So there is a tool to avoid getting there, and eventually, if, none the less, the problem erupts, the proposed legislation gives the host supervisor the tool to intervene in the case.

Q229 Baroness Wheatcroft: On that last point, could you give us some hint as to how long you think that mediation process might take, because, if a host regulator spotted a problem that looked as if it was escalating pretty quickly, what would his ability to take action be if he had first of all to go through that intermediation process?

Mr Enria: As I said, the proposed legislation envisages that we should be as fast as 24 hours. We should be able, in extreme cases, emergency cases, to rule in one day. I am a bit scared about that.

Baroness Wheatcroft: So would I be.

Mr Enria: But, of course, the mediation in itself is a very light process. It is the chairman, with a narrow number of members of the board, two or three, who listen to the points raised by the two parties and deliberate. The process by itself is quite simple. Of course you can have very complex cases. You can have cases which need to be resolved pretty fast, but you can tailor the procedures to the point you have to address.

Q230 Baroness Wheatcroft: Thank you, Chairman. I would like to ask one more question in that vein. I have been interested to hear what you said about convergence and, of course, the move, slowly perhaps, towards a single market in financial services. Do you think there is any potential conflict between the ring-fencing that Vickers recommends, and the Government has accepted of retail banking in this country, and the objective of a single market in financial services? Do you think we could run into any problems with Europe?

Mr Enria: Of course, the proposal is in a non-harmonised area, so there is no conflict with existing regulations, and I do not see it as being against the principles of the single market. Of course, it depends on how this is declined into regulations eventually, but in principle I do not see conflicts.

Q231 Lord Newby: Given the importance of the financial services sector to London and the UK, there is understandable concern here, I think, that a lot of decisions are going to be taken by ESMA and the EBA, by a group, including many people round the table, whose own financial services sector is very small indeed by comparison to the UK. Can you reassure us to any extent that, in the way the boards operate, the relative scale of the UK financial services sector will be reflected in the way in which the discussions take place?

Mr Enria: First of all, let me say that we are a technical body, dealing with technical regulations, and the arguments of those around the table who have strong technical expertise are, of course, strongly voiced around the table. Let me also remind you that on certain topics, especially on rule making, we have qualified majority voting, which is along the same lines, as it happens, at the European table, the Council table, as for directives and regulations.

I would like to stress, though, that the Board of Supervisors or the decision-making body of the European Banking Authority is composed of people who have supervisory expertise and who should act in the interests of the European market, having the European single market in mind, and then for the board to work really as a collegial body of people, knowing and understanding the situation of conducting European markets as a consequence. Another important point is that we do not work in a vacuum. Our process is very transparent, very open, and envisages a lot of engagement and dialogue with market participants and users of financial services. So we have a lot of engagement with the industry, and our location in London surely does not prevent but actually favours the financial industry here engaging in an active dialogue with us, which they definitely do.

Q232 Lord Newby: I know that you are trying to avoid situations in which you are overruling individual national authorities, and you talked about that a bit earlier on. Could you say something about the circumstances in which you think you might find yourself giving instructions directly to individual financial institutions, because, obviously, they are not at the table?

Mr Enria: First of all, let me remind you that the cases in which we can activate this power, which has attracted a lot of attention because, indeed, it is the most important change, are quite limited. There needs to be in Community legislation specific mention that in this area we could overrule decisions. For instance, the first case that comes to mind is the case of conflict between the home and the host supervisor, in which the home and the host supervisors are in strong disagreement on certain action that the bank intends to take or on whether the bank is respecting European legislation or not. If this is in an area which is covered by the legislation, we have the power to mediate between the home and the host authority, and our mediation is binding, which means that, if one of the two authorities does not want to abide by our ruling, we can overrule the national authority. This might happen.

Q233 David Mowat: You mentioned earlier in your remarks the need for integrated supervisory structures and risk management, and yet there is a little bit of a difference in the regulatory architecture between Europe and what we are proposing with the twin-peak system in the UK. Do you envisage any difficulties for that?

Mr Enria: I definitely do not. We have a lot of different institutional architectures across Europe. There are other countries with a twin-peak type of construction, others which are sectoral and others which are still fully integrated. We need to have a European setting that works together with different national settings. This might require from time to time that national authorities co-ordinate closely with each other and sometimes that some other authorities also come to our table to present their point of view. But that can be done easily and we have to live with the fact that we have different arrangements nationally. For instance, we are definitely competent for prudential regulation for banks, but we have some tasks also in the area of consumer protection, which I understand under the proposed reform in the UK would be under the remit of the Financial Conduct Authority. It might be that when we deal with these cases, the Financial Conduct Authority would have to engage with us directly, but we could have arrangements for that.

Q234 David Mowat: We have had evidence from various people saying that the actual structure of the regulatory architecture may not be the most important feature in terms of it working and the efficacy of it. Given that, would it have made your life easier at the European level if the various member states, particularly the large ones, had followed a similar architecture either to yourself or to each other?

Mr Enria: I agree with the first statement. We have been engaged for a long time on the optimal regulatory architecture. We have to acknowledge that during the crisis there were different types of construction that equally succeeded or failed in the face of the crisis, so I think it is very difficult to identify an optimal structure. At the European level we will have to live for a long while with the differences at national level in the institutional architecture. I think that, more than the framework for the organisation of the different tasks, what is important is that we have a more uniform framework for certain tasks and also, for instance, on sanctions. There are areas in which we have such huge differences across countries that might impinge on the way in which you conduct your tasks at the European level. If you want to push forward a common stance in an area and you have at the table a regulator who does not have powers in that area, that is a problem for the European authority. If you want to push for stronger interventions in an area and you have a national authority which does not have sanctioning powers in that area, we do have a problem. So my focus is more on the tasks and the powers and the sanctioning powers of the regulators than on the general architecture. I believe that we will probably have to live for a long while with differences across countries.

Q235 David Mowat: I have just a final point on that. You mentioned that other major European countries have a twin-peak architecture rather like the UK is envisaging. Can you tell me which ones those are? Which are the major ones which have a similar structure?

Mr Enria: The Netherlands, for instance, has the central bank in charge of prudential supervision for all the sectors. France also, to some extent, although it is constructed a bit differently, has the Autorité de Contrôle Prudentiel, which is now tasked with prudential supervision of all the sectors and is supposedly linked to the central bank, the Banque de France, while there is a separate conduct of business regulatory authority, the Autorité des Marchés Financiers. Some elements of the twin peaks are present also in Italy, although there is also some sectoral division. The Italian system is a little bit more complicated, but the central bank has the majority of prudential tasks . What is different is that it also has some conduct of business responsibilities for the banks. Also, Belgium recently has moved to a structure that is very close to the twin-peak approach, because the central bank has taken the responsibility for prudential supervision.

Q236 David Mowat: Is Germany sectoral at the moment?

Mr Enria: In Germany, there is a separate prudential and conduct of business supervisor for the whole sector. It is not sectoral, but the central bank is not directly involved in supervision, or, at least, it is involved but does not have specific formal competences.

Chairman: One final issue from Nick Brown.

Q237 Mr Brown: Thank you very much for your answers on the regulatory architecture and the comparison with the European Union regime, which I found helpful. May I ask a question about short selling and trading in financial instruments? If the UK regulator decides that circumstances are such that they need temporarily to ban short selling or trading in credit default swaps, would they need to seek pre-clearance from the European Union authorities, and, if they needed to flag it up, are there not dangers in announcing their intention in advance?

Mr Enria: First of all, let me say that short selling is under the responsibility of my colleagues at ESMA in Paris. It does not directly fall within the remit of the EBA, so I will not be dealing specifically with the issue of short selling.

Q238 Mr Brown: My real question is whether they can act in what they perceive to be a situation that requires action immediately, or does there have to be some sort of procedure?

Mr Enria: Again, you should not see the framework of the European authority as a constraint on the national authorities. What I would definitely think important is that, when a national supervisor is about to take a very important action, there is a preliminary consultation at the European table. This could take place in a very confidential setting. It has taken place in a very confidential setting in the case you mentioned at ESMA, and I think that this is a very positive step, because not only does it inform the other regulators of something that can also impact on their responsibilities but it also gives them the chance to

move along the same lines and possibly to move with the same tools, which would probably strengthen the impact of the decision on the markets which are much more integrated. It is crucial that we are able to develop these sorts of discussions in a confidential setting. At the European level sometimes the table is quite large and it is difficult to do so, but we need to make sure that we are able to have these confidential discussions.

Q239 Mr Brown: But you see my point. If word got out that such a thing was coming, do you not think there would be behavioural change in the markets?

Mr Enria: Exactly. So the point is that it is crucial that it is under strict confidentiality and that, as authorities, we are able to exchange information in a confidential setting, otherwise the whole framework collapses. If we are unable to have candid discussions among supervisors and inform each other of concerns that we have with reference to financial institutions or financial markets, then you just have to unfold the whole construction and go to national supervision. But I think this would be a major loss in terms of ability to influence the markets because markets are now much more European and global, and if you want to have an impact there is much more benefit if you are able to co-ordinate your actions.

Q240 Lord McFall of Alcluith: In terms of the cross-border resolution regime, how far do you have to go to get a satisfactory regime yet?

Mr Enria: In Europe, you mean?

Lord McFall of Alcluith: Yes.

Mr Enria: I think a lot of progress has been made globally. I think the Financial Stability Board has done an excellent job on crisis resolution and on bail-in.

Q241 Lord McFall of Alcluith: I will give you one example. In the Baltic countries most of the banks are owned by the Nordic countries, so the Nordic countries' taxpayers would be on the hook on that. If there was a problem in that area, do you have a satisfactory regime at the moment to deal with that?

Mr Enria: The honest answer is that at the moment we do not, but the hopeful answer is that we will have soon because the Commission has already issued consultation papers and plans to come forward with proposals, which I understand are quite ambitious, on a lot of issues in this area. The key point here is to be able to integrate the resolution procedures between home and host jurisdictions so that we have strong harmonisation of the toolbox, the same tools available to the home and the host authorities, and the ability to integrate the resolution procedures in the two jurisdictions.

Chairman: Mr Enria, thank you very much indeed for your extremely clear and lucid replies, which have been very helpful to the Committee. It may just be possible that we will want to follow up on the issue of the "maximum", because there seems to be some

misunderstanding in this country, and I hope you will not mind if I write to you afterwards if there is anything to follow up on that, but we are very grateful to you today for your evidence. Thank you.

Mr Enria: Thank you for your questions and your attention.

Euroclear UK & Ireland Limited (EUI) – written evidence

This submission is in response to the Joint Committee's call for evidence in relation to the draft Financial Services Bill. The response is provided on behalf of Euroclear UK & Ireland Limited (***EUI***), which operates the CREST system, the UK's securities settlement system. EUI welcomes this opportunity to respond to the call for evidence in relation to the draft Bill.

EUI's key concern is that the draft Bill entails a significant reform of the existing Recognised Body (***RB***) regime[105]. No satisfactory case for changing the well established and successful regime has been made. We are concerned that unnecessary reform in this area, without proper analysis and involvement of key stakeholders, will undermine the role of RBs, to the detriment of the UK financial system.

The RB regime was originally established:

- to recognise the distinct 'infrastructure' role of RBs as low or non-risk taking market services, in contrast with standard investment firms[106];
- to reflect the regulatory functions of RBs, setting rules, ensuring orderly and efficient operation and providing neutral oversight and the proper functioning of the market or system which they operate. RBs undertake this responsibility as they are the entity best placed to do so based on their knowledge, experience and position. Together, the RBs form financial infrastructure supporting the financial system and are essential components of the UK regulatory framework;
- to provide a flexible framework to support the distinct and unique business models of each RB;
- to allow close and detailed cooperation between RBs in the interests of the orderly operation of the financial system;
- to provide a close and continuous relationship with the FSA, with detailed oversight and information provision.

These considerations continue to apply. The RB arrangements have been proven to operate very successfully over a number of years, including functioning effectively throughout the financial crises.

The HM Treasury consultation has not identified areas of the current RB regime where shortcomings or regulatory failures have been identified. No scenarios have been outlined (whether actual or hypothetical) where a regulatory failure, or sub-optimal regulatory outcome, resulted from inadequacies in the current arrangements. No specific areas of inadequate information provision were identified.

Despite the above, the draft Bill includes significant reforms to the RB regime. These are confusingly, and incorrectly, referred to as 'technical changes' in the consultation, and include:

- an entirely new rule making power in respect of RBs (and operators of settlement systems[107]);
- watering down of procedural requirements for the making of directions;
- new powers of public censure and fining;
- new additional powers of information gathering and investigation.

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[105] Under Part 18 of the Financial Services and Markets Act 2000.

[106] Ie those authorised under Part 4 of the Financial Services and Markets Act 2000.

[107] Clause 66 of the Bill inserts a new power into the Companies Act 2006 which will enable wide rule making powers to be included in the Uncertificated Securities Regulations 2001.

EUI is concerned that these changes fail to understand the nature of the RB regime and only serve to undermine it, by reducing its effectiveness and calling into question the previous clear and distinct quasi-regulatory role of RBs. The nature and status of RBs will become increasingly unclear and difficult to distinguish from authorised firms. EUI considers that the effective and well established RB regime should not be amended in the way proposed.

September 2011

Professor Eilis Ferran, Professor of Companies and Securities Law, Cambridge University; Rt Hon Alistair Darling MP; Professor Charles Goodhart CBE, Professor Emeritus of Banking and Finance, London School of Economics and Professor John Kay, Economist – oral evidence (QQ 207-287)

TUESDAY 11 OCTOBER 2011

Evidence heard in Public Questions 207 - 287

Members present:

Mr Peter Lilley (Chairman)
Mr Nicholas Brown
Baroness Drake
Mr David Laws
Lord Maples
Lord McFall of Alcluith
David Mowat
Mr George Mudie
Lord Newby
Mr David Ruffley
Baroness Wheatcroft

Examination of Witness

Witness: **Rt Hon Alistair Darling MP,** Chancellor of the Exchequer 2007-10, examined.

Q207 Chairman: Mr Darling, thank you very much indeed for appearing before the Committee today. Our purpose is to draw on your experience in the hot spot during the biggest financial crisis the world has known for an awfully long time. We are grateful to you for publishing your reflections ahead of the meeting which obviates us asking some questions, though it may give rise to others. Perhaps I may begin by asking the very obvious question: what features of the tripartite regulatory architecture which prevailed at the time represented any particular difficulty when you were handling, first, the Northern Rock crisis and then subsequent banking rescues?

Professor Eilis Ferran, Professor of Companies and Securities Law, Cambridge University; Rt Hon Alistair Darling MP; Professor Charles Goodhart CBE, Professor Emeritus of Banking and Finance, London School of Economics and Professor John Kay, Economist – o

Alistair Darling: First, good afternoon. I thought I had seen my last attendance at a Committee of either House, but obviously I thought too soon. As you refer to my book, perhaps I should refer the Committee to my declaration in the Register of Members' Financial Interests, especially in the light of that book, for the sake of completeness.

To turn to your question, Mr Lilley, one of the things that I think is important to keep in the front of our minds is that basically you can make any regulatory structure work. At the end of the day, what is more important are the individual judgments of the men and women who either regulate or, in the case of the tripartite committee, had to reach decisions in 2007 and, more acutely I suppose, in 2008. Perhaps this is illustrated by the events preceding Northern Rock's difficulties and in the autumn following the Bank providing lender of last resort facilities. At the time it was often said that the problem was the tripartite committee. No, it was not. The problem was that there was a difference of view between myself and Callum McCarthy, who at that time was chairman of the FSA, and the Governor of the Bank as to what needed to be done, especially after Northern Rock's difficulties, principally about the need, as we saw it, to put more money into the system to provide liquidity, whereas I think at that stage the Bank was more focused on the solvency problem. I appreciate that the two are related.

I suspect that for the purposes of this afternoon's hearing we do not need to go into the whys and wherefores of that argument, but it is terribly important that as the Committee looks at the new structure what will make or break this are the individual judgments. I hope that I will have an opportunity to say something about crisis management, because perhaps a year later that came into sharper focus. I do not think the problem was so much the structure as individual judgments, although I should perhaps flag up at this stage that in a crisis the question of who actually makes the final decision as to what you do is a very real one. As I explain in the book, I became frustrated that the Bank would not put more money into the system. Only the Bank could do that, and the Treasury would have had to set up a new structure to do that. At the end of the day, I had to answer to Parliament and the country as to what was going on. So, yes, there is always a possible conflict and, as we develop the argument this afternoon, it remains in the new structure, but the big thing is the judgment of individuals.

Q208 Chairman: Do you think that effectively it is unavoidable whether you have a tripartite, twin peaks or single structure?

Alistair Darling: Once you have more than one person in the room it is a problem. We wrestled with this. As you know, we introduced the Banking Act 2009. To be blunt about it, my main concern there was to get a bank resolution regime on the statute book. We made minor changes to the governance, but it is quite difficult to do it when you have a sitting Governor. I am sure there is one thing the Committee will take into account here. I do not know what the official line is, but I do not believe this will be in operation until 2013 when there will be a new Governor in the Bank of England. That is why it is terribly important that Parliament, perhaps even on a non-partisan basis, can take a view as to the governance of the Bank and get it right. Basically, what we have just now goes back to 1946, with the odd tweak along the way. We need to get this right because I think the governance arrangements are antiquated, frankly. It is all to do with the Governor being some sort of sun king around which the Court revolves. I could have made that remark about any Governor; it is certainly not personal to the present one. But what troubles me here is that the governance is not right, and in times of crisis you have the same potential for conflict as I experienced in 2007.

Q209 Lord Maples: The question I was going to ask flows fairly naturally from that. We have had quite a lot of discussion in this Committee on whether it is the architecture, the people, the culture or style of regulation that is important. You have half-answered that. In your book you say you think regulation needs to be much more intrusive. In answering could you take a step back? I can appreciate the difficulties in which you found yourself when there was a crisis, but the idea is that a system of regulation should spot the crisis before it happens, so to speak, and forestall it. In that context, could you discuss the question of more intrusive regulation, the judgments of individual people and the architecture? Is that going to help? Do you think this would have helped had it been in operation in 2006 and the early part of 2007?

Alistair Darling: It is terribly difficult to judge that, because clearly this structure was going to be post all the lessons we learnt from the last three years. My view is that, if this is what the Government want to do, let's try to make it work because you do not get too many chances to change the regime.

I also note that in the Government's publication in June it was said that regulation was to be judgment-led. I kept asking myself who would dispute that one. I think there is something in the argument that the culture of the early part of the last decade, which I am bound to say all political parties went along with, was one where light touch regulation—it is a term I do not like and I do not believe I have ever used—was the order of the day. Part of the problem was that I did not think the FSA fully understood how banks like RBS were operating. If you look at the risks that were building up over a period, I do not think the FSA had a firm handle on it. Equally, the Bank of England had responsibility for financial stability since 1998—it was not statutory but it was there—but I just do not buy the argument that they could not do anything about it because they did not have the powers. They had the bully pulpit, if you like, but they did not climb into it very often. It has to be said that the culture, not just in this country but in most western developed economies, was the same; that is, everything seems to be okay, so it must be okay. That is why I say in the book that I think we must get ourselves into a situation where the regulators have a better understanding of the key risks and exposures in the systemically important cases.

I know the counter argument around at the moment is that the regulators can never hope to get into a bank so deep to understand that, and in any event should regulators be standing in the shoes of management? Therefore, the answer surely is to make banks hold so much capital—maybe 15%—that if it goes wrong there is a buffer. Probably the truth lies somewhere between those things, but certainly the lack of intrusive regulation was a contributory factor, not just here but crucially in the United States, when a lot of people seemed to know what was going on but nobody did very much about it.

Q210 Mr Brown: Alistair, this is a pre-legislative scrutiny procedure and so we can make recommendations about what should be included or excluded. Are you recommending to us that we make specific reference to circumstances where there might be a difference of opinion between the Chancellor and Governor and we should set out how that should be resolved or a conclusion reached?

Alistair Darling: Yes. I think the whole point of pre-legislative scrutiny is that both Houses should have the opportunity to make recommendations and draw from as wide a pool as possible. This is a case where I can see the problem and I can tell you that if you do not

resolve it, it will occur again, but I do not have an off-the-cuff solution or suggestion. As I said in reply to a point put by Mr Lilley, it is inevitable that at some point you will have a difference of opinion. This model is predicated, I think, on the idea that you appoint the Governor or the Bank to run the system. Presumably, if the Governor gets it wrong, he or she is sacked and a new person is brought along, and basically the Chancellor's job when the Governor comes along is to write the cheque if there is a need to bail out a bank or do whatever. In practice, life is not like that. I do not think that in 2007 I would have got away with standing up in the House of Commons, probably having put a brave face on what had gone on elsewhere, and taking responsibility for it. It does not work. At the end of the day, we live in a democracy. Somebody has to be accountable.

We are talking about acute circumstances. I hope this does not happen every second year, although the way things are going one cannot be too complacent about that. There has to be some mechanism which means that the Chancellor does more than act in a passive role and respond to someone, in this case the Governor, coming up with a proposal. It may be this is dealt with in the memorandum of understanding referred to in the consultative document. It might be more difficult to put it into statute, but it is my view—I say it in the book because that is my experience—the Chancellor has to be responsible for this; I do not see who else could be doing it.

No doubt you will have heard evidence from a wide range of views inside and outside this House. I can only tell you my own experience having gone through not just one but two crises: Northern Rock and then, more acutely, in 2008 when, I have to say, the Governor and I were absolutely at one on what we should be doing. For the avoidance of doubt, Mervyn King played an exceptionally important role in the bank recapitalisation in 2008. But my experience throughout all this is that there will come times when there will be a collision of judgments, but in a crisis somebody has to be in charge. It is very difficult for two people to be in charge if there is a difference between them. Perhaps one way to resolve it would be to make it clear in advance that in such and such an event the Chancellor would be in charge. Incidentally, I am dead against the idea that in advance you would declare a state of emergency, because you might as well throw in the towel at that stage. You can just imagine the situation if everybody said, "Look, we're going down the tubes." That would be unhelpful, even though I once had a go at heralding such a thing in a newspaper interview.

Q211 Baroness Wheatcroft: I would like to develop that argument a little further. You referred to the Governor as a sun king character. Mervyn King's conviction that moral hazard was all-important is well known. If there had been a different sun king there at the time, with a different relationship with the Chancellor—perhaps the one you are talking about—do you think that Northern Rock could have been taken over by Lloyds TSB rather than going the route that it did?

Alistair Darling: There are two points. It is impossible to answer the question. In the book I pose the rhetorical question: what would Eddie George as opposed to Mervyn King have done? Do not misunderstand me. As to moral hazard, at some stage we need to have a go at rediscovering some of it because it is rather absent at the present time. I thought that the argument about moral hazard was completely irrelevant in the autumn of 2007 because I could see that we were heading towards a situation where bank lending was drying up; it was freezing. What worried me was that the Bank did not seem to have much of a handle on what was going on in the banks. It is impossible to say whether if it was a different

Chancellor and different Governor it would have been different. Possibly. If you look at the response of the ECB or the Fed, they took a much more aggressive role during that autumn. It was not until all the central banks came together shortly before Christmas that the Bank changed.

What I was getting at is that in this day and age you want governance that is more in tune with the times. Yes, you have a Governor but perhaps a board of directors. I think the Court has had its day. I tried to reform it and I am bound to say it did not work out the way I intended. If you look at this document, the idea that the Court would form guidelines for the new Financial Policy Committee is just fanciful. The person who runs the Bank of England at the moment is the Governor, and it has always been like that. Perhaps Montagu Norman was the epitome of this style of governance, but in this day and age it is totally inappropriate. That is why I urge the Committee—of course you have to listen to other people—that if we do not bring the governance of the Bank up to date now we will be missing a chance. Even though this legislation is, if you like, somebody else's, I would give it a fair wind, but we cannot have a situation that we keep coming back to.

Q212 Baroness Wheatcroft: Can you see any reason why the FPC as currently structured would be a subsidiary of the Court rather than part of the Bank?

Alistair Darling: I would have thought it was a core part of what the Bank does. The FPC is a good thing. I am pretty sure I suggested something similar in one of my Mansion House speeches—I do not have it immediately to hand—so it must be a good thing. I am bound to say that it was not developed to anything like this extent. On the other hand, as the Government's own paper here notes, it is novel in that nobody actually knows how to do this. It is all very well to say we should have a mechanism that allows you to lean against the wind. There are lots of distinguished papers on all this stuff, but nobody knows how you do this in practice. You have a committee which, incidentally, from the point of view of the Bank is far too top-heavy; it has six Bank members and four outsiders. That just won't wash. I do not understand why it has been farmed out as a subsidiary of the Court.

Its other flaw is that it can make recommendations to just about everyone under the sun except the Bank. Who controls monetary policy? It is the MPC. You can tell the Treasury that its fiscal policy is no good; you can tell the Chancellor that his policies are wrong. Naturally, you can, fair enough, tell the regulator or issue instructions, but it seems rather lop-sided. It has all the hallmarks of things being bolted on. The Government will be pleased to know that I have no direct knowledge of this, but this looks like the result of negotiation of the sort I recall all too well.

Q213 Baroness Wheatcroft: Virtually every organisation in the aftermath of the crash, although it does not seem to be quite over yet, has looked at what went wrong. Do you think that the Bank should have revisited what happened and where perhaps it did not excel?

Alistair Darling: Yes. As I understand it, the FSA is doing this in respect of RBS. I know it did not start out doing this, but I think I am right in saying they have now agreed to produce something on RBS that might be a bit more illuminating. But it should be no sign of weakness that any organisation asks itself after a period what it got right and wrong. Please do not misunderstand me. The Bank of England and the Governor got a lot right. My purpose here

was to illustrate the things that I thought needed to be fixed from my own experience, because I am quite sure they will come back and be real issues at some point in the future.

Q214 Mr Mudie: What worries me, Alistair, is that we are building a structure which keeps the Treasury and Chancellor out of it. In terms of a crisis it is particularly bad. As you have said, the memorandum of understanding could sort that out. I worry that the powers that have been given to the Bank are now so far-reaching in the general economy that because of the silo-type structure there is no opportunity for you and the Governor to have differences and for those to be listened to. You can send a letter twice a year; you can see the Governor; you can send it to the FPC, and both can say, "We don't agree with you." How can you as a Chancellor stand up in the House and accept responsibility for the running of the general economy having agreed a structure that puts you on the outside?

Alistair Darling: In normal times there is a lot to be said for having someone, whether it is the Bank, FSA or new body—for this purpose that is not so important—detached from Government to be responsible for supervision. MPs and Ministers cannot be responsible for the supervision of banks and so on; they are not equipped to do it. We should not be in that business. I am talking about the acute period when things are going wrong. I understand the model that the Government have tried to come up with, which basically says that even then the Governor is in charge and the Chancellor's job is to say he is prepared to write the cheque. I just do not think in practice, in a time of crisis, you can do that.

Q215 Mr Mudie: I accept that in times of crisis. When you say you do not think the Chancellor should be involved in banks I agree with you, but the structure on the table pulls the Bank and regulator so far into areas that affect the general economy and real economy that it becomes very difficult for a Chancellor to take responsibility for what is happening out there to the real economy rather than the stability of the financial sector.

Alistair Darling: What struck me reading this, particularly in relation to the FPC, is that it gives a bi-annual general economic review of what is going on. The scope for that to prove very troublesome for the Minister of the day is immense. It would be a journalist's joy to have that committee pontificating and telling the Chancellor what to do. In the extreme, are they going to tell him that his policy is completely wrong and he ought to be doing something different? Maybe some constructive tension is a good thing. I do not object to the FPC; I just think responsibility for fiscal policy always has been and will remain the Chancellor's. I am just bothered that in times of a crisis there needs to be clarity of command. It is interesting the Government say there is very little comment on this. That is possibly because I do not think people were fully aware of it. Those of us around at the time went out of our way not to expose these things because at a time of crisis that would have been unhelpful. Basically, I am saying it now because Parliament does not legislate too often on these things and this is the time to try to get it right. I am not saying that I have all the right answers, but I think that in our generation this is the first and last opportunity we will have.

Q216 Mr Ruffley: I am getting a bit worried because I agree with everything you have said so far.

Alistair Darling: Should I be worried, too?

Q217 Mr Ruffley: Probably. To me, the blueprint for reform is confusing. I would like to have your view on this. We are told that the Court will set the Bank's "overall financial stability strategy which the FPC will have to take into account. The Court will be required to publish the strategy and review it at least every three years". It goes on to say that the Treasury's remit for the FPC will take the form of recommendations about how the FPC should in general interpret and pursue its objective, that objective being defined in statute. Can you tell me in that muddle of arrangements what the democratic accountability is of the Chancellor of the Exchequer to Parliament and the British public?

Alistair Darling: I have some sympathy with you in that it looks to me like there are too many people chucking things into the FPC.

Q218 Mr Ruffley: I think you used the words "bolting on". That is what it looks like to me.

Alistair Darling: If you start with fundamentally the same structure as we have had since 1946, this is what happens. The idea was that the old-fashioned Governor was just that; he was in charge and everyone looked to him. The responsibility of the Court was partly housekeeping. He would account to them, but in practice the Court has not played that role. I do not know whether you have had a chance to look at it, but the evidence some of the Court members gave to the Treasury Select Committee in the House of Commons made interesting reading.

Q219 Mr Ruffley: Frightening reading actually.

Alistair Darling: Yes. I think it is worth a good look. My starting point is to have a structure that is based on modern-day thinking and one that can actually operate, and let's be clear about who is accountable for what. The Governor and his board are accountable for running the bank; I think the FPC should not be an add-on to that but should be more central to it. The remit of something like the FPC should not be changing all the time. It is quite proper for the Government and Chancellor of the day to say that is the remit. I would not have the Court in the first place, but I am not sure why under this regime you would involve the Court at all.

Q220 Mr Ruffley: Exactly. Of the Treasury remit, the blueprint says that the Treasury may wish to use the remit to bring recent academic research, experiences or other macro-prudential bodies to the FPC's attention. That seems to me quite a weak power that is enshrined, according to this, in the Treasury remit. Forget the Court for the minute. I am struggling to make sense of this. Can you make any sense of it?

Alistair Darling: Not really. I expect that if you read a splendid article in a magazine you could phone up someone and say, "You should have a look at this." You do not put it in a remit. I do not suppose the Treasury would be drawing the FPC's attention to a glossy publication from time to time but rather something more profound. I just think it would be

much easier if you made the FPC's remit sufficiently broad. Basically, they are supposed to look at the economic horizon and then come up with recommendations. That is the easy bit. You make a perfectly good point, but it is not the main one. The main point is that the whole construction of this is misconceived.

Q221 Mr Ruffley: Do you think that the proposals we have in front of us, rather than starting with a blank piece of paper, benefit by putting in a requirement for the FPC to write to the Chancellor of the day explaining in detail why the FPC have made certain policy choices and decisions?

Alistair Darling: I would not have any difficulty with that. It is rather like the Governor being required to write to the Chancellor if the MPC misses its inflation target. From my experience, there are two sorts of reports. There is a report prepared for you and then it has all sorts of recommendations, half of which you really do not like and half of which you think are neither here nor there. If you do not have to do anything with it, there is a well-established tradition. Followers of *Yes, Minister* will understand precisely what you do with that sort of report, whereas the letter-writing model requires the Governor to write at one minute past 12 on Thursday and for the Chancellor to write back two minutes later. It means that you have to respond to it. If you are going to make recommendations like this, perhaps something that made it bite a bit more would be appropriate. The Bank of England even now produce two financial stability reports. I bet you people would be hard pressed to remember what was in them or done about them since they were first produced. I would not have any problem with that. There is stuff in here that formalises the recommendations and responses. Maybe that could be sharpened up, but, unless there is something that makes you respond, the risk is that you just park it.

Q222 Mr Ruffley: In your book you described the view you took in 2007 that liquidity should be pumped into the system and the Governor of the day was less keen on that at the initial stages, so there was a conflict. There is nothing in here that gives the Chancellor of the day an absolute override power, is there? Do you think that is a weakness? Do you think that an override power in the Chancellor should be enshrined in legislation?

Alistair Darling: There is nothing. I investigated this matter. I was advised that you could use provisions of the 1946 Act, but they had a sledgehammer aspect about them. It is not the sort of thing you really want to be doing when you have a crisis like that. As I said to the Committee earlier, we need to ask ourselves how we can do something, probably in the memorandum but possibly on the face of the Bill, to make it clear that if push came to shove the Government, which have to account for all this, could insist on something being done. If we take quantitative easing just now, it is all too clear what has happened. The Bank has made that decision on quantitative easing, but it is not gong to use the special facilities to buy corporate assets, which is why the present Chancellor is being confronted with exactly the same problems I had. He is now going to come up with a parallel system. That is a bit wasteful and is delaying things. Let's be grown up about these things. As I said to Mr Mudie, I am in favour of getting politicians out of things like setting interest rates and the minutiae of regulation, but there are some big issues. We have just been through a period like this when we need to be grown up about it and have a system that can work in the heat of battle.

Q223 Baroness Drake: We have talked about regulated structures, authorities and responsibilities. Perhaps I may pose a third leg to your comments right at the beginning about the need for better understanding of what is happening. You need highly competent people and access to the information to give you this intelligent core. How do you overcome the constraints in securing that talent? Does the Bill give the FPC sufficient power to acquire and access the information it needs?

Alistair Darling: On your latter point, I am not in a position to say whether or not the legislation is sufficient to allow you to get everything you want. I think the FSA in the last three years probably has more experience in what you need to get. Another issue is: how do you get people of sufficient calibre who are willing to work for the Bank, presumably, or the FSA? This has been a problem. These guys are paid so much in the banking sector. It is quite difficult to persuade them to work for the Bank and in the meantime all their mates are doing terribly well back at the banks. Obviously, they have to go through a period of quarantine before they can go back. I think the Americans manage it better than us. But the real problem is that, unless we get people who understand this, we will always be struggling. I remember a senior executive of RBS saying to me maybe a year before RBS failed, "The FSA do not understand my bank." I reflected a year later that we were not the only people who did not understand it, but unless you have people who understand what makes a bank tick you are in trouble.

Q224 Baroness Drake: I agree. Just staying with the other point about information, notwithstanding the detail in the Bill, what do you think are the real issues, given the complexity of today's markets? What are the challenges in getting that information to allow you to be sufficiently informed to understand systemic risk and to act?

Alistair Darling: In narrow terms, do you have the power to require whatever information you need to make a reasonable assessment about the risks to which that bank might become exposed? That is probably more the province of a corporate lawyer than me, but, as I said earlier to Lord Maples, there is a conflict about just how much a regulator needs to do or know before he or she ends up running the bank, as opposed to saying, "It's too difficult for me; just make them hold more capital." Maybe the FSA's report into RBS when it is eventually published will help here. I understand that may be in the autumn, but you may have better information on that. That might help in terms of what more you need to be able to find out what you need to know. It is not the only thing. We have not touched on—I am sure you have—the whole question of the co-operation between regulators. One of the many things that this crisis has shown is the interconnected nature of the banking system.

Q225 David Mowat: One aspect of all of this is that we need to regulate foreign banks. Part of this structure needs to do that perhaps better than we did. You were in the middle of the whole Icelandic thing. What aspect of these proposals do you think might have facilitated better regulation or warning that all of that was going to happen, if any?

Alistair Darling: The most obvious one is that here we regulate subsidiaries but branches are regulated in the home country. In Iceland we were dealing with a situation where we had little and then absolutely no confidence in their regulatory authority. I met them but mainly because one of their Ministers was paying a courtesy visit. As the meeting wore on, the incredulity of the HM Treasury side grew by the minute. They either did not know what

they were talking about or they were just concealing it. They thought we were picking on them, but the problem was that the branch of Landsbanki was bigger than the entire operation back in Iceland, yet it was being regulated in Iceland by people who either did not know what they were doing or, if they did, they were very negligent indeed. But I think that can be changed only by European legislation. That regulatory regime is pan-European as opposed to British, but it needs fixing because there are other branches of systemically important banks on which we should keep a closer eye.

Q226 David Mowat: To be clear, if they are operating a branch structure, there is nothing in these proposals that would make any difference; it is for the home regulator or someone else.

Alistair Darling: I did look for it and it is touched on; it says there needs to be close co-operation between the regulators, and so there does. I think the general view of the FSA and the Bank is that most regulators within continental Europe are competent and know what they are doing. In Iceland that was not the case. I think the problems in that country are fairly well known. When you end up speaking to their Prime Minister, who asks if they can negotiate on the amount of money they are taking out of the bank, you begin to wonder what you are dealing with.

Q227 David Mowat: But we still end up being the provider of last resort, do we not?

Alistair Darling: We do. What would have happened if we had not guaranteed the savers' deposits in that branch? Most people do not distinguish between a foreign and British bank, especially when they have British-sounding names. If they thought they had lost all their money because it happened to be in this branch, the risk is that people would start taking their money out of the next branch and the next branch. Remember, all this was happening in the same week as the Irish banks got into trouble and the Irish Government had, wrongly in my view, offered to guarantee all the deposits in their banks. It is a real problem when you have branches in a country operating on a completely different regime from everybody else and the regulators do not have sight of what is going on. Perhaps if we had had sight of what was going on there a lot earlier, we could have blown the whistle on them. But Iceland came in the system through the EEA and obviously it is not in the European Union.

Q228 David Mowat: Just to be clear, had the Icelandic banks been subsidiaries and not branches, you were happy that the regulation that occurred worked?

Alistair Darling: Put it this way: the FSA had the power to do it. I would hesitate to say that I was entirely happy. It is not a happy situation when you discover the weekend before the thing closes that large sums of money are being taken out of it.

Q229 David Mowat: But that was not caused by the fact it was a foreign bank; that would have happened anyway.

Alistair Darling: I am quite sure the FSA would want to look again at what it was doing in relation to the Icelandic banks, but the big problem is when you have a branch that is not

regulated. Normally, it does not matter. There is hardly a bank in the world that does not have a branch in London. Obviously, we do not want to offer to regulate the entire world, but, when the branches are a small fraction of the whole and you are happy that the home state knows what it is doing, that is okay. What is not okay is when you get a tiny country with three large banks that basically come to Britain to attract funds and a very small part of what they are doing is back in their home territory, and you have a regulatory system that at best is out of its depth.

Q230 Lord Newby: I want to move on to the Independent Commission on Banking and its proposals. You have been pretty sceptical about whether their proposals would be capable of stopping another crisis. Can you explain your scepticism?

Alistair Darling: The final report of Vickers is a much better one than the interim one, not least because of some of the claims, not by the commission but by others, about how the interim report when it came out would stop the banking collapse from happening ever again. One should always be wary of people who say something will never happen again, because I do not think you can ever be sure of that.

You cannot divide the world into good Captain Mainwaring-style retail banks which collect money and lend it out and are decent, honourable people, and investment banks that are full of wicked gamblers and so on. Life is not like that. If you look at the losses incurred so far, you will find the retail banks are right up there. Look at the Irish banks that essentially are retail banks. HBOS was a retail bank and it lost money just through bad judgments. I think the good/bad argument does not stand. More importantly, in times of peace when things are stable you can let most banks go because it does not happen suddenly; it is gradual and you can manage it and no one panics. They do not think, "Right. We're going to take our money out of all the other branches." But in times of severe stress such as we had you do not have to speculate what will happen. The Americans let Lehmans go down. Lehmans was an investment bank with no depositors' money in it. It did not cause but precipitated a chain of events that led to RBS coming within hours of total collapse, and the rest of the banking system with it. Another example is that we had to use the bank resolution procedure to deal with Bradford & Bingley and Dunfermline, which are not systemically important in normal times, but my view was that even letting a small bank go down at a time of stress meant that it could spread from one place to another. Look at what happened with Northern Rock and so on.

The premise that this will stop everything happening in the future is wrong. I think it will contribute, first, when it comes to wind down or resolution. It will be so much better if the bank has already been separated out. Some of our big banks are remarkably complex. Go and look at the brass plates on the doors of some of them and you can just see what the problem is. In terms of internal management, making them more aware of where its funding is coming from would probably make for better management. On that aspect I am not against Vickers at all. I was against and highly sceptical about some of the claims made around it. Some of the changes he suggests are very good, and perhaps the business at UBS is a salutary reminder that the banking system is far from getting to a situation where it actually knows what it is doing.

Professor Eilis Ferran, Professor of Companies and Securities Law, Cambridge University; Rt Hon Alistair Darling MP; Professor Charles Goodhart CBE, Professor Emeritus of Banking and Finance, London School of Economics and Professor John Kay, Economist – o

Q231 David Mowat: One of the aspects of Vickers that has probably got less coverage than ring fencing or capital requirements had to do with competition. Do you think his recommendations on competition, and more generally the promotion of greater competition within the banking sector, would be helpful?

Alistair Darling: Yes, I do. Frankly, the only way you will get more competition, cheaper loans and greater choice is by getting another major high street competitor. If you are talking about little bits and pieces, it will take years. The compulsory divestiture on the part of RBS and Lloyds provides an opportunity for the front end of Northern Rock to be sold. There is no point in my speculating on it, but it is well known that there are various other banking groups looking around to see what they do in this part of the world. There is potential there, and I would like to see another entrant. There are also other people who do not own a bank at the moment and who might be interested in providing another retail bank. That aspect of Vickers was, as you say, largely overlooked but they did a very important piece of work.

Q232 Chairman: I think we have given you some indication about macro-prudential tools that you might like to use. Perhaps I may put a general question and you may choose to elaborate beyond it. During your relatively brief period before peace broke out—but you were also in the Treasury anyway—did you feel that the Bank and Treasury had the means of controlling the growth of credit, other than putting up interest rates?

Alistair Darling: My recollection is that the brief period lasted six weeks, so there was not too much time to reflect on all that. I could not agree more with the Government when they say this is novel territory. All the commentators say it is novel territory and perhaps we should do a bit more research before we start doing any of it. There are some things that you can do in this country. As far as I can see, there are two. One is that you use fiscal means if you want to dampen down a bubble that you may see rising or you use monetary policy through interest rates, but that in itself is problematic. I think I am right in saying that when Mervyn King was asked about this before the House of Commons Treasury Select Committee in 2007—maybe Lord McFall will remember this—he said that, had he put interest rates up in 2004, industry would have been howling in protest saying, "It's not our fault you have a housing boom; we don't need that."

If you look at the bubble that undoubtedly grew in the first part of the last decade, it was not happening just in this country; it was being fuelled by a huge credit boom in the United States. No one can be against the idea that you survey the horizon, look at the pressures and so on. Two people can do something about it in this country: one is the Chancellor and the other is the Governor of the Bank of England, although in this case the FPC can recommend to one apparently but not to the other, which does not seem terribly balanced.

Of course, there are other things you can do, as all of us well know. The Treasury has a battery of measures it can take that influence various things that might be happening in the economy, although at times these levers are not terribly direct in what they do. Some of it is leaning against the wind, sometimes just blowing against it. It can be quite problematic. I think it is a good thing, but I would not build it up into something that somehow will stop us ever having booms and busts in the future.

Q233 Lord Maples: Let me explore a slightly different aspect of this. Your Government and the current one have set the inflation target as a measure of consumer prices of one form or another. The Bank met those during the period leading up to the crash. I think there were a lot of extraneous factors to do with Chinese imports and things like that. Nevertheless, they were concentrating on that and met it. At the same time, the money supply under M4, or whatever we now use to measure it, was growing at 10%, 11% or 12% a year. In any normal circumstances you would have said they should be raising interest rates. Of course, we saw asset price inflation alongside that. You had a situation in which they were meeting their consumer price inflation target but asset price inflation was roaring away. Do you think that the inflation target needs to be a little broader or more subtle? It is arguable that, had Mervyn King raised interest rates in 2004-05, it might have quietened down the lending boom within the banks which got their leverage ratios up to 50:1 and that sort of thing.

Alistair Darling: There is certainly a staple case for doing that. Now that inflation is at 4.5%, the bank has not met their target for a considerable time, and far longer than was ever anticipated when the regime was put in place. When we set up the Bank and put in place the MPC, the prevailing theology of the day was that what mattered was the inflation rate. That is why the target is inflation, subject to the Government's economic policy. For most central banks their target is inflation; that tends to be what they look at.

Q234 Lord Maples: But only consumer price inflation.

Alistair Darling: Yes. Where we are now is that our central bank and others are also implicitly targeting growth. Inflation is there but it has been parked. I happen to believe—because it is my way of thinking—that I am with the MPC at the moment on this. The lack of growth is a huge problem for us, Europe and America. But, if we are going to do that and we have decided that inflation is only one part of it and maybe growth is the other, perhaps it would be better to say so.

I have supported what the MPC have been doing, but it is a bit like the sunny uplands of growth that all Chancellors forecast. You show low figures and then you go on to 2.5%, 3% and so on. It is a bit like inflation; it is going to come down but, rather like a bow wave, it keeps moving forward. I am still not persuaded that giving the Bank of England an additional duty apart from inflation would be a good thing, because if you give too many targets you might as well have none. Perhaps now is the time when some thinking needs to be going on within the Bank and Treasury as to the precise role of the central bank. I do not know for how long this will go on, but I can see a situation where the Bank of England are still bothered about growth and we have high inflation maybe four or five years down the line. That will be a problem. All of us round this table are, with respect, of a certain age and remember what happens when inflation gets into the economy. It takes a long, long time to get it back out. It hits people on fixed incomes, of which there is a growing number, and elderly people of which there will be a growing number as well. It is 12 or 13 years since the MPC was set up. Perhaps it ought to be the subject of a discussion, not because we need to change it next week or next year. The MPC are right to be worried about growth. It just shows how fiscal and monetary policy having been diverged 13 years ago are now converging but no one is admitting it.

Q235 Mr Mudie: Are you leading up to having a dual mandate as the Fed do? The concern is that they are worried only about the stability of the financial sector, whereas if they have all these powers that lead up to interfering in or getting close to fiscal policy is this not the time to give consideration to giving them employment, growth and inflation targets?

Alistair Darling: We had a lot of discussion about this in 1998 when we set up the MPC at the Bank of England. At that time it was felt that the imperative was to send a very clear signal that we wanted to keep inflation under control. As you know, inflation had been a big problem for 30 or 40 years before that. Our view was that at that time, if you gave the Bank more than one target, it could pick and choose and it would dilute it. But the remit is to hit the inflation target subject to supporting the Government's general economic policy, whereas the Fed, because of the experience of the 1930s, has two explicit targets. I do not think that 13 years on is too soon for us to reflect on this, not least because it is actually happening. As to the quantitative easing announced last week, I read the Governor's letter but to me it appeared to be far more about him saying, "I am very worried that growth appears to have ground to a halt and I am putting more money into the economy." I do not expect the Governor and Chancellor to depart from what they say publicly, but maybe we should have a sensible discussion about this.

I have always been bothered that, if you give people a choice of things to do, they will pick the easier rather than the harder one. I worry if we get ourselves into a situation where inflation becomes another British problem, as it was certainly in the 1970s and the early part of the 1980s. Perhaps we should have a sensible discussion about it, because, if people are right and we are in this for a number of years, then growth will be just as important as the fear of high price rises.

Q236 Lord McFall of Alcluith: I go back to the earlier question about who is in charge. I remember that when the witnesses came before the Treasury Committee in the crisis everybody was asked whether they had done their jobs properly and they said yes, so how did we get into this particular situation? I felt that a certain culture prevailed in the FSA and Bank of England. For example, the FSA did not bother very much to supervise the smaller banks. Northern Rock was just a small bank and they did not know what was going on. I remember that they had had about seven engagements with the bank over an 18-month period, of which four were by telephone. You can see that culture. The politicians have given away independence for a good reason; they do not want to be seen to interfere, but when a real crunch point arrives there needs to be political involvement at the end of the day. In terms of this legislation is it possible to have, say, a representative of the Chancellor in these organisations? I know the disadvantage of that, but if there is a representative of the Chancellor there is no hiding place for people. I think there was a hiding place for people previously on this issue. At the end of the day, it is the Chancellor who has to sign the cheque on this particular issue. The Chancellor has to understand what is happening in these organisations and the culture prevailing in them. We could find that with the new arrangements for the Bank of England there is a uniformity of culture and therefore the same problems will strike a future Chancellor. It has happened to you.

Alistair Darling: As I said earlier, I am not particularly attracted to bringing regulation into Government. Whether it is a representative of the Chancellor or Treasury civil servant, who I suspect it might be, I am not particularly attracted to that. Most of my remarks this afternoon have been addressed to a situation of crisis. In normal times it is reasonable to

expect that you appoint the head of the FSA, or in future presumably the Governor of the Bank of England, but if they get it wrong they pay the price for it. I appreciate it is always difficult. Members of the previous Government before us will remember the problem over who is responsible when a prisoner breaks out. Is it the head of the Prison Service or the Minister? That is always a difficult one. My view is that a crisis is quite different from normal peacetime.

I think your earlier remarks about the FSA are perfectly fair, in that this was part of the culture: if everything seemed all right it probably was all right. One of your earlier reports highlighted the fact that eight or nine months beforehand the FSA had seen that Northern Rock was totally dependent on raising funds from America, but it never got high enough up the chain of command for anyone to do anything about it. I honestly do not think that having a Chancellor's representative would have made that unhappy situation better.

Q237 Lord McFall of Alcluith: If we do not have contingency thinking here, we find a crisis and say, "Oh, we've got to deal with the problem." The question is how we get that contingency thinking in practice.

Alistair Darling: My plea this afternoon, as I have said several times, is that now is the time when, on any view, the management of the Bank will change by the time this Bill becomes law. I hesitate to say that we are through this financial crisis because I am not altogether sure we are, but, if the new Government want to make these changes, for goodness sake let's deal with the problems we know exist and are within our very recent memory. We have the advantage. For most legislators who legislate on anything like this it is the last generation that did it. We have all lived through this and know what is wrong. I am not suggesting there is an easy set of answers, but if we do not make a stab at getting it right we will have missed a huge opportunity. So I very much agree with you on that.

Q238 Chairman: To go back to the control of credit supply, you said that basically a Government had fiscal and monetary policy and there had been little support for the Bank raising interest rates back in the mid-2000s. With the benefit of hindsight, would you have advocated a different method of controlling credit growth during the upswing?

Alistair Darling: One example of how you could do it would be to require banks to hold more capital either in general or in relation to particular activities. There are other measures. I was dealing with the point in general terms; that is conventionally how one deals with swings up and down, but particular levers could be pulled to deal with the banks themselves. If, for example, RBS had had to get consent to make a bid for ABN AMRO and had not done due diligence, it would have been entirely acceptable for the regulator to say, "Well, if you do that, you have to raise your capital by a certain percentage", which would have caused the directors to ask, "Do we really want to do this if we have to hold that much more capital? Perhaps it might be an idea to look below the surface and see what is going on in the bank we want to acquire." The holding of capital is one obvious way in which you can dampen bank credit; you can vary it. I am not saying it is easy because you will always be told that you have completely misunderstood the position and what you are suggesting is the wrong thing, but it is certainly a tool that should be at the disposal of what I suppose under this regime would be the FPC and, through it, the prudential regulatory authority.

Q239 Chairman: Conversely, in a period such as we are in now, do you think there are other ways in extremis for the authorities to get money out of the door, indeed out of the banking system, over and above credit easing and quantitative easing?

Alistair Darling: Yes, there is. The first £200 billion of quantitative easing worked because it was on the back of a whole lot of other measures designed to restore confidence and stability. A lot of it was and remains in banks for this purpose and was not quite such a problem in the sense that the banks were stronger because of it. But in relation to more quantitative easing, which we now have, there are technical mechanisms that the Bank can deploy to try to encourage the banks to get this money out into the high street and lent. If it just stays in the bank vaults it will not go into the economy. I assume that it is precisely that worry that has led my successor to say he will set up a parallel credit-easing regime. I just think it is a pity he has to do that because it will take him a while to get it going, and we do not run a national network of banks. Unless steps are taken to ensure that money gets into the high street, it will be in bank vaults where I do not think the problem is at the moment.

Chairman: The final area of questioning is the interaction between our legislative framework and that of Europe.

Q240 David Mowat: You mentioned that you were not too keen on the actual structure that is being put forward here. I think your phrase was "the whole construction is misconceived" in your remarks.

Alistair Darling: The Bank, yes.

Q241 David Mowat: One aspect of the structure is that it does not align at all to the European structure, which is sector-based, whereas this is a twin peak base; it is a matrix. Does that bother you?

Alistair Darling: It took a struggle to get a European structure that was acceptable to Member States, and it was mainly us trying to get recognition at the end of the day that the buck stops with national regulators. The last thing you wanted was a generalised responsibility as far as Europe was concerned, but it all went wrong and the bill landed with a national Government. It is surprising there is very little reference made to things European in here and how they slot in, other than the hope or requirement that we work closely together. Some further clarity about that might be helpful. That said, it must be up to the UK Government of whatever hue to decide what they think is best, but it means that the structure we have here naturally fits into what is around in Europe. Increasingly, there is going to be more co-operation. Some of it is a good thing; some of it I prefer not to have, but it has to work, because increasingly regulation will be co-operative. It also has to tie in with the States and so on, not in terms of structure but flow of information.

Q242 David Mowat: You are right that it is hard to imagine a crisis that would not involve co-operation between the UK and Europe.

Alistair Darling: My reaction to that is horror in some ways. I can tell you that it is difficult enough to rescue a British bank when you have only the British Government to worry about. If you had to consult 27 other Governments, the bank would have been and gone several times before you got round to it. That is what worries me about the European approach.

Q243 David Mowat: In summary, you do not think that the fact we have a matrix structure and they have a sectoral one is a problem.

Alistair Darling: I would sleep happier in my bed at night if I thought we had a system here that was robust and could look after the UK system. That said, it is obvious from the nature of the banking system that it must be able to tie in, be related to and fully understand what is happening in the States and continental Europe. My problem about Europe—present events illustrate the point—is that, if you have 27 different countries arguing about how or if you rescue a bank, we will be in real trouble. I am not a Eurosceptic; I am quite well disposed towards Europe. I am afraid that the last few months have filled me with despair because a lot of my former colleagues who used to sit round the table have lost the plot.

Q244 Chairman: I put a final question which perhaps goes slightly beyond the purview of this Committee but we could not miss the opportunity with you here. In the light of your experience of British banks during the first banking crisis, do you have any reflections on how our partners in the eurozone can better cope with their pending bank crisis? Will it be possible to do so without recapitalising and/or nationalising their banks?

Alistair Darling: Some countries in Europe were slow to face up publicly to the fact that their banks had problems too. I remember the first ECOFIN meeting I attended after Northern Rock. One could not help but detect round the table a very strong feeling of Schadenfreude. They were not quite smiling but one or two could hardly contain themselves. I remember saying to one Minister, who will remain nameless, "You've got exactly the same problems as we have", and he conceded privately that they did. Greece needs to be sorted out, but banks in Europe do need to be more capitalised.

Going back to Mr Mowat's point, what confidence can you have in the new structures where they carried out two stress tests that, first, ignored the interconnections between banks and, second, for political reasons, decided there was never going to be any question of sovereign default? Even earlier this year the possibility, let alone probability, of Greece defaulting was there. That does not help if you have a system where it has been politically nobbled. That is why European finance ministers really need to face up to it. The lesson of three years ago is that, if you know you have a problem with your banking system, it will not go away; it is far better to sort it out. We went a long way to clean out our banks three years ago. It took a bit of time but we did it; we recapitalised them and it has worked, which is always one test to apply to a policy.

Q245 Chairman: Thank you very much indeed, Mr Darling, for an extremely constructive session from our point of view. It was very clear, well informed and based on a lot of experience and contributes to our thinking.

Professor Eilis Ferran, Professor of Companies and Securities Law, Cambridge University; Rt Hon Alistair Darling MP; Professor Charles Goodhart CBE, Professor Emeritus of Banking and Finance, London School of Economics and Professor John Kay, Economist – o
Alistair Darling: Thank you. Perhaps this is my last contribution to a Select Committee of this House. Who knows?

Examination of Witnesses

Witnesses: **Professor Charles Goodhart CBE**, Professor Emeritus of Banking and Finance, London School of Economics, **Professor Eilis Ferran**, Professor of Companies and Securities Law, University of Cambridge, and **Professor John Kay**, Economist, examined.

Q246 Chairman: Thank you very much indeed for agreeing to appear before the Committee. For the record, perhaps I may ask you to introduce yourselves, even though we know who you are.

Professor Ferran: I am Eilis Ferran. I am a professor at Cambridge University.

Professor Goodhart: I am Charles Goodhart, a retired professor from the London School of Economics.

Professor Kay: I am John Kay, an economist attached to various places now.

Q247 Chairman: I would like to start off by asking a variant of a question that I asked the Chancellor. Based on the aspect of the Bill we are considering, which assumes we have a financial stability objective, it has been put to us that you cannot really define stability until it has disappeared. Therefore, it will be difficult to work out whether its committees are doing their job and it might be better that it had the objective to ensure that there is a stable and steady supply of credit into the economy. Would you agree with that? Do you think it is possible to control and ensure a steady and stable supply of credit into the economy?

Professor Goodhart: There will always be cyclical fluctuations, so credit will be growing faster during upswings in the economy and slower during downswings. The MPC already have a role where they try to use their general interest rate policy to mitigate the extremes of the cycle. The role of the Financial Policy Committee is much more to be concerned about the interaction between credit fluctuations and unsustainable movements in particular kinds of asset prices.

Professor Kay: It is important to realise that we are not and cannot be in this building devising our financial services regulatory regime for the world, and we will not achieve financial stability for the world. Therefore, our objective ought to be to protect the British non-financial economy, in so far as we can, from the instability which will inevitably exist in the world as a whole. That is a very different set of issues from the ones that would be involved in devising a regime to promote financial stability for the world. In Vickers we have taken the first steps towards recognising that as an objective, but it is a way of thinking about these issues that I have not seen in much of the discussion of the Bill that is before you but which I think is necessary. We cannot achieve financial stability globally at all; we can make a marginal contribution to it but not much. We can achieve more stability within the UK. The

instability we experienced in the UK in 2007 and 2008 was to some degree, not principally, caused by a credit cycle within the real UK economy; it was caused by what happened in the global financial markets.

Professor Ferran: As a lawyer, sometimes we have to distinguish between terms that are defined quite narrowly and others that are appropriately left in a more open textured form. I think that, just as we do not define confidence when we look at the objectives of protecting confidence in the system, similarly leaving stability in a broad open form, recognising that it would have to be fleshed out in an operational sense, has a lot to be said for it in terms of not inadvertently defining it in a way that turns out to be over-restrictive in a future scenario.

Q248 Baroness Wheatcroft: To be a little more specific and talk about the role of the PRA and FCA, are you clear that these regulatory authorities will know who it is they should be regulating in the first place? How is it to be decided what is prudentially significant and should therefore come under the PRA? Are we going to have areas of doubt, or are you quite clear on that?

Professor Ferran: The Treasury will pass an Order telling us what the PRA-designated activities are. It is envisaged that that Order will confer power on the PRA itself to designate some functions as being regulated by it. The criteria used by the PRA for that purpose will need to be set out with considerable clarity in terms of those investment firms dealing on their own account which are sufficiently significant to pose a potential systemic problem.

Q249 Baroness Wheatcroft: Do you see any difficulty in defining which organisations those are? Professor Goodhart, when we look at the shadow banking sector, for example, are you confident that we will be regulating the right bodies?

Professor Goodhart: As John says, we are not alone in this. There is a move worldwide to try to designate certain financial intermediaries, known as G-SIFIs, that are systemically important globally and to extend it to nationally systemically important financial intermediaries. This is not an easy exercise to do. What is significant depends on the context. It goes beyond intermediaries. For example, markets are systemically important, and centralised counterparties, CCPs, on which most standardised derivative products will have to be traded will be systemically important. It is a process where you know many of the factors: size; interconnectedness; the number of counterparties; relative risk; and importance to the economy generally. The question of how you designate SIFIs has been studied by institutions all over the world.

Q250 Baroness Wheatcroft: But you mentioned markets. At the moment markets and exchanges are to be regulated by the FCA, which seems rather strange.

Professor Goodhart: That is one of the aspects of the present Bill which I find most disturbing, because the question of the interaction of markets and intermediaries is very systemically important; it is critical to the continued efficient running of our economic and financial system; and it has been put with a body whose main concern is with consumer protection. The main skill sets of the people employed by it are likely to be those of

accountants and lawyers. They are not, with due respect to my colleague, necessarily the right people to be concerned with macro-economic systemic relationships. Indeed, I would say that possibly the flaw of the Bill before you is that it puts the prudential control of markets with the conduct of business institution, whereas in my view clearly it should have gone to the PRA.

Q251 Baroness Wheatcroft: There is a suggestion that these institutions should go to the Bank of England itself rather than the PRA. Is that something you have dismissed?

Professor Ferran: That is where the clearing houses will go.

Professor Goodhart: I think that markets as a group, including clearing houses, should all be looked at similarly. Whether they should go to the PRA or the Bank of England, those two bodies will work very closely together. Whether they should go to the PRA or Bank is a secondary issue, but they should not be with the conduct of business institutions.

Q252 David Mowat: My question is about competition and the extent to which you believe the FCA should have any specific role in promoting it.

Professor Goodhart: Competition has many virtues, but it is not necessarily always consistent with stability. I thought that the final report of the Vickers Commission was much better than the interim report in this case because it dropped the strong suggestions for trying to have challenger banks at all points of time. It is precisely the challenger banks that start small and are looking to become big and part of the established framework that usually do the damage by making much laxer conditions in order to get a much larger share of the market. The Icelandic banks were typical challenger banks; Anglo Irish Bank was *the* challenger bank. There is a new book out about that. Northern Rock was an archetypal challenger bank. It is a very good idea to have more competition, but in this field you have to be very careful that the more competitive banks are not making the system less stable by introducing much, much easier terms. It is usually the incoming challenger who becomes the bad apple in the barrel and turns everything rotten. That was very much the case in Ireland.

Q253 David Mowat: The issue that remains is that from a consumer protection point of view you might want to enhance competition. What you are saying is that new entrants are likely to be inherently less stable in terms of regulation.

Professor Goodhart: Yes, and the Bank of England recognise that. For example, under Pillar 2 of Basel II the Bank of England imposed much higher capital requirements on new-entry banks for a variety of reasons. One of the lessons that financial regulators have to learn very early on is that it is not just the banks that are doing badly about which you have to be careful; it is the banks that are growing very fast about which you need to be most concerned. You need to ask yourself: are they growing fastest because effectively they are taking on most risks?

Q254 David Mowat: For clarity, you would not expect this legislation necessarily to have anything in it regarding the promotion of competition.

Professor Goodhart: No. I am all in favour of competition as long as it is understood that it is not necessarily always consistent with stability. Regulators have to be very careful to ensure that the incoming new banks maintain appropriate lending standards.

Professor Kay: I would be very unhappy about that kind of approach. I agree with Charles that competition and stability are to a real extent in conflict with each other.
The truth is that for a century or more in Britain we have had a regime in which in effect we had a cartelised banking sector which led to a high degree of financial stability, but that deal and that era is over and we are not going back to it. At the moment we are in danger of getting the cartel without the stability, which is the worst of all possible worlds. That deal is over and we now have to say that this is, and ought to be, a competitive industry like others, particularly as far as concerns the retail sector, because retail consumers are not being well served by the present oligopolistic structure. That does not mean we impose very tight controls over bank entry, as Charles describes. It means that we encourage new entry, but we have to have a regime in place that enables new and indeed old institutions to fail as a result of the competitive process without it doing great damage to the economy as a whole.

To a large extent we now have in place a structure that would have allowed Northern Rock to fail without having systemic consequences as a result of that failure. It seems to me that is the place we ought to be, not in the process of imposing restrictions on Northern Rock taking more share of the mortgage market so that we could be perfectly sure it would not fail. I think that is the wrong way to go about it.

Q255 Mr Brown: Are the arrangements we have under consideration at the moment such a regime? My question is a pretty fundamental one. Is it going to achieve its objective of protecting the state, the taxpayer and maybe the consumer as well from another set of events that we have just been through?

Professor Kay: I do not think it is, and that is why I am much more impressed by what is in Vickers to get us towards the twin objectives you have described of a market that serves consumers better and avoids the dangers of failure of wholesale markets than the kinds of proposals that are in this Bill. But I start from the very general philosophical proposition that in most industries, including this one, our experience is that the kind of regulation based on generalised but not very specific supervision of firms' behaviour is not very successful. We do much better with regulation that focuses on structural issues and focuses laser-like on the small issues that are central to public policy concern, while allowing a good deal of freedom in other aspects of business management. That is the philosophical approach I would advocate in financial services, as in other industries.

Professor Goodhart: I certainly agree with John that we will get more financial crises. We always have had them, and always will have them, starting with the South Sea Bubble. The Dutch even managed to make a crisis out of tulip bulbs. If a fairly stolid nation like that can do that, we can certainly provide financial crises in the future, and we will. Neither this Bill nor the Vickers approach will prevent it. The most we can do is try to arrange for a system which will make these crises less devastating than many have been in history and this particular financial crisis looks like being at the moment.

Professor Eilis Ferran, Professor of Companies and Securities Law, Cambridge University; Rt Hon Alistair Darling MP; Professor Charles Goodhart CBE, Professor Emeritus of Banking and Finance, London School of Economics and Professor John Kay, Economist – o

Q256 Mr Ruffley: Professor Ferran, to go back to the FCA and PRA, spreading prudential regulation across those two bodies is, to my mind, very likely to lead to inconsistent regulation. From an academic point of view, can you tell us where that model has been adopted in foreign jurisdictions and whether or not that kind of inconsistency has arisen?

Professor Ferran: I cannot answer that precisely in terms of detailed knowledge of other jurisdictions, but in terms of inconsistency it seems to me that that question has to be linked to the question of PRA designation. If you can achieve a very clear definition of what is PRA regulated, then you are saying these are the entities that need to be supervised prudentially on a going concern basis. That is different from firms which do not pose any systemic risk and can be supervised on a different prudential basis, i.e. on a gone concern basis. In a sense, the problem of inconsistency disappears if you get a good boundary between what is PRA-designated and what is FCA-supervised. As we have already touched on with exchanges, the problem is that the current model does not necessarily aim at achieving that clear dividing line, so there will be some entities that may be on the wrong side of the line, if you like. Difficulties could arise with the FCA having to do a form of prudential regulation, which is not its area of expertise.

Q257 Mr Ruffley: Can you think of any examples abroad where the model is for institutions within the same group being regulated by one authority?

Professor Ferran: I do not feel I can answer that immediately, but in terms of the principle of the matter it is hard to come up with a clear-cut answer. It could make sense for the PRA to have a group-wide view. You definitely would not want to have a structure in which the corporate form could be used as a way of evading proper supervision. On the other hand, for the PRA to be supervising a range of entities which do not really raise any prudential concerns might not be ideal either. Maybe the model the Bill is trying to move toward is one where if there is a mixed group you have closer co-operation between the supervisors of the entities in that group, and the consolidated supervisor can make recommendations and give directions. In terms of the PRA designation, one of the factors that should be there is that of connection with the rest of the group. If there are PRA entities in a group, that should matter in the determination of the prudential supervision of the other group entities.

Q258 Mr Laws: I move us on to the issue of the governance and accountability in the FPC. I would also register my membership of the investment committee of Stanhope Capital, as we discussed earlier. I do not know whether all three of you heard the former Chancellor's evidence earlier. He was not particularly enthusiastic about the governance model for the FPC. In particular, he was concerned that it would be a committee of the Court, and he was concerned about the composition of its membership between essentially bank people and non-bank people. Do the three of you share those reservations at all, or does it not matter very much?

Professor Kay: I do not have a view on this.

Professor Goodhart: The question of the Court has been rather overblown. Ever since the Bank Rate Tribunal—most of us were rather small at that time—the Court has not had any policy role and never should have; it is not its function. If I understand it correctly, the Court's position in this is almost entirely administrative. The important issue is being accountable for the FPC's policy decisions, and there the accountability must be to the

House of Commons in general and to the Treasury Committee of the House of Commons in particular. The problem is not to whom they should be accountable so much as how you make them accountable when you do not have any definition of financial stability. The range of instruments they can use is almost entirely untried and people do not know how they are going to work. This is a great difficulty.

As you know, I have been putting forward suggestions that there should be certain presumptive indicators chosen effectively by the FPC to represent warning signals so that, when a number of them flash red, the chairman of the FPC writes to the Treasury Committee of the House of Commons either to say what action it has taken given these warnings or explain why it thinks these particular warnings are not relevant under the circumstances.

Q259 Mr Laws: The list of things you have cited are: the rate of growth of bank credit; the rate of growth of house prices; and growth of leverage. Are those designed to be illustrative from your perspective?

Professor Goodhart: Yes. I think it should be up to the FPC to decide which presumptive indicators it thinks are the most appropriate. They might have a completely different list. I think that when they decide they should write an accompanying paper saying why they have decided that.

Q260 Mr Laws: Do you see any risks in the approach you have suggested that this might bring any inflexibilities into the system?

Professor Goodhart: I would hope not. The financial system is dynamic and always evolving. In 2007 most of us had never heard of CDOs and things like that. It is inevitable that the relationships and system will change. For example, assuming that the FPC gets established and the report of the Vickers Commission is set up, that in itself will lead to changes in the structure and the way the system works. There are changes in information technology. All of the systems are continually changing, and it is one of the obligations of the authorities, including those in charge of trying to achieve financial stability, to assess the important changing relationships as the financial system itself changes. Who knows what it will look like in 10 to 20 years' time? Quite a lot of the intermediaries we have at the moment may have almost disappeared and there will be a whole lot of different ones, and the relationships will change. It is not a static system. One of the great difficulties with financial regulation is that it takes for ever to introduce a new regulatory system. It is such a struggle that people tend to stick with it, and meanwhile the financial system evolves in part in response to the regulatory change, so the regulators are always behind the game.

Q261 Mr Laws: It may be Professor Ferran wants to come in; she is looking slightly distressed.

Professor Ferran: No. I was thinking of the notion that we struggle to change our regulatory system. This is the third time round, at least in my academic career from 1986 to 2011. We seem to change it fairly regularly. On the general question about the FPC and its role, I think Mr Ruffley referred earlier to the Treasury using its remit perhaps to draw the attention of

the FPC to academic work. One of the structures to counteract that put in place by the European Systemic Risk Board, which has also been criticised for being central bank-dominated, is an advisory scientific committee, to which it has appointed a number of very distinguished academics, in particular economists, to feed in to the work of the Board. It seems to me that that type of thing could well be considered. If we stick with an entirely central bank-dominated committee, then at least there is some formalisation of the input into its work by others.

Q262 Mr Laws: To come to the balance of the committee, essentially it has five bank people on it; it has four members appointed by the Chancellor; it has a Treasury representative, who presumably is non-voting; and the chief executive of the FCA. Earlier the former Chancellor indicated to us that he thought that that bank dominance was too much; it was a 50-50, I suppose. I am not quite sure whether or not any of you share that view. Professor Goodhart, are you indicating that you are not too worried about that?

Professor Goodhart: I think the present set-up will impose an enormous burden on whoever becomes the Governor of the Bank of England and has to do the MPC and FPC; he is also the deputy chairman of the ESRB. It is a huge burden and responsibility and very difficult. On the other hand, I am not quite certain what could be done about that, because a key element of maintaining financial stability is the provision of appropriate liquidity both in the system as a whole and to individual intermediaries within it. The provision of liquidity has to come from the Bank of England, in my view, which means it has to play a leading role in macro-prudential regulation. That means the Governor has to be involved. As to relative numbers, one of the difficulties is that getting the right external people on to the FPC may be more difficult than for the MPC. You want people who are expert in commercial and financial affairs. If they are on the FPC they really cannot do anything else, whereas in the MPC the experts who have been appointed—and I agree are primarily needed—are basically academic economists who can serve on the MPC without difficulty. Getting the right kind of commercially savvy people on to the FPC is going to be very much harder.

Q263 Mr Laws: The other issue mentioned earlier by the former Chancellor was accountability of the FPC potentially to the political world. You have mentioned the Treasury Select Committee which has quite a lot of work to do and is already reasonably stretched. Are you satisfied that the political accountability of the FPC as it will be set up under the Bill is going to be effective enough both in crisis and non-crisis situations?

Professor Goodhart: In non-crisis situations, the argument for the independence of the FPC is the same as the argument for the independence of the MPC, which is that the regulation has its major effect during the upswing. If you are in a crisis and everyone is in panic, the market constrains you and your risk aversion is so much greater that the regulators are now trying to find ways to reduce the ratios but hope that it will not appear to be too odd at a time when banks are obviously in difficulties. The real time when financial regulation can affect the system is when it is in a strong upswing. The problem with that is that a strong upswing is enormously popular because everyone is getting richer and tax revenues are coming into the system. Everyone thinks that it is all right; the lenders love it and the borrowers love it. Borrowers and politicians loved subprime. It was quite largely the politicians who pushed Fannie Mae and Freddie Mac into doing more of this. The difficulty is that, if you are faced with a housing price bubble and one of the possibilities you may want

to undertake is to raise capital requirements on banks lending on housing, or tighten up loan-to-value ratios, it will be enormously unpopular politically. To leave the politician with the problem of having to take action which will be extremely unpopular politically, even if necessary, will be quite hard.

Q264 Mr Laws: Do you think that perversely that might justify people seeing a greater degree of political accountability, in the sense that this committee might be taking even more difficult judgments than the MPC, if that is possible? Therefore, when the unpopular decisions you are describing are made, people might well say, "We can't get mortgages and buy houses. Who are these people who are squashing the economy for no good reason? They are totally unaccountable and they turn up in front of a Select Committee a couple of times a year." You are not worried that it will look as if we have given away too much economic power to a bunch of people who look fairly unaccountable.

Professor Goodhart: It is a judgment you can make. I know that my colleague Willem Buiter, who I always enjoy listening to, very much takes the opposite line. He uses as his model the Financial Supervision Oversight Council in the USA which is chaired by the Secretary of the Treasury. He thinks that that is a better framework. You can argue this either way. I understand the line of argument which says that leaving everything to the independent judgment effectively of the Bank of England is undemocratic. I have been doing a study of Swedish monetary policy along these lines. There are very considerable questions about whether Sweden will want to put all responsibility for macro-prudential control into the Riksbank. The question is where you place the macro-prudential control: do you place it with the central bank or the FSA or the micro-prudential authority? It is a delicate issue. I do not think it would be proper to say there is necessarily a right or wrong answer.

Professor Kay: One should think of these political implications in a fundamental way. I hope that one of the things you will be doing is to ask the people who are before you what would have happened, and how things would have been different, in relation to some of the events which happened in the years leading up to 2007. That is true in relation to both the FPC and PRA. Would the attempts by both Barclays and RBS to take over ABN AMRO have been blocked? As the former Chancellor seemed to imply when he talked to you earlier, would you have raised capital requirements in response to that? If you had done that, is that intended to be a way of saying no, or is it a sort of fine for having done something that is not considered wise? What would these two agencies have done in respect of mortgage lending in the UK and to restrict Northern Rock?

Q265 Mr Laws: You have to give us your conclusion of this. Are you optimistic that they would have made a difference?

Professor Kay: My belief is that it is unlikely they would, but, as Charles has said, there is no political constituency at all for taking these forms of actions. The bankers that we are attempting to regulate are against it; the public will be against it; the press will, quite reasonably, be asking why you are depriving us of our cheap mortgages, etc., and our higher deposit rates when it comes to Kaupthing and Landsbanki, which is an even more interesting case of regulatory failure.

Q266 Mr Laws: But does not this argue for the Bill and the Goodhart view, that essentially you put this in the hands of non-politicians and you do not have to worry about it?

Professor Kay: The more you take it away from politics the more likely you will get action, but I think you are still not very likely to get action.

Q267 Lord McFall of Alcluith: At the end of the day who will take the punchbowl away? That is the issue. Who will protect it from the marauding commercial interests and the agitated politicians? The commercial interests say the loan-to-value ratios are too low, and the politicians say, "No. I want to go back to my constituents and tell them there is a better tomorrow." Who is going to take the punchbowl away? I think you are saying that at the end of the day we are all kidding ourselves.

Professor Kay: That is what I believe, yes.

Q268 Mr Mudie: I am sitting here quite calmly and then you set about us politicians. We are not saints. In a democracy we are not all perfect, so when we make mistakes and do things wrong the great thing about democracy is that we are being removed. Charles, you would have heard the Chancellor say that the great thing about accountability with regulators is that, if they get it wrong, action will be taken; they will be removed. The lad who was running the FSA, Hector Sants, is a regulator in the new situation and the lad who was making mistakes at the beginning of the crisis, if you like, was Mervyn King and he is still there. This is the action of the regulator. For two young kids trying to get a house, the average price of a new house is £160,000, so they have to find a deposit of £32,000 before they can get a mortgage under the present regulation set by the regulator. I accept that sometimes we are too soft; sometimes we are a bit pragmatic, but at least public opinion works with us and we have to move among the people about whom we are taking these decisions. That is not the way with regulators.

Professor Kay: That is true, but the question is whether you are willing to take the flak as politicians for saying that a young couple has to put up a deposit of £32,000.

Mr Mudie: We would not do that because it has never been done, regardless of what went on in the last 10 years—

Chairman: Perhaps I may plead for pithy questions and answers. I have a queue of people wanting to come in.

Q269 Mr Mudie: The Court is quite rightly dismissed by the Governor as being a paperclip body. They are administrators and he does not want them in policy, yet in the Bill they will set the financial stability strategy. If we take that away from the Court, as the Bank of England would like, where is the sensible place to put it?

Professor Eilis Ferran, Professor of Companies and Securities Law, Cambridge University; Rt Hon Alistair Darling MP; Professor Charles Goodhart CBE, Professor Emeritus of Banking and Finance, London School of Economics and Professor John Kay, Economist – o

Professor Goodhart: The Treasury Select Committee of the House of Commons.

Chairman: I have to suspend the sitting for a Division in the Commons. We will be back as speedily as we can.

Sitting suspended for a Division in the House

On resuming—

Chairman: As we are quorate and almost complete we will resume. We were somewhat interrupted. I do not know whether unofficially some of the matters were resolved. George, had you finished?

Q270 Mr Mudie: I have recovered. I put the simple question: which body would set up the strategy, because obviously there is no support for the Court having it. Is this not the opportunity to move it sideways? Obviously, you think not, so who would do it?

Professor Ferran: As to the strategy, I do not understand the multi-tiered approach of involving the Court. Either it is the Treasury setting out a more detailed remit or you leave it to the FPC itself.

Mr Mudie: I think that is an excellent answer, but neither John nor Charles will agree.

Q271 Baroness Wheatcroft: Professor Goodhart, you referred to the onerous duties now mounting up for a future Governor of the Bank of England. When he was here, Alistair Darling said this was a role which already had tinges of the sun king about it. It is a hugely powerful role. Figuratively speaking, if we dismiss the Court, as you and I think your colleagues might, it is all very well for the Treasury Select Committee to have a role in holding the Bank to account, but are you comfortable with the governance of the Bank of England as it is, or how would you change it? This seems to give an enormous amount of power to one individual.

Professor Goodhart: Yes, but it is committees and he has to take his colleagues with him. The concern is that a powerful Governor may find it too easy to take his colleagues with him. That goes back to the question of the ratio of externals to internals. There is certainly a question as to whether or not there are too many Bank of England representatives on the FPC and there should be more externals. One of my concerns is whether you will necessarily get the right kind of externals on to the FPC because it is a much more difficult role to fill than in the case of the MPC.

Professor Kay: There is a lot of discussion here about whether we are setting up structures that make either institutions or individuals too powerful. The truth is that we are doing that at the end of a period in which these institutions and individuals have had very little effective power in the areas we have been discussing. To my mind, that makes it odd that this should be such a principal concern. If it turns out that individuals are too powerful and become domineering and make mistakes, there are plenty of mechanisms to get back that kind of power. I am much more concerned by the probability that this regime will not be very effective than I am by the possibility that it might make institutions and individuals within it too effective and powerful.

Q272 Baroness Wheatcroft: I take your point to a certain extent in that Mervyn King said repeatedly that the pricing of risk was wrong but obviously did not have the power to do anything about it. Professor Ferran, do you have a view?

Professor Ferran: In the context of corporate governance, we developed the concept of the senior independent director to perform some functions within the board framework and I wonder whether there is any value in looking at what the external members do in terms of having a stronger voice among themselves in relation to the executive. It may be there are some things that could be taken from the corporate governance context.

Baroness Wheatcroft: That is an interesting thought.

Q273 Lord Maples: I was going to move us to a completely different subject, but this is so riveting that I cannot let it go that easily. The reason politicians stepped back from making these decisions is that they were not very good at making the tough ones. They were not good at taking away the punchbowl when things happened and denying licences to people. They put monetary policy into the hands of the MPC and securities regulation into the hands of the SIB and then the FSA. I do not think that is going to go back. They are people who serve on those committees who are prepared to take those tough decisions. There is plenty of evidence that from time to time they were, though you criticise what happened. Therefore, the question of governance seems to me extraordinarily important. If these institutions are within the Bank of England—I think the Government are committed to it—could you develop this theme a bit more? Within the banks themselves in the run-up to the crisis the non-executive directors performed abysmally in the two banks that went under, and in the case of HBOS they were probably leading the charge. With your experience of watching corporate governance how do you make that work better? It will be far more difficult to be the senior non-executive director of this organisation than even RBS was. Can you see some way of making it a little easier for the person who has those responsibilities to challenge the chief executive? Where is it going?

Professor Ferran: Ultimately, it must come down to the character of the individual. I am struggling to think immediately of something you could put into the Bill to facilitate that. It may be there are some things, but it must come down to the individuals.

Professor Kay: Surely, there is a big difference in that in the case of HBOS and RBS the boards of these institutions effectively served at the will of the chief executive, and that is not true of the institutions we are describing here, or it is very much less true.

Q274 Lord Maples: They would be appointed by the Chancellor, would they not, under the arrangements?

Professor Kay: Yes.

Professor Goodhart: In terms of the appointments I think my colleague Willem Buiter was again correct that the terms should not be renewable so there is no question about somebody wishing to curry favour with anybody else. But, if they are not to be renewable, a three-year term, which the MPC has at the moment, is too short because it takes everybody quite a long time to get up to speed. In my view, the externals at any rate should have a single non-renewable term of office that should be either four or five years.

Q275 Lord Maples: Is pay a factor in people's willingness to serve? Non-executive directors of public companies always seem to be incredibly badly paid for the responsibility that they then take. Have you seen this at all? Is corporate governance more effective where non-execs are better paid?

Professor Ferran: Where non-executives are paid more? I am not sure.

Q276 Lord Maples: They are expected to spend more time.

Professor Ferran: If they are expected to spend more time and their remuneration is adjusted to reflect that fact, yes. No one will do a job seriously and properly if they feel they are in effect paying to do it in terms of their time.

Professor Goodhart: Again, the FPC would be more difficult than the MPC, because many MPC members were academics and the MPC paid better than universities. For the MPC you want people with professional knowledge. Almost certainly the FPC will pay the externals a lot less than people who would have to give up their jobs totally and not be able to go back to them for quite a long time after they were external members of the FPC, because you would get to know much more in the way of inside information about individual institutions. Again, that makes the position of externals on the FPC much more difficult and delicate than is the case with the MPC.

Professor Kay: There is also a problem that in the nature of this kind of supervision the only source from which you can draw individuals for either the FPC or the PRA is people who have specific industry knowledge and experience. You are simply not qualified to do these jobs unless you have that kind of background. But, if you do have that kind of background and knowledge, almost certainly with the best will in the world you will tend to see the industry and the firms being regulated through the eyes of that industry and the firms that are being regulated. It seems to me that that is an intrinsic problem of supervisory regulation, and there is no getting away from it.

Q277 Mr Laws: I do not want to let Professor Kay's pessimism hang in the air. I want to check whether he is a fundamental pessimist about sorting out this type of thing through the FPC and whether anything will ever work. Is there anything better that you think we can do to make you less gloomy that we will go on failing to stop these bubbles in the future?

Professor Kay: There is quite a lot we can do, but it is not by strengthening the kind of mechanisms that we are describing and analysing here. The concept of regulation that is based on prudential supervision seems to me to have manifestly failed in different guises over two decades or so. There is no evidence of it being so much more successful in other countries that I am confident we could put in place a regime of that kind here which would have the desired effects. That is why I would attach much more emphasis to trying to construct a structure of the industry that is much more robust and resilient than the one we have allowed to develop in the last 20 years.

Chairman: That is a helpful introduction to Lord Newby's questions.

Q278 Lord Newby: If I may try to sum up the questions on the Vickers report, Professor Kay has expressed his support for it already. I just want to check, first, whether all three of you believe that the Vickers proposals in terms of ring fencing and capital are sensible and should be implemented; second, whether you think they are implementable and you can do it in a way that clever banks will not get round; and, third, whether it matters how quickly you do it. Professor Kay has answered the first point, but perhaps he would like to deal with the second and third points and the other members of the panel can comment on it.

Professor Kay: As you said, my answer to the first question is yes. My answer to the second question is that it is difficult. I have been sceptical about how easy it is to do it in the face of pressures to get round it. There are four main issues. One is that you have to limit the assets that can be held by the ring-fenced bank. Second, you have to limit very severely the extent to which the ring-fenced bank can transact with other financial institutions owned by the same holding company. Third, you have to restrict severely the derivative transactions in which the ring-fenced bank can engage. Fourth, you have to establish a separate and substantially independent board that will have the capacity to try to sustain a retail banking culture in the face of the pressures that come from investment banks. These were the tests in my mind for Vickers' final report. Basically, it got a tick in each box as far as I was concerned. I think they have faced up to the main issues and the proposals in that report are quite likely to work. It is important that this be done as quickly as possible, partly because, as I have said several times, I do not think we are going to avoid other potentially larger financial crises in global financial markets. We need to try to prepare a British economy and financial sector that is resilient to that. I am also very worried that at the moment we have a wide consensus of informed opinion in support of these kinds of proposals. Publicity and enthusiasm for that issue will inevitably fade and we will all turn our attention to other things, but the lobbyists on behalf of the banks will be there all day every day for eight years, or however long it takes. The longer it takes the less likely it is to happen in an effective form.

Professor Goodhart: I am quite sympathetic to the report but I do not think they got it quite right. They started from the viewpoint that what was essential was to remove the contingent liability of the UK taxpayer, and the best way to do that is to try to make the

banks a lot safer. The way that is being approached is to follow the Swiss down the Swiss finish line with much more capital and a further tier of bail-in bonds. I have some criticism of bail-in bonds and CoCos but this is not really the time to go into that. Effectively, they want to have loss-absorbing capital of between 17% and 20%, together with liquidity requirements. Then they looked round and asked, "Can we introduce this to the banks as a whole? If we do that, we will make the British banks totally non-competitive within the City of London." They then said, "What can we do?" and they thought, "We can ring fence the retail bits that we think are vital and let the separate investment bank go out and compete under the Basel Committee and Financial Stability Board approach."

The problem with that is that there has been a mistaken tendency to believe that these investment banks are simply socially useless casinos. They play a very major role. I should add here a personal qualification. I act as a temporary consultant to Morgan Stanley. That should be on the table in this case. They play a very major role because effectively they are intermediating between the big borrowers and savers. So all the pension funds and insurance companies—indeed the whole financial system—work through the big investment banks, as do all the big borrowers, but not necessarily through the use of the balance sheet because a lot of it is advisory and analytical. But if the big investment banks were to go down, as with Lehmans, the situation would become effectively untenable. You might—might—just be able to allow one to go; more than one and you would be in the middle of the biggest crisis you ever saw. Therefore, the idea that you have to save these retail banks, but now with the recovery and resolution process and all the rest of it you can let the big banks go is simply pie in the sky. They are not all sitting around in prop desks taking massive punts on whether or not Italy will survive; they are playing the major role in keeping our wholesale financial markets going and intermediating between the bigger players, both nationally and internationally. I think there is a concept in Vickers that this lot really does not do anything of any social value, which is just wrong.

I am also quite worried that, if we have a developing viewpoint that investment banks and investment bankers are just a lot of old buccaneers doing nothing useful and that becomes general, the potentiality for major crises to affect London and, through London, the international financial system becomes greater rather than less. The idea of ring fencing and the ability to liquidate the investment bank bit if it gets into trouble is wrong. I would have preferred to have a Swiss finish with much more capital and, if necessary, bail-inable bonds over the whole of the universal bank.

Professor Ferran: Is it implementable? The Volcker rule ended up with a lot more carve-out and exceptions than envisaged. There is a question about how watertight the ring fence will be. That may be an argument for doing things quickly. As to the point just raised by Professor Goodhart, one strand with which you are already familiar is whether it is implementable given capital requirements in the EU. There is another strand of developing policy at EU level, which is crisis management. That is looking at asset transferability between different companies within a corporate group, recognising that there may be circumstances when you need to override entity structures to facilitate a response to the group as a whole. Whether that policy development within the EU will undermine some of what Vickers is trying to achieve needs to be monitored.

Q279 David Mowat: I want to follow up Professor Goodhart's comment on investment banks. I do not think they are socially useless in the terms you say, but it is useful for entities in capitalism to be able to go bankrupt. Are you saying that these things have evolved to the point where under no circumstances they can be allowed to go bankrupt or, in your words, only one of them might go under?

Professor Goodhart: People, including John at times, have referred to at least parts of banks being similar to utilities, which I think is a very appropriate analogy. Electricity, gas and train companies can go bankrupt but you do not immediately scrap the power stations, transmission lines and rail lines. What you do is get rid of the management and cut out the shareholders.

Q280 David Mowat: Potentially, you sell those assets to other utilities in the instance you gave which would be analogous to Lehman Bros.

Professor Goodhart: That would be exactly the same and I would do it in the banking sector. I would intervene much earlier before the bank had made a significant loss. There are problems of getting a trigger and problems of capitalism, because if you intervene earlier you are taking away people's property while it has a certain value. I would be prepared to do that. I would intervene very much earlier, get rid of the management, take the value away from the shareholders effectively and, if necessary, take it into public ownership temporarily, which in my view should have been done with RBS. Leaving the existing shareholders with any value and the existing management and board in place was a major error. In my view the right approach is to take these institutions into temporary public ownership. You leave the basic staff, IT, connections and market relationships unaffected while you put in new ownership, and then you find a new buyer.

Q281 David Mowat: Does not the process you have described sound quite analogous to chapter 11 bankruptcy in the States?

Professor Goodhart: That was exactly what was done in the Nordic crisis in 1991-92. That was an example of how a financial crisis should be handled.

Q282 David Mowat: Professor Kay, you mentioned four tests for this ring fence to work. If those tests, which are quite onerous, worked, would it be in a composite bank's interest to maintain ownership of retail? Are you not, therefore, effectively doing Glass-Steagall by another means? What is in it for them?

Professor Kay: Probably not. If the investment bankers who now control essentially all the large conglomerate banks are deprived of access to the retail deposit base that has accumulated within the retail bank, they do not have much other interest in the retail side. It is likely that separation will follow.

Q283 David Mowat: The implication of that answer is that, if the ring fence is done properly in the way you say, they would sell those banks, or they might as well get rid of them, because there is no economic purpose in keeping it together?

Professor Kay: I think that is right. If you read the response of the banks to why they would prefer ring fencing to separation, the arguments they present are extremely feeble. They claim diversification from benefits to shareholders which I must say are not things that their shareholders are feeling at the moment.

Q284 David Mowat: Exactly. Therefore, the implication of your answer is that in their response they think they can get round the ring fencing?

Professor Kay: I think they still do, and it is up to all of us to try to make sure they do not.

Q285 Chairman: I think the last time Professor Kay and I discussed these matters I put forward the arguments for doing nothing. Perhaps I may now put the arguments for the complete Glass-Steagall which I would have thought would be: there were no banking crises in America until Glass-Steagall was repealed; if you have investment banks and retail banks together the investment bankers always come out on top and will run it, because they are brighter, cleverer, more ruthless and ambitious; it has been put to me that there are no examples of an investment banker successfully running a retail bank for any length of time, but I do not know whether or not that is true; and they always use the opportunity when they control a retail bank, even if the two are separate, to stuff the retail bank's clients with the rubbish that the investment bank produces. Those are not my views but I would like your comments on them.

Professor Kay: Even if they are not your views they have considerable merit. I think separation and a wider silo-ing in effect of a financial system so we go back to a world closer to the one we used to be in, in which in the main different functions were performed by different institutions, is an essential part of creating the more robust, resilient financial system I described. When we last discussed this I remember that I was very much a minority in advocating any kind of separation of the retail elements. Having, as I see it, won 98% of what I wanted, I am not going to press too hard for the remaining 2%. I would like to try to bank the 98% first in a safe ring-fenced retail establishment.

Q286 Baroness Drake: There are two particular dimensions to consumer protection embraced by the Bill on which I invite your opinion. One is the general principle that consumers should be responsible for their decisions and what that implies for the division of responsibility between a consumer and the firm. The other is the definition of "consumer" in the Bill that appears to be very broad from individual to hedge fund. How far should the consumer take responsibility for his own decisions, and does the Bill strike the right balance between the firm and the consumer? Does such a broad definition of "consumer" mean that the regulator will have problems in focusing on what protection means in that instance?

Professor Ferran: The Bill has to be seen in the context of the way the FSA has evolved. If you look at FSA publications from 2002-03 it was saying, "We are concerned with mis-selling. Mis-buying isn't our problem." That attitude has gone away in the current FSA and it has been doing a lot of work focusing on consumer issues. That is part of a global trend. The OECD is producing guidelines for the next G20 on financial responsibility, recognising that consumer issues need to have higher priority because of their links with financial stability.

As to where the Bill strikes the balance, it says twice, which may be excessive, that consumers have to take responsibility for their own decisions, but it sets that within a framework in which the FCA has to deliver as an operational objective an appropriate degree of consumer protection. It seems to me you cannot have a fixed line between the two, because the appropriate degree of consumer protection will depend on the nature of the consumer, product and other factors. But the onus is on the FCA to ensure that there is the appropriate degree of consumer protection, and what is appropriate will determine how much responsibility the consumer can be expected to take. In some circumstances clearly consumers will not be able to take much responsibility at all and a great deal of consumer protection is appropriate; in other circumstances the balance will not be so far in one direction.

Q287 Baroness Drake: You feel that how the Bill is constructed on the point of consumer responsibility is okay.

Professor Ferran: I think so, because it has to be read together with the approach that the FCA will take following the way that the culture of the FSA has developed over recent years.

Professor Kay: I do not agree. If we were to think of putting a provision like the one you have described into a Bill to regulate, let us say, pharmaceutical products or water supply, we would wonder what on earth was going on. We have not got anything like far enough away from the traditional attitude in effect of saying, "If there is enough small print it is your own fault if you buy it." That raises a real difficulty about what we do. In the case of food, pharmaceuticals or water we stop at it being poisonous. There is absolute agreement on that. The question is: what do we do when it is not poisonous but it is not something that a well-informed consumer would want to buy? There are lots of financial products that are essentially of that kind.

I think it is very difficult to visualise a world in which the regulator, the FCA, is involved in banning these kinds of products. I am reluctant to move very far down that road. The way in which these issues are dealt with in most other markets is that the reputation of a supplier is bound up with the supply of the product. I have no idea what is going on under the bonnet of my car and I do not want to know, but I think I am justified in being reasonably confident that the combination of public safety regulation and private concern by manufacturers for their reputation ensures that what is under the bonnet of the car will make it work. We are not in that position in relation to financial services.

To go back to one of the views the Chairman expressed but may or may not hold, there has been an element in which conglomerate financial institutions have stuffed retail consumers with rubbish. What happened in relation to payment protection insurance is absolutely disgraceful by any possible standards. What is disgraceful is not just that they did it but they fought kicking and screaming through judicial reviews to go on being allowed to do it, even after it had become evident that it was a scandal and one that was in the collective interests of the banks, if not in their individual interests, to stop.

What we have to do over a period of time is bring about a change in the culture of the financial services industry in the way it deals with retail customers. Creating a focused retail banking sector will help to do that, but, more broadly, we have to change the whole way we think about banking conduct, the conduct of financial institutions and consumer

protection in relation to them. To go back to where I started, by putting this provision in the Bill my fear is that in effect we are saying we are not going very far down that particular road. I am very unhappy about it.

Chairman: I thank all three of our witnesses for their very thoughtful contributions which I am sure will greatly help us in our deliberations.

Professor Eilís Ferran – supplementary written evidence

Explanatory note
On Tuesday 11 October 2011, I gave oral evidence before the Joint Committee. The other witnesses in the same session were Professor Charles Goodhart and Professor John Kay. This note expands on some of the remarks I made during the evidence session and on some other issues that arise in relation to the draft Bill.

1. The concentration of power in the Bank of England: some general points
The first striking feature of the proposed new institutional architecture is the resumption by the BoE of major responsibilities for financial market supervision. The UK is certainly not alone in restoring its central bank to a position of centrality in supervision. Paralleling the UK's move towards a "twin peaks" approach, the National Bank of Belgium has recently been entrusted with the micro-prudential supervision of financial markets and services, while responsibility for conduct matters is now vested in the Financial Services and Markets Authority. France has streamlined a model in which prudential supervision is the responsibility of an independent administrative authority operating under the auspices of the Banque de France (the Autorité de Contrôle Prudentiel) by merging four previous banking and insurance licensing and supervisory authorities into one. The Central Bank of Ireland has assumed across-the-board responsibility for both central banking and financial regulation. However, the UK differs from euro area countries in that it will combine wide-ranging strategic and operational responsibilities for both monetary policy and supervisory policy in its central bank. The new arrangements will also consolidate the BoE group's role in crisis management, a turn of events that, in effect, reverses a setback that the BoE suffered when it did not get formal power under the Banking Act 2009 to act as the gatekeeper with respect to putting a bank into the special resolution regime. The European Commission has noted that in many jurisdictions resolution authorities are appropriately separated from supervisors and that it considers such separation to be important to minimise the risks of forbearance.[108] In the UK, henceforth this separation will rest on measures within the BoE to maintain an appropriate distance between the PRA and the Special Resolution Unit that sits within the BoE itself.
The position of the Governor of the BoE will be especially sensitive. Included in that individual's suite of responsibilities will be chairing the Monetary Policy Committee (MPC), the FPC and the PRA, as well as being in overall charge of the BoE's special resolution unit and its payment/clearing and settlement systems oversight department. By any measure, this is a remarkable rota of roles vested in a single individual. The list of appropriately-qualified persons who are willing to put themselves forward as potential successors to Sir Mervyn King, the current Governor, when the position becomes vacant in 2013 may not be a long one.
There are questions as to whether the governance and accountability of the BoE are adequate given the expansion of its responsibilities. These questions are being examined not only by the Joint Committee on the Financial Services Bill (JC) but also by the House of Commons Treasury Select Committee (TSC), a level of political interest that demonstrates the seriousness of the concerns. The TSC inquiry has drawn particular attention to the role of the Court of the Bank of England, which is currently responsible for managing the BoE's affairs other than monetary policy. The TSC's evidence sessions have exposed doubts as to the Court's fitness for purpose as presently structured. One outspoken critic, Dr Willem H. Buiter has described the Court as "a historical legacy institution that now serves no useful

[108] European Commission, An EU Framework for Crisis Management in the Financial Sector, COM(2010) 579, para 3.1.

purpose and creates the appearance or illusion of accountability or oversight where none exist".[109]
These concerns are especially weighty because of the role that the Financial Services Bill as currently drafted envisages for the Court with respect to determining the UK's financial stability strategy.

2. The financial stability objective in detail

Going forward the BoE's financial stability objective will be defined as an objective to protect and enhance the stability of the financial system of the United Kingdom (Bank of England Act 1998, section 2A (draft)). It is clearly important to know what is meant by "the stability of the financial system" but to attempt to spell this out in detail on the face of legislation would be unwise because any such drafting exercise would inevitably be constrained by imperfect foresight and thus would run the risk of setting in stone a definition that proves to be too narrow and/or too inflexible in the longer term. In the context of monetary policy, where the BoE's objective is to maintain price stability (and subject to that, to support the economic policy of the Government including its objectives for growth and employment: Bank of England Act 1998, sec 11), this problem is addressed by a provision whereby HM Treasury is required to write to the MPC at least once a year to specify what price stability and what the economic policy of the Government consist of (Bank of England Act 1998, sec 12). The annual HM Treasury remit letter fleshes out the concept of price stability in practical, operational terms whilst avoiding undue rigidity. The arrangement strikes a balance between operational independence and democratic accountability. In practice, this model has worked quite well.
A different model is proposed for financial stability. It is envisaged that primary responsibility for determining and keeping under review the strategy for achieving the financial stability objective will sit with the Court of the BoE, although the Court will be required to consult with the FPC and HM Treasury, and the FPC may at any time make recommendations to the Court (Bank of England Act 1998, sec 9A (draft)).[110] Hence the crucial significance of doubts as to whether the Court is up to the job of assuming a major policy-setting role.
The FPC, which, on current proposals, will be set up as a committee of the Court (not a committee of the Bank itself, which is the basis on which the MPC is established) will have the objective to contribute to the achievement by the BoE of the financial stability objective (Bank of England Act 1998, secs 9B-9C (draft)). HM Treasury will be able to make recommendations to the FPC at any time and must make recommendations once a year (Bank of England Act 1998, sec 9D (draft)). However, these annual remit letters, which must set out matters that the FPC should regard as relevant to its understanding of the financial stability objective, the responsibility of the FPC in relation to achieving the objective, and matters to which the FPC should have regard in exercising its functions, will not serve as firm constraints. Instead, a weak reporting mechanism is envisaged whereby the FPC must report on whether or how far it accepts HM Treasury recommendations and on what action (if any) it proposes to take in response (Bank of England Act 1998, sec 9D(3)). This wording would appear to allow the FPC to adopt a quite cavalier attitude towards HM Treasury recommendations. Whilst the natural expectation is that the FPC would in practice take HM recommendations very seriously and respond in a careful and detailed way, rather than leaving things to chance the legislation could (and should) reinforce expectations with respect to good practice by at least specifically requiring the FPC to give reasons for not

[109] WH Buiter, Accountability of the Bank of England: Supplementary written evidence, http://www.publications.parliament.uk/pa/cm201012/cmselect/cmtreasy/writev/accbank/m12.htm
[110] Superseding Bank of England Act 1998, sec 2A(3) (inserted by Banking Act 2009).

following HM recommendations. Reinforcing the "explain" part of the reporting obligation would not go as far as allowing HM Treasury actually to dictate the financial stability strategy (which could introduce unhelpful vulnerability to distortions stemming from short term political considerations) but would usefully underpin the political angle.
The FPC is described by the Government as "a powerful new authority sitting at the apex of the regulatory architecture".[111] The mechanisms to ensure democratic accountability that apply to the FPC need to be commensurate with the strength of its powers. Whilst there are some detailed channels of accountability for the FPC that are helpful in this regard[112] (and in the critical area of creating macro-prudential tools HM Treasury is quite properly in charge (see section 5 below)), overall the current proposals can still be criticised for failing to give HM Treasury an adequate say. What operational independence involves and how far it can extend in an area in which decisions may have significant fiscal ramifications for which political responsibility needs to be taken are matters on which the current proposals may not (indeed should not) be the last word.

3. Financial stability, economic policy and the FPC

It is noticeable that the financial stability objective, unlike the monetary policy objective, does not make reference to supporting economic policy. This is consistent with a policy choice that runs through the draft Financial Services Bill to remove references to promoting competitiveness from financial supervisors' mandates. This choice has attracted criticism from certain parts of the financial services industry but been commended by the IMF as a feature that enhances the clarity of supervisors' mandates.[113] Whilst standing by its choice, the Government has responded to critics by accepting that in view of the interaction between financial stability and economic growth the Bill should not be completely silent on this matter. The draft Bill therefore provides that the FPC is not required or authorised to exercise its functions in a way that would *in its opinion* be likely to have an adverse impact on the capacity of financial sector to contribute to the growth of the UK economy in the medium or long term (Bank of England Act 1998, sec 9C(4) (draft)(emphasis added)). The subjective wording of this draft provision has not fully satisfied critics. However, "removing the punchbowl" from an industry that is becoming overheated in the short term is something that the FPC should certainly be able to do, and for the legislation to be framed in a way that allows it to follow its own judgment as to the longer term implications of that action is appropriate. Strengthening the political input into the formation of the financial stability strategy (as outlined above) may be a better way to address many of the concerns that lie behind the criticism of the drafting of this particular clause.

4. The composition of the FPC: over-dominated by the BoE?

Under the current proposals the BoE has five seats on the FPC (the Governor, the two deputy governors and two BoE executives) (Bank of England Act 1998, sec 9B (draft)). The other members are the Chief Executive of the FCA, four externals appointed by the Chancellor and a representative of HM Treasury. There is considerable overlap between the

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[111] HM Treasury, A New Approach to Financial Regulation: The Blueprint for Reform, Cm 8083, June 2011, para 1.29.
[112] Minutes of FPC minutes must be published: Bank of England Act 1998, s 9Q (draft). The FPC must publish a financial stability report twice a year and these reports must be laid before Parliament (Bank of England Act 1998, s 9S (draft)). Publication must be followed by a meeting between the Chancellor and the Governor of the BoE and a record of these meetings must be published (Bank of England Act 1998, s 9T (draft)). A representative of HMT will serve on the FPC (Bank of England Act 1998, s 9B(1)(f) (draft)).
[113] IMF, United Kingdom: The Future of Regulation and Supervision Technical Note, IMF Country Report No 11/230, July 2011, p 5.

membership of the MPC and the FPC. This is a deliberate design choice that is intended to ensure that "each committee is fully aware of the work of the other and able to take it into account in its analysis".[114]
Around the world there are different views on whether systemic risk oversight bodies should be central bank dominated or should have a membership that is more broadly representative of the stakeholders in the financial services industry (including its users) as a whole. The European Systemic Risk Board (ESRB) adopts the central bank model.[115] The US Financial Stability Oversight Council adopts a more stakeholder-oriented model. There are risks either way. "Group think" could beset a body comprised of individuals mostly drawn from the same narrow pool. A group drawn from a diverse range of sources could struggle to agree.[116]
It is the "groupthink" risk that is pertinent in relation to the FPC. It will fall mainly on the four external members of the FPC to challenge BoE "house" thinking and to provide alternative perspectives. Arguably it would be better to increase the number of external members so that they have a stronger voice. However, experience with appointments to the interim FPC has already demonstrated that it will be hard to attract suitably expert and experienced individuals to take on a role that will not be full time but which will probably debar them from many other activities because of the acute sensitivity of the information to which they are privy. Requiring more external members could simply exacerbate this problem. The terms and conditions of appointment of external members will thus need to be very carefully fine-tuned to meet the reasonable expectations of suitably qualified individuals; and the internal governance arrangements of the FPC will need to be designed in such a way as to ensure that the views of the externals carry due weight.
External liaison committee could also be considered. For example, the ESRB has an "advisory scientific committee" comprised of persons who, under its founding Regulation, are to be chosen on "the basis of their general competence and their diverse experience in academic fields or other sectors, in particular in small and medium-sized enterprises or trade-unions, or as providers or consumers of financial services".[117] World class academic economists and others have been appointed to serve on this committee. This approach may not be exactly right for the FPC, which is already different from the ESRB in having independent external members. However, the Government's suggestion that HM Treasury could use the annual remit to bring recent academic research or experiences of other macro-prudential bodies to the FPC's attention is a recognition of the need for the FPC to be exposed to many different viewpoints.[118] The annual remit letter is one mechanism for doing so; but there could be other structural arrangements that would be worth exploring.

5. The FPC's functions, powers and tools

The FPC will be charged with the tasks of identifying, monitoring, and taking action to remove/reduce systemic risks with a view to protecting and enhancing the resilience of the UK financial system (Bank of England Act 1998, sec 9(F)(1)(a)) (draft)). Systemic risk in this context means a risk to the stability of the UK financial system as a whole or to a significant part of that system (Bank of England Act 1998, sec 9C(5) (draft)) and includes systemic risk

[114] TSC, Financial Regulation: A Preliminary Consideration of the Government's Proposals: Government Response to the Seventh Report from the Committee, HC 958, May 2011, para 21.
[115] E Ferran and K Alexander, "Can Soft Law Bodies Be Effective? The Special Case of the European Systemic Risk Board" [2010] European Law Review 751-776
[116] Hal Scott has described the FSOC as "a ten-headed hydra … [that] will not be effective": H Scott, "Little to celebrate on Dodd-Frank's birthday", Financial Times, 20 July 2011, p 8.
[117] ESRB Regulation, art 12.
[118] HM Treasury, The Blueprint for Reform, n 4 above, para 2.11.

attributable to structural features of financial markets, distribution of risk, and unsustainable levels of leverage, debt or credit growth (Bank of England Act 1998, sec 9C(3) (draft)). The FPC will be empowered to give directions to the PRA/FCA requiring macro-prudential measures and to make recommendations within the Bank, to HMT, to PRA/FCA or to other persons (Bank of England Act 1998, sec 9F (draft)). It will be required to prepare and publish financial stability reports twice a year (ibid).

The power to give directions requiring macro-prudential measures (MPMs) has attracted particular attention in the scrutiny process. There is an element of stepping into new territory here – indeed the IMF has noted that "what macro prudential policy can deliver is somewhat of an unknown in any country".[119]

The proposed approach to the legal framework for MPMs is that measures will be specified by HM Treasury by Order (Bank of England Act 1998, sec 9K (draft)). Orders will be subject to the affirmative resolution procedure in Parliament, except in situations of urgency. HM Treasury must consult with the FPC before making an Order prescribing an MPM, or at least with the Governor if delay would be prejudicial to financial stability. MPMs made under the exceptional procedure for circumstances of urgency will have an expiry date, but not those made under the ordinary power (Bank of England Act 1998, sec 9L(3) (draft)). The arrangement whereby the making of MPMs is a matter for HM Treasury and Parliament and decisions about use are for the FPC is appropriate. The FPC will be able to make recommendations to HM Treasury with respect to MPMs (Bank of England Act, sec 9N(2)(a) (draft)) but the decision will properly remain with HM Treasury.

No draft of an Order prescribing MPMs is available at the time of writing but widely-discussed examples of what it may include are countercyclical capital requirements, leverage limits, forward looking dynamic provisioning, and collateral requirements (eg loan to value ratios).

It will be for the FPC to trigger the actual application of a MPM by giving a direction to the PRA/FCA requiring them to secure implementation (Bank of England Act, sec 9G (draft)). As currently drafted, the draft Bill provides that the Order setting out MPMs *may* require the FPC to maintain statements of policy as to their use on a measure-by-measure basis (Bank of England Act 1998, sec 9K(4) (draft)). This discretionary approach may not give adequate weigh to the benefits of having standing policies in place, and not only for those who may be on the receiving end of MPMs and those with concerns about the FPC's accountability in respect of its powers. Policies setting out particular courses of action, especially if they contain more-or-less automatic triggers, can usefully shield the FPC from political pressure to avoid taking unpopular actions and from industry lobbying. It should not be impossible to draw up statements of policy that provide this sort of discipline but still leave sufficient leeway for discretionary intervention in previously unanticipated circumstances. A statutory requirement for standing statements of policy could also be relaxed for MPMs prescribed under the exceptional power for circumstances of urgency.

From an accountability perspective, there are suggestions that a further desirable improvement would be to reinforce transparency with respect to MPMs, eg by requiring the FPC to publish an impact assessment alongside any direction.

6. Information-gathering powers

One of the FPC's responsibilities will be to monitor the shadow banking industry. Its monitoring efforts may lead it to make recommendations to HM Treasury to move the regulatory perimeter (as envisaged by Bank of England Act 1998, sec 9N (draft)). A question

[119] IMF Technical Note, n 6 above, p 22.

that arises is whether the FPC needs to have direct information-gathering powers in order to perform this function effectively.
The PRA will assume the power to gather information relevant to financial stability that was conferred on the FSA by the Financial Services Act 2010 (FSMA, sec 165A (draft)). This power is attended by procedural safeguards. There is a need for a statement of policy (currently maintained by the FSA) and a requirement for the service of a formal notice in writing that an information-gathering requirement is to be imposed, an opportunity for the recipient to make representations, and a duty to give reasons. It would not be appropriate to confer on the FPC direct information-gathering powers without similar procedural constraints but it is not clear how they could be made to work in the context of a policy committee as opposed to a frontline supervisor. The PRA will have a duty (FSMA, sec 354C (draft)) to provide to the BoE any information in its possession that it thinks will or may assist the Bank in achieving its financial stability objective. This duty will apply whether or not the Bank has requested that the information be disclosed to it. This obligation, together with the BoE's new power to issue directions requiring the FCA or the PRA to provide information or documents that are reasonably required on connection with the exercise of its functions (Bank of England Act 1998, sec 9U (draft)), may suffice to ensure an adequate flow of information without the additional complications that could flow from attempting to equip the FPC with direct powers.

7. Macro-prudential tools, national discretions and maximum harmonization

This issue has become prominent because EU regulatory policy for financial markets has shifted decisively in favour of detailed standardization rather than mere harmonization of core requirements at a minimum level. In early stages of the response to the financial crisis, leading UK figures broadly accepted the inevitability of "more Europe". However, as this policy has come to be applied in the revision of capital standards, some reservations have emerged.
The new EU CRD IV framework comprises a proposed Regulation[120] and a proposed Directive.[121] The Regulation is explicitly intended to be maximum harmonization. The Commission has made the case for this approach – the single rule book – on three grounds.[122] First, that inappropriate and uncoordinated stricter requirements in individual Member States could result in the shifting of underlying assets and risks to the shadow banking sector or from one MS to another. Second, that differences could obstruct fundamental freedoms. Third, that they could cause significant distortions of competition. These are powerful arguments.
But the Commission does not intend completely to close the door to a differentiated approach at national level. An exception is provided in the Regulation for MSs to apply higher risk weightings to exposures secured by mortgages on immovable property in specific areas. If there is one exception, the possibility of negotiating for others cannot be ruled out. However, a more promising line for the UK in seeking to ensure that EU law does not constrain its options unduly (eg with respect to imposing higher capital charges on ring-fenced retail banks as proposed by the Vickers Commission[123]) may be to explore the flexibility within the CRD IV Directive for competent authorities to address macro-prudential concerns at national level. In particular, it will remain possible for MSs to impose additional capital requirements on individual institutions or groups of institutions as part of

[120] COM(2011) 452.
[121] COM(2011) 453.
[122] COM(2011) 452, p. 10.
[123] ICB, *Final Report: Recommendations* (London: ICB, September 2011).

supervisory review where justified by special circumstances.[124] Also the level of countercyclical capital buffer will need to reflect specific macroeconomic risks in a given MS and thus will be set at national level.[125] The Commission has accepted that the countercyclical capital buffer could even go above the 2.5% set under Basel III (but the ESRB and EBA would be involved to ensure that the setting of the buffer rate is done in a way that is consistent with internal market principles).
Given that the need for some flexibility at MS level is not disputed by EU policymakers, the fears that have been expressed in the UK about the constraining effect of CRD IV may be overstated, although this is not to deny that intense negotiations will still be required to ensure that EU legislation and legitimate domestic policy goals dovetail effectively with each other. The UK will probably need to accept that an effectively fixed, non-negotiable point in deliberations with other MSs and with the Commission is that EU law will not countenance action being taken at the domestic level without regard to its impact on the stability of the financial system in other MSs (see, eg, CRD IV Directive, art 8 (Commission proposal)).

8. Making the move to "twin peaks" work: general comments

It is clear that the time for debate about the desirability in principle of breaking up the FSA into the PRA and the FCA has passed. No institutional model for financial market supervision is perfect and it is possible that desirable improvements could have been achieved, at less cost than a break-up, by an internal restructuring to create an internal twin peaks within the FSA. However, the focus now has to be on making the model that has been chosen work as well as possible.

As the proposals have gathered substance since they were first announced in 2010, it has emerged that for many purposes it will be correct to regard the FCA as the FSA renamed, albeit with a narrower focus and an expanded array of powers. Insofar as this implies continuity rather than a clean break with the past it is welcome because the positive developments within the FSA in recent years (such as intensive supervision, credible deterrence) are worth retaining.
It is the stripping out of the micro-prudential supervision of systemically significant financial institutions and firms that is the one major change. The PRA, which will assume this responsibility, has the potential to be a superior micro-prudential supervisor than the FSA because it is more narrowly focused and is in a position to benefit from the linkages that go with being part of the BoE group. However, success is by means assured.

9. The scope of PRA prudential supervision

In headline terms, the PRA will be the UK's prudential supervisor and the FCA will be responsible for conduct of business. However, the detail is more complex because in fact the PRA will be the prudential supervisor of only that subset of the financial industry that is considered to be systemically important. Thus only a minority (in number) of firms will be dual-regulated by the PRA and the FCA. Most firms will continue to be supervised for both prudential and conduct purposes by the FCA. This approach preserves the benefits of the single regulator model for firms that do not give rise to serious prudential concerns. These

[124] COM(2011) 453, p 10.
[125] COM(2011) 453, pp 12-13.

benefits relate to efficiency and effectiveness gains/economies of scale and scope through the avoidance of duplication and overlap.

The new system for dual-regulated firms will work on the basis that a firm that seeks permission to conduct activities that are or which include any "PRA-designated" activity must apply to the PRA (FSMA, sec 55A (draft)). It is the PRA that will formally grant the permission but it can do so only with the consent of the FCA (FSMA, sec 55F (draft)). Applications by other firms will go the FCA.

The scope of "PRA-designated activities" therefore lies at the heart of this system. The draft Bill provides for HM Treasury to set out "PRA-designated activities" by Order (FSMA, sec 22A(1) (draft). This is the mechanism that is expected to be used for the designation of deposit taking and insurance as activities falling within the scope of PRA prudential supervision.

It is envisaged that some but not all firms authorised to deal for their own account will also be prudentially supervised by the PRA. In this case, the proposed mechanism for setting the dividing line is that HM Treasury will by Order confer power on the PRA to set criteria for designation (FSMA, sec 22A(2) (draft)).

The need for the PRA to establish clear criteria to enable it to identify institutions that could threaten the stability of the UK financial system has some broad similarity to the need at the international level for criteria to determine globally systemically important financial institutions. The work done in international fora suggests that a relatively simple indicator based measurement approach is desirable.[126] This involves looking at the size of banks, their interconnectedness, the lack of readily available substitutes for the services they provide, their global (cross-jurisdictional) activity and their complexity. The indications thus far are that the PRA will adopt a similar approach.[127]

"Interconnectedness" in this context is likely to include connections with PRA-supervised companies in the same group. This is noteworthy because a case could be made for all firms within the same group to be prudentially regulated by the same authority (which is not what is currently proposed). There are arguments either way on this point. The potential advantages can be readily identified: consistency, minimising of regulatory burdens for the firm, and clear sight of enterprise-wide risks for the supervisor. The legal framework should not leave room for misuse of the corporate form in order to impede proper supervision. On the other hand, since the PRA's focus is to be on reducing risks to the stability of the system it could cloud the picture for it to be responsible on a solo basis for the prudential supervision of firms that individually pose no risk to overall stability. Other provisions in the draft Bill provide for "group" considerations to be taken into account in particular circumstances and for specific consultation between the authorities on certain matters.[128] On balance, the proposed approach appears to reach a workable position.

Procedures governing the process whereby an investment firm that is eligible for PRA designation is actually so designated need to be further refined. Irrespective of the clarity and objectivity of the criteria adopted, there is likely to be room for disagreement as to their application in a particular case. The framework in the

[126] Basel Committee on Banking Supervision, Global systemically important banks: Assessment methodology and the additional loss absorbency requirement, Consultative Document, July 2011.

[127] Bank of England & FSA, The Bank of England, Prudential Regulation Authority: Our Approach to Banking Supervision, May 2011, p. 8.

[128] Eg the FCA must consult the PRA before determining an application for permission (or variation of permission) by an applicant that is a member of a group which includes a PRA-authorised person: FSMA, sec 55E(3) & sec 55H(5)(draft); the authority responsible for consolidated supervision under EU directives can give directions to the other "if it considers it necessary to do so for the effective consolidated supervision of the relevant group": FSMA, sec 3K (draft). Cases where a PRA person is a member of a group is one of the matters that may be covered in the MoU between the PRA and the FCA: FSMA, sec 3E(2)(e). Note also FSMA, sec 192BA (draft) which provides for the giving of directions to unregulated holding companies that are financial institutions.

draft Bill does not yet make it clear how a firm could go about challenging a determination that its activities are within the scope of PRA designation.

10. Splitting responsibility for prudential supervision between the PRA and the FCA: a source of inconsistency?

The PRA and the FCA will have different objectives and different rulebooks, their areas of core expertise will be different, and their supervisory cultures and styles are expected to diverge over time. Thus there is a strong likelihood that their approaches to prudential supervision will not be perfectly consistent. The risk of inconsistency would not matter too much if the dividing line between the PRA and the FCA cleanly reflected the distinction between "going concern" prudential supervision (focusing on capital that supports a firm's continuing business) and "gone concern" prudential supervision (capital that is needed in the event of the failure of a firm). However, the risk cannot be ignored because it is envisaged that there will be a relatively small number of firms that could pose systemic concerns that will be under the FCA (ie some large asset managers and some investment firms that deal as principal but do not meet the criteria for PRA designation), and the FCA will also be responsible for exchanges. In any system in which responsibilities are divided between a number of different bodies, there are bound to be difficult cases around the boundaries. Co-operation between the authorities, including arrangements for the FCA to draw upon PRA expertise in borderline cases, should help to mitigate problems but it may well be that experience will demonstrate that the boundary of PRA designation is in the wrong place and requires adjustment. The decision to rely on secondary legislation for PRA designation purposes ensures that there will be flexibility within the system to respond to experience and to changing circumstances.

11. Inconsistencies between supervisors and dual-regulated firms

The risk of the PRA and the FCA taking inconsistent approaches to prudential regulation is but one aspect of a wider concern. There is a risk of a divergence of approach between the PRA and the FCA on matters that have both prudential and conduct of business facets. Such differences could have adverse ramifications for the dual-regulated firms that are on the receiving end. One pertinent context is the proposed approach to approved persons. As the proposed legislation is currently drafted, it would be theoretically possible for the PRA to approve a person to perform a significant influence function – eg a chief executive of a bank or insurance company – in spite of FCA concerns as to whether that person is up to the job on conduct grounds (FSMA, secs 59-61A (draft)). Whilst the PRA and the FCA will be under a general duty to ensure the co-ordinated exercise of functions (FSMA, sec 3D (draft)) and will operate under a MoU (not yet published) that will amplify how they intend to achieve co-ordination (FSMA, sec 3E (draft)), additional procedural requirements for the operation of the approved persons regime in relation to dual-regulated firms may be necessary – such as a specific obligation to consult on approvals or even a requirement for PRA approvals to be subject to FCA consent.
Under the new system, some approved persons carrying on significant influence functions in dual-regulated firms will be subject to both PRA and FCA statements of principle and code of practice for approved persons (FSMA, sec 64 (draft)). Here, again, effective co-ordination not only at the drafting stage (addressed in the Bill through certain procedural requirements: FSMA, sec 65 (draft)) but also in implementation will be vital if duplication and inconsistency are to be avoided. A simple and transparent process that minimises administrative burdens has been promised, but delivering it may not be entirely straightforward.

12. The PRA: objectives and approach to supervision

The PRA will have two objectives: a general objective to promote the safety and soundness of PRA authorised persons; and an insurance objective, framed in terms of contributing to the securing of an appropriate degree of protection for policyholders (FSMA, secs 2B-2C (draft)). The drafting of the insurance limb of objective may need to be fine-tuned (the reference to persons who "may become" policyholders is not easy to understand) but, overall, the objective is appropriately worded.
Much stress has been placed on the fact that the PRA will be "judgment led" in its approach to supervision. This is understood to mean that supervisors will spend more time understanding firms' business models and strategies, and will use their judgments in addressing vulnerabilities within individual firms. Judgment-led supervision (JLS) will be forward looking, and will involve early intervention.
JLS can be regarded as reinforcement for, not an alternative to, principles-based regulation (PBR). PBR, an approach that the FSA in its heyday often espoused, was meant to be about considerably more than drafting style. It was intended to denote a new style of "more grown up" regulation and supervision in which the regulator defined polices and goals, worked with the regulated industry in determining how those goals were to be achieved, leaving room for industry to innovate, but still making judgments about the quality of the outcomes. If PBR had worked as intended it should have led the FSA to concentrate on substantive issues and steered it away from box-ticking procedural concerns. It evidently did not have that impact in practice. One regulatory theorist with expertise in PBR has said that "The experience of the GFC [global financial crisis] is a lesson about what happens when regulators fail to participate actively and skeptically in that interpretive community. Principles-based regulation is premised on concepts of "coregulation", or "enforced self-regulation", but the GFC illustrates how such models can slide into bare self-regulation in the absence of meaningful regulatory oversight and engagement".[129] JLS seems to be intended to prevent backsliding. Can it work? Good JLS cannot be regulation on the cheap. It is therefore a little surprising that the Impact Assessment accompanying the Financial Services Bill indicates a "firm expectation that costs of prudential regulation will fall in the medium term (para 8), with the new JLS model cited as a factor that will contribute to this result (others being improved IT system support, the elimination of duplication between PRA and the Bank and tighter control of costs). The success of JLS will depend crucially on the PRA being able to attract and retain highly accomplished and experienced individuals who are confident in their own judgment and who are prepared to be sceptical. This implies that the PRA must be well resourced.
JLS recognizes, rightly, that it is impossible to exclude an element of commonsense intuition from supervisory decision-making. However, JLS must not be allowed to become a channel for inconsistency, unpredictability and unfairness. Many aspects of the PRA's modus operandi have still to be worked out (eg how will firms be able to pursue differences of opinion up through the PRA hierarchy?) and much of the detail will not belong in primary legislation.

[129] Cristie Ford, Principles-Based Securities Regulation in the Wake of the Global Financial Crisis, 55 McGill Law Journal, Vol. 55, 2010

However, there are some features of the Bill as currently drafted that may require revision to ensure that the PRA operates within appropriate disciplines and controls. One is the framework for references or appeals to the Tribunal since it is currently controversially proposed to scale back the circumstances in which the Tribunal can direct the regulators to take a specific action (FSMA, sec 133 (draft)). Another is the lack of specificity in the PRA's duty to consult (FSMA, sec 2J (draft)). The BoE's view that practitioner and consumer panels (which the FSA is required to maintain and which will be carried forward to the FCA) are vestiges of an outmoded self-regulatory approach to financial services can be disputed. As with the FPC/ESRB, comparative reference can here be made to the position at EU level: the new EU supervisory authorities are required to maintain and to consult with stakeholder groups made up of financial market participants, users of financial services, representatives of SMEs and academics.[130]

13. The FCA's objectives and the duty to promote competition

The FCA's strategic objective will be to protect and enhance confidence in the UK financial system (FSMA, sec 1B (draft)). "Confidence" (like financial stability) is a rather broad and imprecise term but there would be dangers in attempting to articulate the FCA's strategic objective in more precise (and therefore potentially narrower) terms. Requiring the FCA to protect and enhance confidence captures something fundamental: if confidence is lacking, financial markets simply will not flourish. The pivotal importance of confidence is recognised in the OECD High-Level Principles on Financial Consumer Protection (August 2011), which have been prepared for the G20. The very first sentence of this framework document singles out "consumer confidence and trust" as key features of a well-functioning market for financial services that promotes financial stability, growth, efficiency and innovation over the long term.

The FCA will be required in so far as is reasonably possible to act in a way that is compatible with the strategic objective and to advance one or more operational objectives (FSMA, sec 1B (draft)). The operational objectives will relate to: consumer protection (achieving the appropriate degree of protection for consumers: FSMA, sec 1C (draft)); integrity (protecting and enhancing the integrity of the financial system (FSMA, sec 1D (draft)), and efficiency and choice (promoting efficiency and choice (FSMA, sec 1E (draft)).

The biggest talking point with respect to the FCA's objectives is its role in relation to competition. The FCA will be required to discharge its general functions in a way that promotes competition so far as is compatible with its strategic and operational objectives (FSMA, sec 1B(4) (draft)). This duty will require the FCA to continue to develop its expertise in the economic understanding of the operation of competition in markets (building on a strand of activity that has already become more prominent in the FSA (as seen in particular in its work on product intervention)) but it will not result in it becoming a full-blown competition authority. There have been suggestions (eg Vickers Commission, TSC) for the promotion of (effective) competition to be made an operational objective for the FCA. However, this objective would take the FCA into new territory and could create new problems of overlaps, duplication and

[130] European Securities and Markets Authority (ESMA)Regulation, art 37. There are equivalent provisions in the founding instruments for the European Banking Authority (EBA) and the European Insurance and Occupational Pensions Authority (EIOPA)

uncertainties with the specialist competition authorities. It could also further complicate the relationship between the PRA and the FCA because it is conceivable that steps that the FCA as a competition regulator felt compelled to take could pose a threat to stability, thus giving rise to more situations in which the controversial PRA veto (provided by FSMA, sec 3H (draft)) might have to be invoked. Indeed to ask the FCA to take on a new competition objective seems almost contradictory when it is recalled that the need to give regulators clear focused objectives was a fundamental part of the rationale for splitting up the FSA in the first place. There is also the fact that the UK's competition regime is currently undergoing a general review. It is hard to discern a compelling case for making major sector-specific changes before that review is complete.

14. Consumer protection

The proposed statutory definition of a "consumer" (FSMA, sec 1C(3) (draft)) is very broad. The FSA has argued that an inclusive definition is justifiable because high standards across the board are necessary to protect and enhance confidence. This is a persuasive argument. Nevertheless there is a risk that the inclusive definition could result in regulatory thinking that is appropriate for retail financial consumers spilling over inappropriately into the wholesale segment of the markets with adverse implications for innovation and efficiency. Management of this risk will depend greatly on how successful the FCA is in delivering and maintaining the differentiated approach that has been promised.

Although they are often criticised by retail consumer groups who fear that they ask too much of consumers, the references in the Bill to consumers taking responsibility for their own decisions (mentioned in FSMA, sec 1(C) (draft) as a matter to which the FCA should have regard in deciding what degree of consumer protection is appropriate and in FSMA, sec 3B (draft) as a general regulatory principle), should actually play an important role in facilitating the graduated approach that is desirable. A hedge fund or some other type of sophisticated wholesale consumer can and should be expected to take a very great deal of personal responsibility for its own decisions, and the appropriate degree of protection in such cases can be tailored accordingly.

With respect to retail consumers, the balance between consumer responsibility and consumer protection cannot be rigidly pre-set in legislation because much will always depend on context-specific considerations, including the nature of particular savings or investment product that the consumer is buying. The FCA cannot be expected always and everywhere to shield consumers from the risk of harm. That said, it is clear that the FCA will have to interpret its objective to secure an appropriate degree of consumer protection as requiring a greater degree of proactive intervention than was the norm not that long ago.

The FSA of the early 2000s used to distinguish between mis-selling, which it regarded as its business, and mis-buying, which it did not seem to regard as being much of its concern.[131] Such a bullish regulatory stance is no longer acceptable and it is not the approach taken by today's FSA (as can be seen in a variety of recent initiatives, including treating customers fairly, the retail distribution review, and product intervention analysis). Whilst the position may still fall short of the

131 FSA, Reasonable Expectations: Reasonable Expectations in a Non-Zero Failure World (2003) p 8 ("Regulation can limit cases of mis-selling but consumers need to take responsibility for cases of mis-buying (e.g. where a buyer makes an error of judgement when buying a product but is not misled").

expectations of retail consumer groups, regulatory thinking, not only in the UK but at EU level and internationally as well, has come more fully to appreciate, first, how widespread consumer mistakes can distort or even destabilise markets and, secondly, the limited extent to which disclosure and financial education can prevent mistakes. The draft OECD High-Level Principles on Financial Consumer Protection reflect this improved understanding of the workings of retail financial markets, as this extract indicates:[132]

> *This renewed policy and regulatory focus on financial consumer protection results inter alia from the increased transfer of opportunities and risks to individuals and households in various segments of financial services, as well as the increased complexity of financial products and rapid technological change, all coming at a time when basic access to financial products and the level of financial literacy remain low in a number of jurisdictions. Rapid financial market development and innovation, the entry of non-traditional financial service providers and third party intermediaries (in some cases unregulated or inadequately regulated), and misaligned incentives for financial service providers can increase the risk that consumers face fraud, abuse and misconduct. In particular, low-income and less experienced consumers often face particular challenges in the market place. In light of these issues, financial consumer protection should be reinforced and integrated with other financial inclusion and financial education policies. This contributes to strengthening financial stability.*

The Bill will reinforce retail consumer protection by giving the FCA some new powers (although it can be argued that there is little that is fundamentally new and that similar results could have been achieved under existing powers). In particular the FCA will be specifically empowered to intervene in respect of products (FSMA, secs 137C-137D, sec 138N (draft)) and in respect of misleading financial promotions (FSMA, secs 137O-137P (draft)). The new product intervention power has attracted particular attention.

This new power proposes to allow the FCA to make rules banning certain products or product features if this course of action appears to it to be necessary or expedient to advance the consumer protection or efficiency/choice objective (but not usually the integrity objective). The FCA will be able to specify a class of consumer who should not be exposed to a product or only exposed if certain conditions are met. It is not expected ordinarily to be used for the benefit of wholesale consumers. Even in respect of retail consumers, it is envisaged as an effectively "last resort" power (the Government has said that it is not intended to be a substitute for regulation of the sales process).[133] It is therefore open to question whether expediency is an appropriate trigger. A similar comment can also be made about the proposed relaxation of the normal procedural constraints on rule-making powers, as these formalities will not apply to temporary product intervention rules if the FCA considers that it is necessary or expedient not to comply with them. As the Bill is currently drafted, "temporary" means up to 12 months. While it is certainly possible to see the case for an emergency procedure, it is much less clear why rules made under that procedure need to have such a long shelf-life (even with the alternative safeguard of a standing statement of policy for temporary product intervention rules as provided for in FSMA, sec 138O (draft)). The equivalent period for emergency short selling rules

[132] At p 4.
[133] HM Treasury, The Blueprint for Reform, para 2.99.

is 3-6 months (FSMA, sec 131D (draft)). There are thus some drafting points that, even without the additional complication of a changing position in EU law (see section 15 below), would merit attention during the passage of the legislation. But the principle of equipping the FCA to ban products in certain circumstances is now fully accepted.

15. Product banning and EU law

One of the features of the current revision of MiFID (which will take the form of a Regulation (MiFIR) and a Directive (MiFID II)) is a proposed strengthening of EU regulation with respect to product intervention, including product banning powers.[134] The European Commission has proposed a new directly-applicable Regulation, MiFIR, that will empower a MS competent authority to ban products or product features when it is satisfied on reasonable grounds that (a) a financial instrument or activity or practice gives rise to significant investor protection concerns or poses a serious threat to the orderly functioning and integrity of financial markets or the stability of whole or part of the financial system, (b) existing regulatory requirements under Union legislation applicable to the financial instrument or activity or practice do not sufficiently address the risks, and (c) the action is proportionate taking into account the nature of the risks identified, the level of sophistication of investors or market participants concerned and the likely effect of the action on investors and market participants who may hold, use or benefit from the financial instrument or activity.[135] National competent authorities will be expected to take account of criteria and factors specified by the Commission in determining when the threats to investor protection or to the orderly functioning and integrity of financial markets and to the stability of the whole or part of the financial system of the Union arise. These pre-conditions and requirements do not align perfectly with the power to intervene on grounds of necessity or expediency in order to achieve consumer protection or efficiency objectives (but not, ordinarily, in pursuit of the market integrity objective) that is contemplated in the Financial Services Bill.
Other proposed requirements further reinforce the sense of divergence between the EU proposals and those in the draft Bill. Under the new MiFID proposals, national competent authorities will be expected to consult with competent authorities in other MSs that may be significantly affected by the action and also to give at least one month's notice of intentions, including the evidence on which the decision to act has been based, to all other competent authorities and to ESMA. National competent authorities will not be allowed to take action that has a discriminatory effect on services or activities provided from another Member State. ESMA will, in effect, perform a pre-screening role because its opinion on whether the prohibition or restriction is justified and propionate must be published before any ban is imposed.
The new MIFiD proposals do not appear to envisage MS competent authorities having temporary banning powers. Instead such powers would be vested in ESMA itself.[136] The MiFID proposals suggest that ESMA could act on investor protection/orderly functioning and market integrity/stability grounds but this may

134 European Commission, Proposal for a Directive repealing Directive 2004/39/EC, COM(2011) 656; European Commission, Proposal for a Regulation on Markets in Financial Instruments, COM(2011) 652.
135 MiFIR, arts 32-33.
136 MiFIR, art 31.

be open to question because an investor protection rationale for temporary bans is not specifically mentioned in the relevant provision of ESMA's founding instrument.[137]

There is a long way to go before MiFID II and MiFIR are finally adopted and there is likely to be considerable revision and refinement of the proposals along the way. But the fact that the EU has embarked on an initiative that is intended to achieve uniformity (particularly in areas that will be addressed in MiFIR), to avoid potential regulatory arbitrage, and to provide more legal certainty and less regulatory complexity presents the UK with a dilemma: whether to press on with domestic reforms that are not in perfect alignment with the emerging EU framework on the grounds that the example of a fully worked-out domestic model that is already enshrined in legislation could provide the mould for a more finely-tuned EU approach, or to pause in order not to waste time on something that could soon be overridden. The fact that there are already considerable sunk costs – ie UK authorities have invested much time and energy in thinking about the role of product banning powers within a more intensive overall approach to product intervention and consumer protection generally - is a factor that militates in favour of carrying on.

16. UK/EU regulation and supervision

The problem of potential misalignment between the UK and the EU with respect financial services regulation and supervision is not confined to product intervention. Some of the issues stemming from this mismatch are more troubling than others.

The UK's "twin peaks" supervisory model does not coincide with the sectoral approach to supervision that has been taken at EU level with respect to the establishment of the EBA, EIOPA and ESMA. However, the EU supervisory architectures reflects historical path dependencies and current political sensitivities (for example with respect to the physical location of the supervisory bodies (currently London, Frankfurt and Paris respectively)). It is emphatically not a model that was adopted because it was considered to be superior in principle. In fact, the de Larosière Report, which provided the blueprint for the new EU supervisory authorities, thought that there could be merit in moving over time to a "twin peaks" objectives-based structure.[138] There is no reason for the UK to try to emulate domestically an EU model that in large part owes its design to pragmatic considerations, subject, of course to care being taken to ensure that the domestic distribution of supervisory responsibilities does not hamper efforts to ensure that UK interests are effectively represented at the EU level.

There is relatively little detail in the Bill on relations between the UK authorities and EU bodies. There is provision for an MoU between HM Treasury, the BoE, the FCA and the PRA in which the UK authorities must describe how they intend to co-ordinate the exercise of their functions so far as they relate to membership of, or relations with, the European supervisory authorities, EU institutions and other international organizations (Financial Services Bill, sec 44 (draft)). The MoU between the PRA and FCA will also be expected to address relations with the EU supervisory authorities (FSAM, sec 3E (draft)). However, MoUs may not be enough. The European supervisory authorities are becoming a looming presence throughout EU financial services regulation and supervision; they are assuming direct competencies as well as a major role in ensuring pan-EU supervisory coordination and

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137 ESMA Regulation , art 9(5).

138 High Level Group on Financial Supervision in the EU, Report (Brussels, February 2009) (*de Larosière Report*), p. 58.

consistency. ESMA's proposed role in product intervention described in section 15 above provides a good indication of the direction of travel. Hence the particular importance of ensuring that the UK gets this aspect of external relations right. A more formally structured institutional arrangement – such a joint Council of the domestic authorities (which could possibly also function as a forum for feeding in market/consumer/academic expertise) – could help the UK to maximize the effectiveness of its relations with the EU authorities. The IMF has suggested that the UK should indeed consider establishing a clear forum for all regulatory agencies to interact.[139]

One particular aspect of the proposed interface between the EU authorities and the UK authorities appears to be in particular need of attention. Under the new UK arrangements, the BoE will be responsible for the oversight of clearing and settlement systems. Current proposals do not provide for the FCA to assume responsibility for overseeing their conduct of business. At EU level, oversight of clearing and settlement systems will come within the scope of the European Market Infrastructure Regulation (EMIR) and it on to ESMA (whose natural interface at UK domestic level is with the FCA) that EU level responsibilities will mostly fall (eg it is ESMA that will participate in colleges of supervisors for clearing houses). EMIR will require MSs to designate a competent authority for functions resulting from EMIR. It will allow MSs to designate more than one competent authority provided that respective roles are clearly determined and provided a single authority is responsible for coordinating co-operation and the exchange of information with the Commission, ESMA, other national authorities, EBA etc. The FSA has argued, compellingly, that the FCA should have an explicit roe in the conduct of business supervision of these entities in order to put it on the same footing as its key EU counterparts and to enhance the credibility of its participation in relevant ESMA discussions.

Moving, finally, from a specific area to a more general point, the Financial Services Bill presents an opportunity – not taken in the current draft – to set out explicitly a duty on UK authorities to have regard to the potential impact of their decisions on the stability of the financial system in other Member States (which would reflect the duty proposed in CRD IV). A "have regards" list is a legislative tool which is used in various places in the Financial Services Bill to guide the operations of the new authorities. It is important to be quite disciplined about the compilation of a "have regards" list because simply adding more and more items will eventually dilute its impact. A strong argument can be made to the effect that the need for national supervisors to be concerned about the risk that their actions could export risks to other parts of the single market is sufficiently important to transcend competing, brevity-oriented considerations.

October 2011

[139] IMF Technical Note, n 6 above, p 5.

Fidelity international – written evidence

Fidelity international is a global asset management business. We operate in fifteen 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 bn in the UK for private investors, pension funds and insurance companies.

Fidelity is strongly supportive of any measures which strengthen the position of consumers in the financial services market and therefore supports the underlying direction of the draft Bill as it relates to retail consumers.

There is one overarching issue which we would wish to draw to your attention at the earliest possible stage. This is the fact that 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.
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. The Government seems not to understand that financial services is a highly-skilled business which , in normal circumstances, would be likely to migrate more slowly than manufacturing. It seems to us that it would be helpful to add to the current draft Bill a further operational objective, for the FCA at least, 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.

We have not sought to answer all the questions but only those most relevant to our business.

2 What lessons can be learnt from the approach of other countries to regulation of the financial sector?

As noted above we operate in a large number of centres around the globe. It is not possible to blame the crisis on a particular type of institution: universal banks failed, simple banks failed, local banks failed, international banks failed, mortgage banks failed.

And some of each of those types rode the difficulties well. Similarly we do not observe any particular regulatory structures that could be said to portend good regulatory outcomes. What we do observe is that there are differences between the expertise and quality of regulation. We believe this to be more important than structure.

Having said that we would comment that intuitively it would seem better to have closely aligned those responsible for the stability of the currency (control of inflation), those responsible for the stability of the financial system, and those responsible for the stability of the major players in that system. In that sense we are supportive of the principles behind the Bank, FCP, PRA structure.

3 Is it appropriate to make such major changes to the regulatory system by way of amending legislation, rather than starting afresh?

We would prefer to see new legislation which would be easier to understand and comment on.

4 **Are the accountability and governance arrangements for the Bank of England, FPC, PRA and FCA satisfactory?**

Fidelity will be regulated for the most part by the FCA, so our remarks relate to the FCA alone. 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.

On another issue 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.

14 **Given that the PRA and the FCA will inherit FSA staff does the draft Bill do enough to ensure a new regulatory culture and a more proactive approach to regulation? Will these two new bodies have staff with the appropriate skill and expertise?**

We view the point is an important one. The FCA talks of a new Business Analysis Unit and will have a much greater focus on competition. Those skills are not noticeably present in the current FSA. However we do not think these points can be built into statute. We would, however, suggest that the FCA should be allowed to acquire staff only on the basis of "one in, one out", otherwise the costs of regulation will climb to the detriment of the industry and the end consumer.

We are also concerned that given the primacy of the PRA in prudential matters there could develop an adversarial culture in both 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 misselling 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.

One further issue which could be attended to when considering culture is that it would be helpful for the FCA to have a clear policy of approach for firms. At the moment firms wishing to approach the FSA with information or concerns are limited to whistleblowing channels and are constrained by uncertainty about the attitude of their line supervisors to such reports. They thus tend to act anonymously through trade associations where they decide to act at all. We feel that this runs counter to the reliance that the FCA's Business Analysis should in future be placing on intelligence-gathering from across all market participants.

15 Are the FCA's primary objectives appropriate? Is significant emphasis given to the promotion of competition?

Frankly 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.

16 Are the responsibilities of the FCA towards the regulation of markets appropriate?

We do have concerns about the split of responsibility between the Bank, for clearing and settlement (under a systemic risk objective), and the FCA for markets (under a market conduct objective). We understand that settlement systems can be systemic, but so too can recognised investment exchanges and other trading venues, not least as policymakers turn to 'on exchange' trading as a proxy for systemic risk mitigation (e.g. for OTC derivatives under MiFID). In this respect, the relationship between exchanges and the clearing and settlement

systems that underpin them is symbiotic. While we understand that the MiFID Directive covers both wholesale and retail conduct of business, we wonder if it would make more sense to put the exchanges and clearing and settlement systems together in the Bank which has a history of market operations.

We also have concerns about both wholesale and retail market participants being defined as 'customers'. That seems to us to fail to recognise the huge void in understanding, expertise and practice between, say, a retail investor in stocks and an investment bank acting as counterparty to a trade.

If the policy objective here is to seek to control the flow of 'products' from the wholesale market into retail investors' hands (by making each participant in the chain responsible for the next participant as their 'customer') we think there are more effective ways of achieving this end – namely, by focusing solely on those entities that act as the conduit between wholesale and retail markets.

17 Does the draft Bill strike the right balance between the responsibilities of consumers and firms? Are the FCA's new powers in the area of consumer protection appropriate?

We are very supportive of the FSA's moves towards swifter intervention in the areas of product intervention and financial promotions and have no difficulty with seeing them enshrined in law for the FCA.

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 damage the reputation of firms and individuals concerned, and potentially, the whole industry. Ther needs to be some element of natural justice built in, it could be that the RDC and the board of the FCA could be brought into play to offer a view on individual cases.

18 Are the prudential regulatory responsibilities of the FCA towards FCA-only regulated firms given sufficient emphasis and detail?

We welcome the proposed division of prudential responsibility between the PRA and FCA as this will bring the prudential regulation of UK asset managers in line with the prudential regulation of Continental and US asset managers – all of whom are regulated on a 'gone concern' basis as agency firms.

To this end, we would advocate that the division is reflected in separate prudential rule-books for each competent authority.

We would also go further however and would advocate that the FCA is given a specific objective to manage its prudential responsibilities on a basis that is proportionate and bespoke to its constituent firms in order to further demarcate the difference between the FCA's 'gone concern' and the PRA's 'going concern' obligations.

The stark difference can be illustrated with experience in the Barings crisis. Over a weekend the bank went into administration. Dealing in units of the Baring unit trusts was suspended on the following Monday but resumed on the Tuesday. For asset managers, lack of prudential capital may cause welfare losses to consumers, but their money is not lost.

The need for separate rule books is driven by European practice where, unlike anywhere else in the world, asset managers will continue to fall under the Capital Requirements Directive (CRD) alongside banks. This awkward position is then exacerbated for asset managers in three key respects:

- Firstly by the fact that the CRD is at base a 'going concern' piece of regulation derived globally from the Basel Accord's banking regulations. In this context it is worth noting Europe is the only area to have pushed Basel banking requirements down onto asset managers. In the US and Asia regulatory authorities have applied Basel requirements to banks and insurers only, and have continued to treat their asset managers under separate 'gone concern' prudential regimes.
- Secondly by the fact that in its latest iteration (CRD IV) the CRD has itself removed a number of its own proportionate elements that previously gave non-bank entities some relief – leaving European asset managers with a whole raft of bank-like prudential obligations ranging from liquidity arrangements to counter-cyclical buffers
- And thirdly by the fact that fund management companies already have their own prudential requirements under the UCITS and AIFMD Directives (in the form of a proportion of AUM), as well as legislation governing the custody of fund assets, the custody of uninvested client money and appropriate forms of consumer redress.

Thus, while we believe it is entirely correct that for the FCA "the focus will be on ensuring that firms can fail in an orderly manner, with appropriate levels of consumer protection, through the FSCS, and the protection or segregation of client assets", it is becoming increasingly clear that the CRD is not the appropriate vehicle for delivering this objective for UK regulation. This may in part explain why the majority of Continental asset management regulators have chosen simply not to apply the CRD to their asset management firms (in what we believe is a wilful, but understandable and helpful, mis-reading of the Directive).

Instead and in the meantime, it will fall to the FCA to make a proportionate reading of an inappropriate Directive. In this context we would remark that the recent IMF mission's comments on the need for a single prudential rule book for the PRA and FCA is wrong and probably arises from a lack of understanding of the FSA's unique approach to the interpretation of an already defective Directive for asset managers.

The FCA must therefore be given the appropriate tools and powers to enable it to implement the CRD appropriately – again in three key respects:

- In terms of European representation the FCA will need to be empowered to represent the interests of UK asset managers under the CRD in a debate that is likely to be dominated by the UK bank lobby and the PRA; the FCA;s role in the current consultation will be crucial.
- In terms of the legislative process the FCA will need to be empowered and encouraged to make a proportionate implementation of the CRD in order to meet its 'gone concern' objective – e.g. through strategic gold-plating of European legislation; and
- In terms of supervisory approach (also touched on below) the FCA will need to break from current FSA – and future PRA – practice of designing supervisory ARROW visits around the calculation and holding of adequate quantities and qualities of regulatory

capital. The FCA's supervision of asset managers will need to be redesigned to focus much more on conduct of business systems and controls.

We think the best way of delivering these elements is for the FCA to be given a specific objective to manage its prudential responsibilities on a basis that is proportionate and bespoke to its constituent firms.

We would also urge HMT to take this opportunity of reviewing the correlation between the 'permissions' granted to UK firms under the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (the RAO) and the investment activities and ancillary services as prescribed under the European Union's Markets in Financial Instruments Directive (MiFID).

Currently there is a mismatch between the two which puts UK firms out of kilter with a whole range of European Directives and Regulations – not least the CRD- which are, quite naturally, built upon the set of investment activities and services set out under MiFID and not those prescribed by the UK's singular RAO.

19 Will the new regulatory arrangements reduce the risk and cost of dealing with miss-selling of financial products?

Yes. We believe the FSA currently, and the FCA prospectively, have set themselves a welcome series of tasks concerning earlier intervention on products and promotions. We also believe they will have considerable difficulty in achieving their goals. But we applaud the direction of travel.

We do have some questions about the future operations of compensation schemes which, however organised, will have a mixture of PRA /FCA firms, and FCA only firms. Protecting consumers whilst offering fairness between different business models must be achieved.

20 Are the proposals for co-ordination between the PRA and FCA clear and adequate? What would be the advantages and disadvantages of having a Single Point of Contact and/or a joint rule book for dual-regulated firms?

The proposals for co-ordination are not clear and need further work whether in statute or in an operational framework. As noted above we would not want a joint rule book, particularly on prudential matters. As already mentioned, asset management firms such as Fidelity have been disadvantaged in the past by the FSA's inability to distinguish on prudential issues between solvent institutions, such as banks and insurers, and agency-only firms, such as asset managers. A joint prudential rule book might further exacerbate this muddled treatment.

We have sympathy with the remarks in the Technical notes of the recent IMF mission that more formal co-ordination arrangements between the PRA and FCA would be welcome, particularly with regard to representation in Europe and internationally, as well as on day-to-day supervision.

21 How do the proposals in the draft Bill fit within the new European regulatory regime? What freedoms and constraints will the UK have to operate within that regime?

This question is difficult to answer as the European backdrop on all these matters is a moving feast at this time. And much will depend on whether the European legislation is enacted as regulation or directive. We do not see under current European law any showstoppers thus far.

We do have considerable concerns about the representation by the UK regulators in Europe. The FSA was never clear whether this was a central function or was to be handled by the relevant policy experts, and, although it is not a question for statute, we would urge the FCA to take Europe more seriously than the FSA has done.

We are also concerned by the ESMA seat being taken by the markets side of the FCA. There should be a public agreement that when retail conduct issues are being considered by ESMA the seat is ceded to the responsible part of the FCA. (Our concerns would grow if our suggestion that markets should move to the Bank were to be taken up.)

More generally we have considerable sympathy with the CBI proposal for a statutory International Regulatory Committee overarching the FCA and PRA.

22 Does the draft Bill contain any proposals or omissions, not covered by the questions above, which cause concern?

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 are also concerned by the fact that there seems to be no quality control over FOS adjudications with different individuals drawing different conclusions from the same facts. This capricious behaviour is a significant barrier to potentially beneficial developments for financial services consumers.

We should be pleased to answer any further questions the Committee has on these important issues.

September 2011

Finance and Leasing Association (FLA) – written evidence

Introduction

1. The Finance and Leasing Association (FLA) is the leading trade association for the consumer credit, motor finance, and asset finance sectors. Our members include banks and building societies and their subsidiaries, the finance arms of leading retailers and manufacturing companies, and a range of independent firms, many of whom are not banks.

2. In 2010, FLA members provided £70 billion of new finance to UK businesses and households. £50 billion of this was in the form of consumer credit, including 30% of all unsecured lending in the UK, made available via credit and store cards, unsecured loans, store credit, second charge mortgages, and funding for half of all private new car sales. The remaining £ 20 billion was provided to private and public sector businesses, funding around a quarter of UK fixed capital investment during the year, including support for 750,000 small and medium-sized enterprises.

3. We are pleased to contribute to the Joint Committee's scrutiny of the draft Financial Services Bill. The Government has separately raised the question of whether the regulation of consumer credit (currently conducted by the Office of Fair Trading) should transfer to the new Financial Conduct Authority (FCA) created by the Bill. While we recognise that the Government has yet to take a final decision, our comments below focus on those aspects of the Bill likely to be of relevance if such a transfer takes place. We also deal with a number of more general questions, including the potential impact of the Bill on the lending market for small businesses, in which – as shown in the numbers quoted above – our members are very active.

4. We would be happy to give further evidence, written or oral, regarding any of the issues covered below in our answers to the Scrutiny Committee's questions.

Questions

1. Is the separation of prudential and conduct regulation into a "twin peaks" system the right approach?

The "twin peaks" approach can work, so long as proper provision is made for active communication and collaboration between the new agencies respectively responsible for conduct of business and prudential regulation. The importance of getting this right is illustrated by the problems encountered by Equitable Life, at least some of which resulted from poor communication between the (then) independent prudential and conduct regulators.

While the draft Bill establishes principles for the PRA and FCA, including a duty to coordinate their functions, it is important that machinery is created to ensure such coordination works in practice. Equally important is the need to avoid unnecessary duplication of regulatory requirements or – worse – inconsistencies of approach, which

could impose unnecessary costs on regulated businesses. We therefore support common approaches to authorisation, rule-making, reporting, and supervision.

The draft Bill provides for an annual review of the memorandum of understanding (MoU) between the PRA and FCA. We believe that this should contain a provision ensuring that if the PRA's power of veto over the FCA is used other than on an exceptional basis, a review of the relationship between the two bodies should automatically be triggered, with the aim of ensuring more effective cooperation.

3. Is it appropriate to make such major changes to the regulatory system by way of amending legislation, rather than starting afresh?

The attractions of amending existing legislation presumably include higher speed and lower costs. But these can be false economies, and it will be important that careful work is undertaken to ensure that potentially unintended consequences are avoided.

For example, the Government has proposed basing a new consumer credit regime on the existing provisions of the Financial Services and Markets Act (FSMA), currently applied by the Financial Services Authority (FSA) in other parts of the retail financial services market. But this will not work, not least because in the credit market the main risk lies with the lender rather than the customer. The reverse applies in the deposits and savings market, and much of the existing FSMA-based regime is predicated on that fact. In consequence, many elements of the existing FSA retail products regime would simply not be applicable in the credit markets, including the current capital adequacy regime, the system of appointed representatives, and several other significant features which we have identified for the Government. (See Question 16 below for more detail.)

We have therefore recommended to the Government that the new consumer credit regime should instead take as its starting point the EU Consumer Credit Directive (CCD), recently implemented in the UK via the Consumer Credit Act (CCA). This would not only avoid the problems just outlined, it would also help manage the major issue of how to deal with the existing loan books of the nearly 100,000 holders of current consumer credit licences. The existing CCA regime provides certainty for consumers and lenders by setting out explicitly what is expected of credit firms at different stages of the credit life-cycle, and includes extensive – and recently radically-revised – consumer protection provisions.

4. Are the accountability and governance arrangements for the Bank of England, FPC, PRA and FCA satisfactory?

We welcome the requirement on the FPC and PRA to publish an Annual Report. However, in the early stages of the new regime, Parliamentary scrutiny may need to be more frequent, and it might be sensible to make explicit provision for that. Both regulators should also be required to publish draft Annual Plans to establish their priorities for the year ahead. These plans should be subject to prior consultation with the industry and other stakeholders. We also believe that the PRA should be required to hold an annual meeting in the same way as the FCA (paragraph 13 of new Schedule 1ZA).

11. Are the PRA's objectives clear and appropriate?

Yes, subject to clarification of 'proportionality' in the context of the regulatory principles to be applied by both regulators (Chapter 3, paragraph 3B(1b)). Proportionality needs to be considered in the widest context – i.e. not just as regards regulated persons, but with regard to the likely impact of the regime on those with whom they do business, including small businesses and consumers.

14. Given that the PRA and the FCA will inherit FSA staff does the draft Bill do enough to ensure a new regulatory culture and a more proactive approach to regulation? Will these two new bodies have staff with the appropriate skill and expertise?

This is a concern. It is not currently clear that the FSA, OFT or the relevant Government departments are resourced adequately for the formidable task of planning and executing the transition to the new regime. This is particularly true in the area of consumer credit. If the regulation of consumer credit is transferred to the FCA, the new regulator will need a detailed knowledge of the credit markets and the extensive UK and EU legislation and regulation which currently governs them. It will also require the necessary resources to ensure an orderly transfer of nearly 100,000 regulated credit suppliers to a radically different regime. Given the scale of the task, we estimate that the project may take five to seven years to complete, bearing in mind that the last revision of the Consumer Credit Act – a much less radical exercise – took four. The Government needs quickly to do the detailed planning necessary to ensure the sourcing and effective deployment of the skills and expertise needed, for what could be the biggest regulatory upheaval in a generation.

15. Are the FCA's primary objectives appropriate? Is significant emphasis given to the promotion of competition?

The FLA supports the proposed strategic and operational objectives of the FCA, and we welcome the recognition that the FCA must discharge its functions in a way which promotes competition. But we believe that this needs to be underpinned by a statutory objective, a view supported by the House of Commons Treasury Committee. The operational objectives only allow the consideration of competition where it is 'compatible' with them (Chapter 1, paragraph 1B(4)). This could lead to a damaging loss of focus on the importance of effective competition for healthy markets.

We also believe the use of the term "consumer" needs to be clarified. It is not clear from Chapter 1, paragraphs 1C (1-4) whether the Government intends that the FCA should regulate the provision of financial services to small businesses as well as to private consumers. Currently, the CCA regime for consumer credit covers the provision of finance to around 3.2 million of the UK's 4.8 million businesses. This has already had the effect of creating two parallel regulatory regimes for business finance, leading to real and costly problems for the FLA's asset finance members who provide finance for both parts of the business community. The special regime for smaller businesses makes little sense, and the protections provided to customers by the CCA offer little, if anything, in addition to what is already provided by the FLA's own Business Finance Code.

Moreover, despite the fact that the recent Consumer Credit Directive (CCD) specifically exempts business lending, the Government chose to apply the CCD regime to all parts of the market covered by the CCA. This has involved the FLA's asset finance members in substantial implementation costs, including new agreements with customers and the

procedures and staff to ensure compliance. They are also facing high costs from dealing with customers who are being advised to challenge business agreements on irrelevant technicalities under the CCA regime. As a result, some business finance providers have already decided to avoid offering finance to unincorporated businesses.

The proposed new FCA consumer credit regime would materially worsen this already difficult situation. New conduct of business rules, layered on top of existing requirements, would significantly increase the cost of lending to businesses, as a result both of the one-off implementation costs and the ongoing compliance burden. This would reduce competition and choice in the market. It would become much harder for small businesses to raise finance for business investment, particularly the tens of thousands of businesses which rely on help from smaller, independent asset finance companies. This could lead to business failures. These consequences would follow whether the new regime applied only to those SMEs already covered by the CCA (3.2 million) or to the total business population (4.8 million). Under paragraph 1C (3a) of the Bill, the latter figure is presumably intended, as any "may use services within subsections 4 or 5."

We believe that the FCA should be concerned mainly with private consumers. If businesses are to be included, the definition should be tightly drawn so as to include only the most vulnerable businesses – those most akin to private consumers – such as unincorporated micro-businesses (as defined by the European Commission) with no more than 10 employees.

16. Are the responsibilities of the FCA towards the regulation of markets appropriate?

We support the principle that "a burden or restriction which is imposed on a person, or on the carrying of an activity, should be proportionate to the benefits" (Chapter 3, paragraph 3B(1b)). This will be particularly important if the FCA takes on responsibility for the 100,000 or so current holders of credit licences, most of whom are not banks, and 40% of whom are sole traders. The FSMA-style requirements set out in the Government's December 2010 consultation paper on a new consumer credit regime[140] included three aspects of the current FSMA regime which gave us particular concern.

First, and as indicated above, we do not believe that consumer credit firms should be subject to capital requirements, because their capitalisation does not present a risk to the customer. Lenders would effectively be required to hold capital against a risk which would not materialise, and which would restrict their lending capacity. (Increased FSA capital requirements in the mortgage market have had exactly this effect – customers are finding it harder to get mortgages, because lenders have had to restrict to whom they lend, as well as having less available to lend in the first place.)

Second, the current FSA Approved Persons regime is onerous, and some existing FSA-authorised firms have struggled to recruit staff willing to be subject to the direct responsibility and liability which is involved. It is simply not clear what benefit the application of such a regime to the consumer credit markets would bring. A much smaller market would be the likely result.

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140 'http://www.hm-treasury.gov.uk/d/consult_consumer_credit211210.pdf, HM Treasury

Third, the Appointed Representative (AR) regime for intermediaries would be impossible to apply in the very highly-intermediated credit markets. Lenders are unlikely to be prepared (or able) to take on responsibility for ARs in credit brokers and/or credit intermediaries. This was amply illustrated when FSA regulation of insurance intermediaries was introduced in 2005. Many lenders were unable to take on the responsibilities required, and so withdrew from the market. The introduction of a similar regime in the credit markets would have a very serious adverse effect.

17. Does the draft Bill strike the right balance between the responsibilities of consumers and firms? Are the FCA's new powers in the area of consumer protection appropriate?

We agree that firms should have proportionate measures in place to review and evaluate new products, including their cost and distribution, as well as to monitor how products operate in practice. Any requirement for pre-approval would stifle product innovation and lead to delays in delivering services to consumers. But the proposed FCA powers to ban products (section 137C) would have similar adverse implications for lenders, especially if action were taken some time after a product had been brought to market, and perhaps achieved significant consumer take-up. There would also be the risk of business failure where firms offered only one product.

Although the Government has suggested that the subject of a Warning Notice would be consulted before publication of their name under Schedule 8 of the draft Bill, we believe that any such publication should be delayed until any appeals process has been exhausted. To do otherwise could leave consumers confused and unsure as to what action they should take if they have an account with the company concerned. Inappropriate action in response to a Warning Notice could leave the customer disadvantaged if a Notice of Discontinuance were subsequently issued.

19. Will the new regulatory arrangements reduce the risk and cost of dealing with miss-selling of financial products?

The introduction of new product intervention powers will allow the FCA to take early action where it finds evidence of miss-selling. The scope of these powers is as yet unclear. It is therefore too early to assess their impact on miss-selling, and whether – for example – they will result in more "vanilla flavour" standardised financial products, and if so, the nature of any consequent impact on consumers.

21. How do the proposals in the draft Bill fit within the new European regulatory regime? What freedoms and constraints will the UK have to operate within that regime?

The UK's freedom of action in the consumer credit markets is restricted by the recent EU Consumer Credit Directive (CCD), and in prudential regulation by the EU's new Capital Requirements Framework, (CRD4).

The CCD was implemented in the UK as recently as February this year, following extensive work in finalising the domestic legislation and putting the new regime in place. Given this, if a decision is taken to transfer consumer credit regulation to the FCA, a sensible starting point

would be to 'lift and shift' the existing CCD-based lending rules to the new regulator, pending any more radical changes.

As regards prudential regulation, CRD4 will remove the national discretions previously available, so allowing less flexibility for the PRA than previously enjoyed by the FSA. It is therefore crucial that the UK authorities involved in negotiations on the text of CRD4 consult fully and openly with stakeholders on the key issues, before the Directive is finalised. Important areas for the asset finance industry include proposed changes to the eligibility criteria for physical collateral, which could have a very significant impact on the availability of finance for UK SMEs. We are concerned that these decisions are currently being made without proper debate in the UK.

September 2011

Financial Ombudsman Service – written evidence

1 The Joint Committee on the Draft Financial Services Bill has called for evidence as part of its consideration of the draft Bill. The Financial Ombudsman Service welcomes the opportunity to contribute to the Committee's evidence.

About the Financial Ombudsman Service

2 The Financial Ombudsman Service is the statutory-based scheme for the resolution of complaints between financial businesses and their customers. We are established formally under the Financial Services and Markets Act 2000 but are based on several predecessor schemes, most of which were established by industry. We are an impartial body that provides an informal alternative to the courts, resolving complaints by individual consumers and small businesses who remain dissatisfied after complaining unsuccessfully to a financial firm. The ombudsman service is independent of the parties in dispute, and operationally independent of government and regulators. We are funded entirely by the industry via an annual levy and case fees.

3 We handled more than one million initial enquiries during 2010/2011 and for most of these we were able to provide general advice or guidance. We accepted 206,000 new cases, which was a 26% increase on the number of cases recorded in the previous year. This was largely a result of a significant increase in the number of complaints about Payment Protection Insurance (PPI). Since the ombudsman service was set up, and to the end of 2010/11 we have received a total of 1,172,719 cases of which 26% have involved the sale of mortgage endowments, 19% have involved the sale of PPI and 4% have involved unauthorised overdraft charges.

4 The Financial Ombudsman Service has a distinct and discrete role. It has no remit to act as a regulator, a consumer champion or to reflect the interests of businesses. Its functions are complementary to the other bodies in the wider regulatory framework including the Money Advice Service and the Financial Services Compensation Scheme.

The draft Bill and white paper

5 We welcome the fact that the draft legislation retains the independence of the ombudsman service and the fundamentals of our operating model and quasijudicial role. Our independence is important because we do not represent the interests of either consumers or industry – so both parties to a complaint can be confident that our decision will be impartial and therefore fair.

6 Independence must go hand in hand with strong governance and accountability. So we welcome the provisions in the draft Bill to strengthen the current requirements which will, in part, formalise some of the things that we already do on a voluntary basis.

7 We also welcome the new provisions which would require the ombudsman service to disclose information to assist the FCA in advancing its objectives, and the complementary requirement for the FCA to take this information into account.

8 Because we attach considerable importance to being an open and transparent organisation we are pleased that the draft Bill includes a clause which would give greater clarity about the ombudsman service's ability to publish information, in particular ombudsman determinations.

9 The draft Bill also includes a number of technical changes which will assist the practical handling of complaints, again we welcome these.

10 We are aware that the businesses which use our service require us to keep pace with developments in the industry and we are mindful that developments in technology change the way in which consumers elect to communicate with organisations such as ours. We are

therefore pleased that the Bill has been drafted in a way which will not compromise our ability to ensure our service continues to reflect the reality of the financial services market.

The joint committee's questions

11 While most of the questions posed by the committee go beyond the remit of the ombudsman service, we would like to make some observations in response to the following question:

Will the new regulatory arrangements reduce the risk and cost of dealing with miss-selling of financial products?

There is no doubt that the widespread mis-selling of some financial services products has had a significant impact. The mis-selling of PPI has had a negative effect on consumer confidence at a time when the reputation of the industry was already undermined. Mis-selling has caused detriment not only for the consumers who have been its victims, but also those who have been deterred from taking up financial services products and so denied the benefits they can offer. It has generated large numbers of complaints, often intermediated by claims management companies and so has consumed significant resources, for the regulator and for the ombudsman service as well as for financial firms and their customers.

12 There appears to be a broad consensus that, had action been taken by the regulator to intervene at an earlier stage, much of the consumer detriment and unnecessary cost might have been prevented. It is also the case that in the absence of an early intervention by the regulator, the ombudsman service has had no choice but to deal with large numbers of cases on an individual basis and as a result has been criticised by the industry for acting as a de-facto regulator.

13 We are optimistic that recent changes to the existing legislation, which are now being implemented, when taken together with the proposals set out in the draft Bill, are likely to have the effect of reducing mis-selling. This is because they combine three key elements:

Early **identification** of issues which might lead to mass detriment. The ombudsman service and the FSA, with OFT in respect of consumer credit, are now working together closely through a new coordination committee established this year to help identify emerging areas of conduct risk. That coordination will help regulators to take early and proactive intervention where it is required. As part of the process, the ombudsman service shares with FSA and OFT information about the issues it sees in its casework. This helps to ensure that retail market conduct risks are identified early before large scale detriment or large volumes of complaints have arisen. The draft Bill will strengthen this by requiring the ombudsman service to disclose information to the FCA.

The new focus on conduct regulation, with the FCA using early and proactive **intervention** to ensure that the interests of customers are protected, is intended to help prevent large scale customer detriment occurring. The FSA has said that the new FCA will have greater willingness to intervene earlier to deliver better outcomes for customers.

The FCA will have a range of regulatory **powers** to tackle areas of large scale customer detriment should they arise – ranging from requirements for "backbook reviews" of past sales and the use of s404-style redress schemes (which have the effect of "binding" the ombudsman into that solution), to solutions which are essentially complaint-led.

The new arrangements address many of the concerns of industry stakeholders that, for wider issues, the ombudsman service and the regulator need to be able to work in a joined up way. The new s404 powers have already been used successfully in two recent high profile cases. However, the effectiveness of the arrangements will depend upon the new regulator being adequately resourced and being able to secure a significant change in its operational culture to deliver the change in approach which is required.

14 No regulatory regime or industry will avoid all conduct failings. So the ombudsman service has a role in resolving the problems that inevitably arise from mistakes,

misunderstandings and poor practice that fall below the threshold for regulatory intervention. This helps to underpin customer confidence in the expectation that where such problems do arise they can be resolved promptly, fairly and with the minimum of formality. Where the customer and financial business cannot agree, the availability of the ombudsman service as an alternative to the civil courts provides a proportionate, low cost and accessible means of resolving disputes.

2 September 2011

Financial Ombudsman Service; Money Advice Service; Reserve Bank of Australia; Consumer Focus; Which?; Citizens Advice Bureau; moneysavingexpert.com; Mr Paul Lewis and Financial Services Compensation Scheme – oral evidence (QQ 99-206)

Transcript to be found under Consumer Focus

Financial Services Authority (FSA) – written evidence

1. We welcome the opportunity to submit this memorandum to the Joint Committee on the Draft Financial Services Bill. The Committee's scrutiny presents an important opportunity to debate the major reforms proposed in this Bill and to identify the key judgements and decisions which Parliament and Government will need to make during the passage of this legislation.

2. We support the high-level policy objectives of the draft legislation and are working closely with the Treasury and the Bank of England (BoE) to prepare for the new regulatory regime.

3. In this memorandum we comment on the draft Bill, highlighting those areas the Committee may wish to consider as part of their scrutiny, and noting a number of other points on which we would find it particularly helpful to have the Committee's views. We also set out our assessment of the principal implementation risks and our proposed mitigations. Our memorandum covers:

    - the Prudential Regulation Authority (PRA);
    - the Financial Conduct Authority (FCA);
    - effective coordination, in the UK and internationally;
    - accountability of the new regulators; and
    - other important issues on which the Committee has invited views.

4. We believe that if the new regulators are to succeed in delivering the required improvements in prudential and conduct regulation, it will be very important that their objectives are clearly articulated and agreed at the outset and that they are 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 new regulators will need to take stronger action to limit the growth of emerging problems in financial stability, consumer protection and market developments. To do this they will need to make difficult balancing judgements and important trade-offs. It will be important, therefore, for Government, Parliament and society to give the new authorities guidance on the appropriate balance to be struck between cost and effectiveness of regulation; consumer freedom and protection; early intervention and innovation; and structural intervention and market autonomy[141]. Furthermore, Parliament will also need to recognise that the new regulators will continue to depend significantly on, and be constrained by, detailed requirements to be set out in international agreements that are still currently in negotiation.

6. This memorandum does not address issues relating to the wider financial stability remit of the BoE and the Financial Policy Committee (FPC).

[141] 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

7. The FSA has also provided the Committee with three papers, recently published, which outline the proposed regulatory approaches of the PRA to banking and insurance supervision (jointly with the BoE) and of the FCA[142].

The Prudential Regulation Authority

8. The FSA shares the Government's objective to improve the arrangements for supporting financial stability in the UK, through the establishment of the FPC and the PRA. Since 2008, the FSA has made significant improvements in its approach to the regulatory supervision of firms, in particular by implementing a more intensive and intrusive regime. This legislation and the establishment of the PRA (and the FPC) represent an important opportunity to build on those improvements and to close the major gaps in the current arrangements. However, it should be considered that no regulatory system or supervisory model can guarantee to prevent another financial crisis.

9. We have already recognised the deficiencies of the previous prudential regulatory framework (set out in international agreements, in particular Basel II), especially the capital and liquidity regimes, and the inadequacy of the FSA's historic supervisory approach. That approach – based on a widely-held belief in efficient, self-correcting markets - reflected the broad consensus at the time and the FSA's understanding of Government's, Parliament's and society's expectations of what a regulator should and should not do.

10. We welcome the PRA's single focused objective to promote the stability of the financial system through the supervision of individual firms. Other measures in the Bill designed to improve the oversight of financial stability include:

    - establishing the FPC, which should ensure that firm-specific supervision by the PRA is fully integrated with macro-prudential oversight of the system as a whole;
    - placing greater emphasis on recovery plans and "resolvability" which, building on the work of the FSA and the BoE over recent years, should provide scope to return firms to a more stable position after a period of stress.

11. The PRA will seek to achieve its financial stability objectives through building on the recent approach of the FSA. The principal elements of its new supervisory strategy will be:
    - a significantly improved international capital and liquidity regime which will be implemented in the UK through the Capital Requirement Directive IV;
    - greater focus on recovery and resolution planning to increase the probability of orderly failure without recourse to public funds;
    - a forward-looking judgment-based approach to supervision. This will include a new supervisory assessment framework, replacing the current Advanced Risk Responsive Operating Framework (ARROW) and a formal proactive intervention framework which will ensure that the regulator acts swiftly and transparently when remedial action is required; and

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[142] *The Bank of England, Prudential Regulation Authority: Our approach to banking supervision* (Bank of England and FSA, May 2011); *The Bank of England, Prudential Regulation Authority: Our approach to insurance supervision* (Bank of England and FSA, June 2011); *The Financial Conduct Authority: Approach to regulation* (FSA, June 2011).

- a focus on improving market discipline through increased transparency.

12. The PRA's new supervisory assessment framework will focus on the main issues which could affect an institution's safety and soundness, concentrating on outcomes rather than process. The PRA will engage in thorough and forward-looking analysis of firms' business models, governance, capital and liquidity, and, in the case of insurance companies, the adequacy of reserving policies. It will also look at risks posed to the financial system as a whole by individual institutions (a perspective which it is not realistic to expect the management of individual firms to take). It will focus its resource on the institutions that pose the mains risks to that system.

13. We support measures in the draft legislation which give the PRA prudential oversight of insurance firms. We welcome the two complementary objectives for insurance supervision - to secure an appropriate degree of protection for policyholders and, as needed, to minimise the adverse impact that the failure of an insurer or the way it carries out its business could have on the stability of the system. However, we recognise that the division of prudential issues from conduct is not as straightforward for insurance companies as it is for banks and we therefore support the current wording of the PRA's objective, which ensures clarity of responsibility in relation to policyholders' returns.

14. We agree with the Government's intention that the PRA should be responsible for overseeing the integrity of the balance sheets of individual insurance companies. This will include reviewing an insurer's governance processes and assessing whether these involve management making informed, forward-looking assessments of the firm's financial strength, including risks both to the assets and liabilities on its balance sheet. Inadequacy of reserves was an underlying issue in a number of past cases, including Equitable Life. We will of course also have to consider carefully the interaction between the FCA and PRA in relation to other consumer protection issues in the insurance sector.

15. We recognise the importance of diversity in the financial sector, including the contribution made by mutuals. We therefore welcome measures that will allow the PRA to take a proportionate and risk-based approach to the supervision of these firms. We also support the additional requirement on the regulators to include in cost benefit analyses an assessment of the impact of proposed rules on mutually-owned institutions.

16. We also support measures in the draft legislation which will allow the Government to add to or adapt the PRA's objectives if this is required in the future.

<u>Ensuring orderly failure and reducing the likelihood of using public funds to support troubled banks</u>

17. We strongly support measures designed to reduce the likelihood of having to use public funds to support troubled banks and to ensure that if failure does occur it does so in an orderly manner.

    - In pursuit of this objective, the PRA will ensure that all deposit takers draw up credible recovery plans which will be comprehensive and include measures to restore capital and liquidity and improve governance.
    - It is not the PRA's responsibility to prevent firm failures altogether. It will therefore ensure that all deposit takers put in place effective resolution plans.

The framework is now established and was endorsed by the International Monetary Fund (IMF) in its recent assessment of the UK financial system143. Once it has been developed, it will be possible to handle future failures in more orderly way, which will reduce the probability of the need to utilise public funds. Furthermore, the PRA and the FPC and the Special Resolution Unit will all reside in the BoE group, which should ensure clear lines of responsibility and the ability to react quickly, effectively and in a coordinated way to any further crisis.

- The BoE and the PRA will play an important role in developing international crisis management arrangements. Given the number of complex cross- border banking groups operating in the UK effective international crisis management arrangements are a priority.
- Notwithstanding the progress made to date to put in place effective domestic resolution plans, we would draw the Committee's attention to the fact that major banking groups are complex structures and it will be some time before effective resolution plans can be achieved, and furthermore, effective plans for many large complex groups will not be possible without international agreement.

18. Against this background the PRA will need to have a very low tolerance of risk where a firm's failure could have an impact on financial stability. This could arise where, because of the firm's size and complexity, it is inherently the case that there can be no complete certainty that the failure would be orderly. It also needs to be recognised that the failure of an individual firm might lead to the risk that the peer group or class of firm might fail due to a common cause, generating significant harm to the system.

Clearing and settlement

19. **We acknowledge the argument that co-ordination between the PRA and the FCA would be simplified if the PRA (rather than the BoE itself) was also responsible for the prudential oversight of clearing and settlement organisations. We recognise, however, that this would require a further reorganisation of the current BoE structure and thus is probably not justified at this stage. However, in our view there would be merit in ensuring that the legislation is sufficiently flexible to allow for such a change in future, without the need for primary legislation.**

The Financial Conduct Authority

20. We also welcome the measures set out in the draft Bill which, through the establishment of the FCA, seek to enhance the protection of consumers, especially retail consumers, in the financial services sector. This legislation is being debated against a background of low levels of confidence in the financial services sector as a whole. Conduct issues have been a major factor since 1990, particularly the significant instances of widespread mis-selling of financial products to retail consumers – personal pensions, mortgage endowment policies, split capital investment trusts and, most recently, payment protection insurance.

21. 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

[143] IMF Article IV consultation with the UK (July 2011) http://www.imf.org/external/country/gbr/index.htm

on dealing with observable consumer detriment after the event. The FSA has recognised the inadequacy of this essentially reactive approach in preventing a series of episodes of systematic mis-selling and last year announced a revised approach to dealing with conduct risk. This involves earlier intervention in the product chain, to anticipate and head off consumer detriment at a much earlier stage, before risk crystallises. Since then the FSA has made some progress in the new direction. This legislation and the establishment of the FCA represent 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.

Objectives

22. We welcome the Government's policy of setting out objectives in the Bill to give a clear steer to the regulator on what it is expected to achieve. However, we have some observations about the objectives as currently drafted.

The strategic objective

23. The FCA's strategic objective is a very broad one - 'protecting and enhancing confidence the in the UK financial system'[144]. In our view it is important to recognise that the FCA is only one of a number of bodies whose actions can have an impact on confidence in the UK financial system. In particular, the level of confidence in the financial system that arises from financial stability is a matter for the BoE, the FPC and the PRA. Furthermore, confidence in the financial system is also affected by the general state of the economy. The current formulation, therefore, risks giving rise to a lack of clarity as to precisely what the FCA is required to deliver. **We would favour a change to the FCA's draft strategic objective which explicitly recognises that the FCA contributes to protecting and enhancing confidence**.

Efficiency and choice objective

24. **In the draft Bill the FCA has an operational objective of 'promoting efficiency and choice in the market for [financial services]' and an overall duty to promote competition[145]. We are concerned that this does not establish the extent and nature of the FCA's responsibilities with sufficient clarity.**

This is for two reasons:

- first, the draft efficiency and choice operational objective and the competition duty raise questions about the interaction between the respective responsibilities of the FCA and the Office of Fair Trading. Our experience in other areas has shown that conferring overlapping responsibilities on two authorities risks real confusion (both in the authorities themselves and in the minds of the regulated industry and the wider public) as to who is responsible for what. For the FCA, the question will be particularly acute where, for example, both the FCA and the competition authorities are able to take action where they perceive markets are not working effectively;

[144] As defined broadly in new section 2B (6) of the Draft Financial Services Bill.
[145] New section 1E(4) of the Draft Financial Services Bill

- second, on occasions there can be real conflict between promoting choice and securing an appropriate degree of protection for consumers. For example, the FCA expects to use its powers of early intervention to ban or restrict the distribution or promotion of particular products, which will of course limit consumer choice. The draft legislation would therefore put the FCA in the position of having to decide which of two potentially competing objectives it wishes to advance.

25. We recognise that there are a variety of views on what competition remit the FCA should have. For example, it has been recommended (by the Treasury Select Committee and in the interim report from the Independent Commission on Banking) that the FCA should have either a competition objective or a primary duty to promote competition. This is possible; however, Parliament should be aware that this would make the FCA a very different organisation from that which is currently envisaged in the draft Bill. It would be likely to move the regulator away from pursuing consumer protection for its own sake, and towards seeing to achieve such protection through the efficient operation of the markets. However, our experience is that even where certain markets appear to be competitive, the regulator needs to use tools other than competition to ensure that consumers receive an appropriate degree of protection.

    An alternative approach might be for the FCA not to have an operational objective related to efficiency and choice, but to rely on a standalone duty to promote competition where compatible with its statutory objectives, similar to the duty currently in Section 1B (4) of the draft Bill. This would give the regulator a clear steer about what society expects it to do in carrying out its functions; however, it would limit the regulator's ability to intervene actively on competition issues as many of our powers are tied to our statutory objectives. This could therefore have consequences for the FCA's ability to address the root causes of problems where weakness in competition is the principal driver.

26. **Either of the alternatives set out above would give the FCA a clear steer as to what was expected of it, but both have ramifications for the FCA's approach to regulation. Our concern with the current formulation is that it might place the FCA in an unclear intermediate position. We recognise that this is a complex and important question and we would, therefore, very much welcome the Committee debating this matter fully to provide further clarity on these issues.**

<u>Authorisations</u>

27. 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.

28. However, the future senior management of the FCA have a significant concern 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[146]. 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.

29. Recent events in the Netherlands have called into question the efficacy of the arrangement proposed in the draft Bill. The Netherlands operates a 'twin peaks' system, with an authorisations regime similar to that proposed by the draft Bill for approved persons in that while it confers the decision-making power on one regulator, there is a requirement to consult the other regulator. In a high profile case, the two Dutch regulators were unable to agree on whether the Chief Financial Officer of a firm was fit and proper to hold his post. This disagreement reached the press, and the Dutch Finance Ministry was unable to resolve the regulators' competing views. As a result, the Dutch Government commissioned a report, which led to a recognition that it was unrealistic for two different agencies with differing objectives to agree in all cases where significant regulatory decisions (for example authorisations) were to be made. This has led to a proposal for new legislation giving one regulator the lead in authorisations, but giving the other the right to veto the authorisation.

30. **We recognise there are differing views on this issue. However, taking account of the Dutch experience and the IMF's view in its recent report[147], the future senior management of the FCA feels strongly that the Bill should – in line with the arrangements for 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.**

Powers to deal effectively with misconduct and mis-selling

31. We consider that the Government's proposed legislation provides a basis for the FCA to deal effectively with misconduct and mis-selling, 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 (for example, poor firm conduct at point of sale);

146 Draft Financial Services Bill - Section 3D (1) (a).

147 The IMF in its recent Financial Services Action Plan review noted the importance of the approved person's 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.

- having a more interventionist stance and lower tolerance for consumer detriment 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 the FCA will not be able, with finite resource, to prevent every incidence of poor consumer outcomes from crystallising).

32. Our experience tells us that the successful implementation of this approach will require the strengthening of our early intervention powers, and we recognise the product intervention power in the Bill as a step in the right direction.

33. However, it is important for Parliament and society to recognise how even these enhanced powers will operate in practice. Our experience is that members of the public and Parliamentarians have been of the view that - as a matter of public policy – 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 redress is constrained by the general law, in particular by questions of causation. If the breach of rules either did not cause the loss, or was merely a contributory factor, the FCA will not be able to require firms to pay full redress.

34. **If society expects as a matter of public policy that the regulator should be in a position to require greater levels of redress to be paid then the FCA needs to be given a clear mandate and powers to do so in the new legislation. 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 the Committee debating this matter, in particular to achieve further clarity as to the FCA's mandate in this area.**

Increased transparency of enforcement actions

35. We welcome the Government's intention to give the new regulators power to publicise that a Warning Notice has been issued. However, the Bill as drafted requires the regulators to consult the subject of the notice before doing so. 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 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

36. It is important that the FCA should have a strong and broadly-based markets regulation function. We therefore welcome the Government's confirmation that the FCA will continue to perform the functions of UK Listing Authority currently undertaken by the FSA. This will give the FCA the necessary coverage of the capital markets transaction chain, spanning both primary and secondary markets. The legislative framework and objectives proposed for the FCA will enable it to implement a regulatory regime appropriate for wholesale markets, with the focus on ensuring the integrity of markets and proper standards of conduct by market participants.

37. Under the Government's proposals the BoE will become responsible for supervising the providers of systemically important infrastructure (central counterparty clearing houses and settlement systems). **However, we consider that the new legislation should explicitly recognise the role of the FCA in the conduct of business supervision of these entities. This would put the FCA on the same footing as its key EU counterparts (who share supervision of clearing and settlement with their national central banks/prudential regulators) and make it a fully credible participant in discussions on this area in the European Supervision and Markets Authority.** A model of shared supervisory responsibility would also reflect the likely implementation in many Member States of the European Markets Infrastructure Regulation currently being negotiated, under which Member States will be responsible for designating one or more authorities to carry out the authorisation and supervision of clearing houses.

Prudential supervision

38. We support the measures in the draft legislation in relation to the prudential regulatory responsibilities of the FSA towards FCA-only regulated firms. All 24,500 firms in this category will be subject to a minimum level of baseline supervision in line with international standards. For the vast majority, prudential supervision will be on a 'gone concern' basis where the focus will be on ensuring that firms can fail in an orderly manner, with appropriate levels of consumer protection through the Financial Services Compensation Scheme (FSCS) and the protection or segregation of client assets. **For the small number of firms whose failure, even if orderly could threaten the integrity of a particular market[148], we believe the FCA should follow a more active supervisory programme on a 'going concern' basis. This should give the FCA sufficient time to intervene when problems occur and where necessary allow the firm to fail in an orderly fashion.**

Effective coordination, in the UK and internationally

39. 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**

[148] Examples include large asset managers whose trading activity is disrupted and investment firms who deal as principal and are therefore the counterparty to consumers (both wholesale and retail), such as inter-dealer brokers.

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.

40. It is widely recognised, including in the draft legislation, that the success of the new regime will depend substantially on the new authorities' ability to co-ordinate their activities, among themselves within the UK, with other authorities in the UK (for example, the Financial Ombudsman Service and the Financial Services Compensation Scheme) and in their engagement in the EU and internationally. We therefore support the measures in the draft legislation to address these challenges:

41. The PRA and the FCA will seek to minimise the impact of dual regulation on the 2000+ PRA firms, 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.

42. The FSA is currently considering with the BoE 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 BoE 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.

43. The policy and regulations which govern the PRA and FCA will be significantly determined by decisions taken in the EU. In addition to EU legislation, 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.

44. The FSA (together with the Government, the BoE, 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 PRA and FCA. The FCA will represent the UK, in close coordination with the PRA and BoE in the European Securities and Markets Authority (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 PRA will represent UK interests in the European Insurance and Occupational Pensions Authority (EIOPA) and the European Banking Authority (EBA), in close coordination with the FCA and, in the case of EIOPA, with The Pensions Regulator.

Accountability

45. The FSA welcomes robust arrangements to hold the new regulatory authorities to account for their performance and their achievement of their objectives. They should be

accountable to Parliament, Government and the public, not to the firms they regulate. The backbone of an effective accountable system is clearly defined and agreed objectives for each regulator, against which success or failure can be measured; otherwise, future regulators will be criticised for failing to do things which they did not believe to be their responsibility. We expect the Treasury Select Committee to play a key role in the new accountability arrangements, and we welcome their recent announcement of an inquiry into the accountability of the FCA.

46. It is right that regulators with the powers available to the PRA and the FCA should be subject to checks and balances. Regulated firms, who will fund the new regulators, have a legitimate interest in their economy and efficiency, so, while the FSA already makes use of the National Audit Office for its own audit, we welcome Government's proposal to put this on a statutory footing for the FCA and the PRA.

47. We also welcome the Government's other proposals for holding the new regulators to account and for improving transparency. These include a new requirement on both regulators to make a report to the Treasury in the event of a regulatory failure. The operation of this requirement in practice will require careful consideration and clarity around the triggers that would set off any requirement to report. For example, the obligation to publish a report, and the desirability of transparency, should not impede or prejudice the FCA's ability to pursue its primary obligations as a regulator. This concern is most acutely apparent where the FCA is conducting enforcement investigations. We feel strongly that the Bill should provide that the duty to report should not be triggered while enforcement activity is ongoing.

48. **Finally, although we agree that the regulators should be accountable to Parliament, we would welcome further debate in Parliament as to where it wishes to draw the line between ensuring adequate accountability and allowing the regulators to make judgements, both in rule making and in relation to individual firm decisions.** Historically, allowing the regulator a space in which to make its regulatory judgements has been seen as a good model in terms of independence of decision-making, including by the IMF in their Financial Services Action Plan, and more widely**.**

49. Furthermore, it needs to be recognised that in a judgment-based approach to regulation, which requires regulators to base their assessments of risk on their view of the future, there will be inevitably be occasions where the supervisor's judgment turns out in the light of events not to be the best option chosen. It is important, however, that the accountability process does not prevent such judgments being made, for if it were to, the future concept of supervision which parliament envisages would be undermined. The accountability and appeals process should focus on ensuring that the regulator has acted within its authority and done so in a reasonable manner.

Other important issues on which you have invited views

<u>Legislative process</u>

50. The decision on the most appropriate legislative means through which changes to the UK financial regulatory system should be implemented is in our view a matter for Government and Parliament.

Operational issues

Staffing, skills and expertise

51. Ministers have explained in what ways they expect the new regime to improve on the past. We recognise that the success of the new authorities will depend crucially on the quality, motivation and performance of their staff. The new regulators will build on the progress that the FSA has made in recent years to improve its supervisory processes, to upskill its existing staff and to recruit and retain additional staff with the right range of market, regulatory and other skills and experience. The PRA will benefit from being part of the BoE group.

52. When the work to develop the new regulators' target operating models - which is progressing well - is complete, we will carry out a skills audit to identify areas in which our staff need further development, and we will develop a targeted training programme tailored to the objectives of each regulator. This will form part of a wider package designed to help recruit and retain staff.

53. In order to deliver the agenda of the new authorities it is clear that there will need to continue to be significant investment in staff. Recruitment in particular areas will remain challenging due to demand for a limited supply of certain types of skills, since the regulators are not in a position to match the level of pay offered by the open market.

Lessons from overseas regulators

54. Our extensive discussions with overseas regulators underline the importance of effective co-ordination, whatever the institutional arrangements. We recognise that each regulatory structure has advantages and disadvantages, depending on the circumstances of the country concerned. No one model is perfect. Previously well-regarded systems such as those in the United States and Spain are now suffering well publicised gaps in coordination or financial stability problems. However, in Australia, the regulatory structure, based on a twin-peaks model that was reformed in the early 2000s, has come through the crisis well.

The cost of regulation

55. Another important factor is that 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.

56. We have previously said that we do not expect to have to increase employee numbers to staff the PRA[149]. Over the last year, the FSA has increased its headcount by nearly 500 staff, recruiting the additional people and skills that we have needed to expand our prudential supervision capability – based on the lessons we learned from the crisis. We

[149] *FSA Business Plan* 2011/12

anticipate the costs to operate the PRA when it is established will be broadly equivalent to the costs of prudential regulation carried out by the FSA. Moreover, there are likely to be opportunities for efficiency savings and, as a result, we aspire to being able to reduce costs in the longer term.

57. By contrast, the FSA has not hitherto changed its approach to, or resources devoted to, conduct regulation to the same extent. 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. We have already made a start in moving in the new direction, including through our credible deterrence strategy in relation to enforcement, and most recently in our Discussion Paper on product intervention, and we expect this trend to a more interventionist approach to continue.

58. It must be recognised that these reforms may have implications for the cost of regulation. There are always efficiency savings that can be made in any organisation, and the FSA is committed to making those where it can. However, efficiency savings may be insufficient to offset the costs that the new approach to regulation envisaged by the draft Bill will entail. As noted earlier, a system which requires 2000+ 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

59. In addition, society will need to accept that the new regulators will tolerate some degree of prudential and conduct failure. It is important that Parliament 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, 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.**

60. We look forward to supplementing this Memorandum in oral evidence to the Committee in due course. If the Committee would find it helpful to have further written evidence on particular points at this stage, we would be happy to supply it.

5 September 2011

Financial Services Authority (FSA) – oral evidence (QQ 915-1004)

THURSDAY 10 NOVEMBER 2011

Evidence heard in Public Questions 915 – 1004

Members present:

Mr Peter Lilley (Chair)
Mr Nicholas Brown
Baroness Drake
Mr David Laws
Lord Maples
Lord McFall of Alcluith
Mr George Mudie
Lord Newby
Lord Skidelsky
Baroness Wheatcroft

Examination of Witnesses

Witnesses: **Hector Sants**, Chief Executive Officer, Financial Services Authority and CEO designate of the Prudential Regulation Authority, and **Lord Turner of Ecchinswell**, Chairman, Financial Services Authority, examined.

Q915 Chairman: Good morning. I welcome our two witnesses and thank them for agreeing to appear before the Committee. We are very grateful. I start the ball rolling by asking a question which has puzzled me in particular. It first arose in a retrospective analysis of the Northern Rock situation, where there was dispute as to whether it could have been solved by providing more liquidity or whether it was necessary to allow the bank to fail. Since then all the evidence we have received from almost everybody has not mentioned the liquidity issue—the lender of last resort function. Do either of you think that anything needs to be done on that, and what are your reflections on the past?

Lord Turner of Ecchinswell: Hector may want to comment more because he was actually there at the time of the Northern Rock debates. I have only read about them, although in very considerable detail and in particular in relation to thinking about the report that we will shortly produce on RBS, where some of the same issues necessarily arise.

I am not sure there is a major issue here. It is important within the "lender of last resort" to have a suite of approaches which involve standard facilities which exist in normal times: discount windows and also general market operations. Those are clearly set out by

the Bank of England and published and made available, as indeed is typical of most central banks. You then have the possibility of special manoeuvres in periods of particular stress, such as we had with the special liquidity scheme. You then obviously have the final backstop of emergency liquidity assistance.

I am not sure that one needs to define in law, any more than it is at the moment, how that suite works. I think there is an interesting issue in the future of what the role of the Financial Policy Committee will be in relation to that as against the Bank per se. If we were to roll back to March 2008—which, if I remember rightly, was when the special liquidity scheme was first introduced—it would be very odd if, in future, such a thing was not a detailed area of discussion for the Financial Policy Committee rather than solely for the management of the Bank per se. I would not, however, imagine that there is anything within the law at the moment which would exclude that discussion from the Financial Policy Committee, but, if there is an issue, I would look at what the role of the Financial Policy Committee is in those debates. That would be my reaction to it.

Hector Sants: I might just add and reflect a little on the 2007 experience, which you invited me to do. First of all, I will state what we all know but it might be worth reminding ourselves. In general, banks neither fail specifically because of capital nor specifically because of liquidity. They generally fail because of a combination of capital and liquidity problems. Broadly speaking—and that is certainly the case of the failures we have seen in the 2007-08 period—what happened was a liquidity problem because of an expectation by the market of a capital problem. That expectation of a capital problem may or may not have been the right expectation, but, once the market believes there is not sufficient capital, then very quickly a bank will experience liquidity problems. In assessing the soundness of an institution, you absolutely have to look at both. In assessing how you deal with a bank approaching resolution or failure you have to manage both of those issues. We all recognise that.

There is then a question that it has to be right, as is the case, that the central bank has a set of liquidity tools which can enable and facilitate orderly resolution. It is very important that when you are providing liquidity from the central bank, in the context of an institution that faces the possibility of failure, you do so with a clear understanding of what you are bridging to. One of the problems in 2007 was that, without a resolution mechanism, you were potentially providing liquidity to a failing institution without any end game in prospect, and that is a very dangerous situation in which to be.

The first observation has to be that, if you have the right mechanisms for central banks to provide liquidity, it is very clear that you need a complete package so that it is linked to a definitive end game. It is unreasonable to provide liquidity unless the central bank believes either that the institution is solvent or there is a clear end game.

In the case of Northern Rock, therefore, part of the problem was a lack of understanding of where the end game was. There is, of course, a sub-debate as to whether that liquidity should be visible or not visible to the marketplace. That is a very difficult debate. On balance, I think there are circumstances when it is reasonable for it not to be visible, but that is a difficult debate.

The third debate which occurred in the Northern Rock context is whether there are other sets of circumstances, other than those leading to a resolution end game, under which the authorities as a whole should potentially be willing to provide liquidity. In those sorts of circumstances that may well have to be liquidity which is effectively guaranteed by the

taxpayer. One of the options at one point that was possibly on the table, without going over the detail of the history, as I am sure everybody is aware—let me put it that way—was providing liquidity to Lloyds to purchase Northern Rock. This would clearly have been liquidity for a commercial transaction which Lloyds were potentially entering into because they believed it to be beneficial to their shareholders. There would have been an argument for providing that liquidity and for allowing that transaction to go ahead. I actually proposed that that transaction should go ahead. That liquidity should have come from Government, not from the central bank. That then takes you into the question of how you manage a crisis and what the role is of Government in providing an additional toolkit underpinned by the taxpayer. Those decisions should properly be ones for the Chancellor.

Q916 Chairman: There does seem now to be a presumption in all the discussion from the ICB outwards that the issue is resolving a bank in crisis, not propping it up and letting it survive, yet we are told the TARP System has made a profit in America, which meant they were not all as insolvent as we thought. We are constantly told that the British Government may make a profit on some of their investments in these banks, which also suggests that they are not as insolvent as we were led to believe. I am just puzzled as to why nobody even mentions this issue and whether a failure to mention it and a failure to reflect it in any of the objectives in the legislation may mean that regulators in future think this option is off the table.

Lord Turner of Ecchinswell: No. Can I make two comments? It is entirely accepted implicitly—and maybe you are right that it has been surprisingly absent from some of the debates—that there is a classic lender of last resort capability. That reflects, of course, going back to the Bagehot statement and understanding that you can have circumstances in which there is a solvent bank which can be subject, for a set of self-reinforcing reasons in the market, to a liquidity run, and that in those circumstances central banks should be willing to extend—the classic statement is "to solvent banks and against good collateral"—liquidity which sees them through those circumstances. That is still entirely accepted and at least is implicitly within what everybody is talking about. The standard suite of facilities that the Bank of England has is designed to meet that capability, both in a standard form such as a discount window and with the possibility of emergency liquidity assistance as well.

Let me pick up on one point. You mentioned the point about resolvability. We should not assume that resolvability of a major bank in future will mean there is no need for liquidity assistance. It is very important to realise that, when we talk about our very largest banks, we should not imagine that if they ever got into trouble—hopefully they will not again— we are going to close down those banks and have them cease to exist. Frankly, the disruption of that, for instance, to the supply of credit to the real economy and to the relationships that they have with small and medium enterprises is going to be so great that it is harmful.

In relation to our very largest banks we should not, therefore, be imagining that resolvability means the disappearance and closure of the institution. It means a process whereby that bank can keep in operation but without the public putting up new equity capital, because there is either enough loss-absorbing equity or debt which, either directly or through a bail-in process, can be used to make sure that you resolve it and it keeps going as an institution but without public equity support. However, it is highly likely that in such circumstances you would need central bank liquidity support to support such an operation

and to see it through that period. That is not excluded by what we think about when we use the word "resolvability".

Hector Sants: That is a very important point. We absolutely need to recognise that there are sets of market conditions under which, if there is a bank which has insufficient capital, even if you have replenished that capital through some type of bail-in process, which means that the taxpayer has not been required to put in capital support, that does not mean that it will immediately be able to replenish its liquidity in the commercial marketplace. It could well be that the marketplace is so frozen, regardless of the capital circumstances of the individual bank, it cannot access the marketplace. Liquidity provision is thus potentially a key transitional tool to manage orderly resolution. Maybe I might just have the opportunity to reiterate something I have said a number of times and which is very clear in the documentation we have produced. It is not the objective of the PRA to avoid banks failing; it is the objective of the PRA to ensure that, if they do fail, they fail in an orderly way without systemic consequences, and, preferably and ideally, without cost to the taxpayer. Providing liquidity which does not ultimately incur cost to the taxpayer, because it is liquidity to solvent banks has to be a key part of the central bank toolkit. Indeed, surely it is one of the central reasons for aligning the micro-prudential regulator with the central bank. The lack of co-ordination around that point was obviously one of the key issues in the previous structure.

Chairman: Thank you very much. Perhaps Mr Mudie would like to get us back on track.

Q917 Mr Mudie: Lord Turner, in a recent speech you spoke about prudential policy and the need to have some discussion about the extent of it. You put two alternatives on the table: should it focus on financial stability or adequacy of credit supply? Which one do you think should be the main focus, or do you think you should be able to do both together?

I will add this. If you are doing adequacy of credit supply, can you do that as a regulator without getting specific instructions from the Government in terms of objectives? Your credit supply is either growth or employment, etc., etc.

Lord Turner of Ecchinswell: It is a fundamental issue. I asked them as questions, partly because I am not absolutely sure what I would give as the answer. It is an important thing for us to think about, and it relates in particular to the role of the Financial Policy Committee. This is the macro-prudential space.

The primary function of the Financial Policy Committee should be based on financial stability. What is interesting then is that you can always justify a focus on credit supply by saying, "But if the credit supply was not there, the economy will downturn in any case and that will threaten financial stability." You can escape your dilemma by making that point, but that does fully resolve the issue. You could imagine some circumstances in which we had perfectly solvent banks which, however, were solvent by de-leveraging and squeezing credit supply to the real economy.

If you look at the minutes of the shadow FPC from September, you will see that de facto we were struggling with that issue and getting into the belief that we had to have a point of view on good and bad financial stability. There is a debate there about de-leveraging. There is a clear recognition that banks could improve their capital ratios in two completely different ways, one of which is by having more capital and increasing the numerator and the other is by de-leveraging.

My own feeling is that the FPC de facto in those debates was expressing a concern for the overall balance of the supply of credit and that it will not be able to avoid that in downturn circumstances in future. Therefore, we cannot have a completely narrow point of view that all that matters is financial stability.

Q918 Mr Mudie: The added question was, if you settle on that, do you then start a debate with the Treasury or the Chancellor as to targets, and what size of credit supply to meet what objectives is necessary?

Lord Turner of Ecchinswell: That is a good point. It would be quite difficult to express this as very specific targets for credit supply. To say that the credit growth has to grow by a certain amount—

Q919 Mr Mudie: No; just with monetary policy where you have an inflation target, just like the Fed have two targets. Your credit supply, ideally working, should help to deliver 2.5% growth or full employment.

Lord Turner of Ecchinswell: That is a good point. I would be wary of anything which was a quantitative target because it would be difficult to know in advance what is attainable. For instance, a growth target assumes that we have enough science to know what the sustainable long-term growth path of the economy is, and we may not do that. For instance, the Fed is not expressed as a specific growth target; it is expressed as a generalised commitment to maintain employment and growth of the economy. I would not personally be against some such words being put into the role of the FPC, because that is, in the downturn, where we will de facto be in any case.

Q920 Mr Mudie: I don't know whether this is in your speech, because it is put in the brief in different type, so you can take refuge in "I didn't say this", but you raise Project Merlin. You are not the first one, I think, to articulate a worry that some of us have about monetary policy creeping into broader economic policy which affects the real economy rather than the financial stability of the financial sector. You are suggesting that, arguably, this type of issue could be within the FPC's remit in the future. That is very interesting in two ways. It is putting forward a situation where you, as a regulator, can tell banks where to channel their money. Presumably, you are removing from the Chancellor the responsibility of saying, "I would like to see more money and will you sort this out with the banks?" Don't you think you have articulated a really grey area, and if you are making a bid for this power, can you defend it?

Lord Turner of Ecchinswell: I am not making a bid for that power. There is one very careful phrase in the speech, where it says that if we are going to end up believing that particular categories of credit are more important than others—i.e. that SME lending is more important than commercial real estate—you could argue that that is a decision the Treasury ought to be taking rather than the FPC.

Q921 Mr Mudie: Why should we argue that, Lord Turner? Should that not be the starting point?

Lord Turner of Ecchinswell: Here is the grey area that you get into and that we are into already. There are phrases in the latest FPC minutes which ask the FSA in its discussions with the banks to try to make sure that de-leveraging, to the extent it occurs, does not happen in a fashion which is harmful for the real economy. We do not think of that as being targeted at the level of, "We know that SME lending is of this value, mortgage lending is of this value", and so on, but we do have a vision that the high levels of leverage of the financial sector include a large element that was essentially internal to the financial sector—a whole load of trading relationships, etc.—and that in general, insofar as we have any influence, if they are de-leveraging, we would like to see more de-leveraging of that intra-financial system complexity and trading activity and less on the generality of lending to the real economy.

At that level of balance, it is reasonable for the FPC to be involved. Once you get down to a more micro-level, which is, "Should there be special support for first-time buyers against re-mortgagers?", then that clearly has to be a Treasury and Government decision. It is difficult to imagine an FPC which does not have some point of view. Within a de-leveraging process, does it have a preference for banks to be eliminating inter-bank trading activity as against lending to the real economy?

Q922 Mr Mudie: I understand that, but the specific example you raise is not general. Arguably, this type of issue could be within the FPC's remit. We have the specific example you have raised, which is Project Merlin, where the Government considered that insufficient funds were going in and got people together. That is a specific sector. Don't you think this is regulatory creep in a very big way into policy?

Lord Turner of Ecchinswell: You do have a problem in that you do not have the direct quote from the speech. The direct quote from the speech is rather the other side. It is basically saying, "When you get to this level, this is clearly to do with the Treasury and Government rather than the FPC." If you look at the actual detail of the speech at that point, that is the balance of what it is saying.

Q923 Baroness Wheatcroft: Are you suggesting, when de-leveraging is required, that the FPC may have to take a view on what constitutes socially useless trading or transactions?

Lord Turner of Ecchinswell: It is very difficult for us not to get into that. There is a belief, which is a reasonable belief, that, if you look at the increase of the financial sector leverage over the past 20 years, a surprising amount of it is explained by an explosion of intra-financial system complexity. Even if you are not willing to get into the issue of whether that is socially useful or not, it is something which created very significant risk. The explosion of a set of gross exposures between financial institutions, even if by definition they net out, creates a system which is just much more complex for regulators to understand and which is much more susceptible to a set of contagion and knock-on effects. Even if one sticks rigorously to "our only concern on the FPC is financial stability", we cannot avoid a point of view on whether that very large level of intra-financial system complexity and trading was adding enough value to compensate for the risks that did exist. Those subjects are being discussed at the level of the International Financial Stability Board and the Basel Committee.

For instance, we do have to decide whether we have the capital weights right for inter-bank activity, for trading activity. There is a reasonable case that we have not, as it

were, leaned with our capital constraints enough against the explosion of that complexity and those connections.

Q924 Baroness Wheatcroft: Moving away from that to look at the Tobin tax, or whatever one calls it, that is being suggested, it would follow from what you are saying that probably the potential take from a Tobin tax is going to be much less than people are suggesting because there are going to be fewer transactions.

Lord Turner of Ecchinswell: It may be the case that, if there were higher capital requirements against trading activities, those might tend in any case to reduce the amount of trading activity, at least by banks, but of course you have trading activity by hedge funds and non-banks as well.

Q925 Mr Laws: On the point that Mr Mudie started us off on about the balance between stability and growth, and your point, Lord Turner, that there is a risk that solvency is achieved through de-leveraging rather than raising more capital, are you both satisfied that the deal that was struck a couple of weeks ago in the eurozone, which involves raising more capital for the European banking system, avoids that risk, and all that will happen is that that will be achieved through de-leveraging rather than raising capital?

Lord Turner of Ecchinswell: This issue was extensively discussed in the EBA and was also discussed between the EBA and the IMF. We were also involved in some of those discussions. The general statement which was made in that capitalisation programme was that it should occur as far as possible without this producing a harmful de-leveraging. It is true to say that the tools that you have available as a regulator to give effect to that are somewhat limited. There is, by the way, an issue here which relates to the recommendations of the ICB which may in the long term be relevant to this. The issue concerns the fact that we cannot be certain where capital is being allocated. One of the points of the ICB's proposal is that we will end up with capital which is devoted entirely to a particular set of retail and commercial banking activities and is ring-fenced for that. There is an interesting and unexplored issue, on the assumption that we go ahead with the ICB's proposals, as to whether in future some of the FPC's recommendations in relation to capital will relate to the level of the ICB ring-fenced entity rather than or in addition to the group. That is a bit of a side comment

Broadly speaking, we supported the capitalisation. We believed that it was required as best possible to build confidence in the banking system. We will try as best as possible to make sure that that does not drive a harmful de-leveraging process. If we had not gone ahead with that recapitalisation, we could have had worse de-leveraging. That recapitalisation commitment was a response to a steadily growing set of funding stresses in the European banking system, which, left to themselves, will drive de-leveraging.

Hector Sants: I will add to that. As Adair has just said, we were strong supporters of the EBA proposal. We entirely recognise the risk to which your question alludes. Therefore, we were also strong supporters of putting in the mitigant which has been put in, which is that individual national supervisors have to sign off each of those plans and that one of the obligations on the supervisor is to make the judgement as to whether that plan is sensible and avoids the risk you describe. We argued strongly to get that mitigant put in because we are indeed worried about the point you raise. There were other potential ways of doing it.

We would have preferred, for example, to have an absolute capital amount, but that was not going to be achievable in the debate. We thus did support the mitigating action that has been put in—that individual supervisors have to sign off the plans.

Q926 Mr Laws: I don't want to go too much off course with our inquiry, but aren't there already signs that the aspiration is not being delivered and that some of the biggest eurozone banks are cutting back on their lending rather than raising additional capital? When they did a similar thing in the States, did they not just basically say to the banks, "You will raise a certain amount of additional capital within a fixed period of time"?

Hector Sants: Correct.

Q927 Mr Laws: So completely avoiding what—

Hector Sants: Yes. The UK's position and the FSA's position in the EBA was precisely that: to argue for an absolute amount of capital. That was drawing on the US experience. That would have been a preferable strategy. To your other point, it is a little early to draw that conclusion. To be fair, of course, we are talking about institutions we do not regulate as the lead regulator, so I should be measured in my observations. We are aware, from the conversations we have had with non-UK banks, that some of them were in any case going through a de-leveraging process as a response to the funding challenges they were in. To some degree therefore we are always going to have a problem here with the counter-factual. There is an element of de-leveraging which is occurring in any case.

Q928 Mr Laws: In terms of the macro-prudential tools and the ones that we might like to have available, if you rewind to 2003, before everything went wrong, and imagine that we had the FPC back then, which of the macro-prudential tools that are being considered at the moment would have been useful, if any, for avoiding the problems that we later got into? How would you have used them over that period of years in the run-up to 2007-08?

Lord Turner of Ecchinswell: That is an issue which the FPC is now looking at in detail. The staff of the FPC are running precisely those exercises to try and look at the counter-factual as to what would have occurred. My immediate reaction is to think that at least three tools might have been appropriate in order of certainty.

The counter-cyclical capital tool would undoubtedly have been applicable at some stage and, I think, appropriate to apply. We could well imagine that one might want to use that beyond the 2.5% indicator in Basel III. That is a potentially powerful tool. It is the one tool where pretty much everybody across the world is absolutely clear that that is part of the suite.

Across that period of 2003-07, when you look in retrospect, some of the things that were happening on funding as well and the growth of the reliance on wholesale funding markets were also important. In part, we would not have allowed that in any case by the tighter static and continuous liquidity requirements which are coming in in Basel III, but there is an issue as to whether there should be at least one counter-cyclical liquidity tool: i.e. an ability to tighten liquidity requirements or to limit growth of wholesale funding on a counter-cyclical basis. Certainly one would look at that.

However, the issue of loan-to-value ratios either in residential mortgages or in commercial property is, perhaps, less certain. If you look at the UK, in retrospect, by far the biggest credit problems have arisen in the commercial real estate space rather than in the residential space. My list would definitely be capital and maybe liquidity and loan-to-value ratios.

Hector Sants: Perhaps I could add one additional point. I agree entirely with that list of three. I would particularly emphasise the fact that historical analysis shows that commercial property was by far the single biggest source of erosion of bank capital in respect of UK bank failures. I did want to add one other point so we are conscious of that other area of a potential toolkit. There is an argument that the FPC could have powers to make structural interventions in the OTC market. Potentially, for example, it could have forced earlier the actions of the type which are being facilitated by the FSB to move OTCs on exchange. Some types of structural interventions to improve transparency and visibility could be another area.

Q929 Mr Laws: Leaving aside that specific time period, although there clearly was quite a property bubble or increase in prices going on, are you saying that you would have used the power in that period or whether you would want it for the future? You might well want a power that would enable the FPC to control the property market and property prices that would not simply be the blunt tool of interest rates.

Hector Sants: Yes.

Q930 Mr Laws: Is that right, and does that create any big concerns for you, given that it would potentially mean that you would be doing something that might be very unpopular, which is stopping some people on low incomes from being able to buy their properties?

Lord Turner of Ecchinswell: Yes; we are saying that, but it is fundamental. One of the fundamental things we now understand about credit booms is that they are very strongly reinforced through the extension of credit and the increase of asset prices. This can occur wherever there is a potential for an asset price movement, but history shows that by far the biggest element is in both residential and commercial real estate. Broadly speaking, in pretty much every banking crisis for the last 50 years there is always commercial real estate and sometimes residential real estate. Commercial real estate is present at the scene of the crime in almost all circumstances.

That follows from this process, whereby the very process of extending credit pushes up the asset price and convinces people that that is a good thing to do, and there is a whole cycle that we need to address. If we try and address that cycle by simply raising the interest rate, the elasticity of response of that sector is such that you will increase the interest rate to the severe detriment of, for instance, some non-commercial real estate SMEs long before you have slowed down that boom. The fundamental proposition for us is that we need a new tool and that tool has to be able to focus on credit to support asset price increases, and in particular residential and commercial real estate houses.

It is clearly the case that that may in future require a Financial Policy Committee, for instance, to impose or tighten a loan-to-value ratio limit or some other appropriate measure of leverage at the very time where people are enjoying the benefit of that and, indeed, where

Governments are receiving a beneficial impact on their popularity from that credit boom. In a sense what we are trying to achieve is, I assume, the same independence for the FPC on that as we achieved on interest rates with the independence of the Bank of England. It is a major step, but I think it is required. Without that tool, we have learned that we cannot control asset price cycles simply with the interest rate lever.

Chairman: I cannot fault either questions or answers, but somehow we are only a quarter of the way through and three quarters of the way through our time. I urge everyone to gallop and précis from now on.

Q931 Mr Laws: I will accelerate on to my last question rather than probing that interesting area any more. Given the additional powers you are going to take on in order to do this job properly—and you have already given us a helpful indication of what some of those might be—the Bank's powers are going to increase very considerably and potentially in very controversial ways, both in respect of the population who want to buy their houses and, potentially, the industry. What now needs to happen both in terms of consultation with the industry and also in terms of modernisation of the Bank's governance and accountability to allow the Bank to be given these rather extensive new powers?

Lord Turner of Ecchinswell: If we are talking in particular about the Financial Policy Committee, the crucial elements are being put in place already. They are the application to the Financial Policy Committee domain of the similar controls that exist on the MPC side. We have developed on the MPC side in the UK, to a greater extent than many other central banks around the world, an overt set of minutes which make clear what the arguments were for an against and which, where there are actual votes, record who votes, which is not done in some other central banks. On the whole, the MPC accountability through its transparency of decision making has worked well. Fundamentally, we need to think about how we apply the same set of disciplines to the FPC.

Admittedly, it is slightly more difficult in relation to the FPC, for this reason only. Whereas on the MPC side Government are able to set what the target is in a precise quantitative fashion, on the FPC side we are going to have to have a broad qualitative description of what those objectives are. I am not sure that we can resolve that other than by the commitment to the transparency of the process through which the FPC will go.

Q932 Lord Maples: Following on from that slightly, the MPC is a largely independent committee. There are still a couple from the Bank of England. There is the Governor and one of his deputies, but most of the rest are independent, whereas the FPC is dominated by the Governor and Bank staff. There is the Governor, three deputies and two Bank of England executives as against four non-executives. There has been quite a lot of discussion in this Committee—and I would be interested in both of your views about this—that, first, the FPC should have a majority of non-executives on it. I mean not the current Court but really well-informed and engaged people, properly remunerated and properly resourced but nevertheless not responsible directly to the Governor for their careers and performance. Secondly, maybe the Governor should not be Chair of the PRA but somebody else should. This would perhaps introduce greater accountability and transparency to the process. I would be interested briefly in your views. Do you think this is a serious issue or really not very important?

Lord Turner of Ecchinswell: The MPC has a balance of five internals versus four externals. The FPC has essentially—it depends how you count the PRA—seven to four or something like that. Both of them have a majority of people who are, as it were, full-time employees of the institutions. The FPC has the complexity that one of those is from the FCA rather than the Bank itself.

This is a workable way forward. There is a very careful balance to be struck between enough external challenge but also an institution—the Bank and its staff—which is trying to develop a coherent, intellectual point of view. One of the guards against that being over-dominated by a point of view is the fact that we do see, in the case of the MPC, the individual votes. It is not the case that the five from the Bank always vote the same way. There is a diversity of opinion even within the five from the Bank. I am not convinced that this is an intractable problem as long as one has the transparency and as long as one has the same intelligence on the FPC side as we have on the MPC side. Part of the role of FPC members, both internal and external, is to make external comments on their position which make it clear where they are along the spectrum of points of view, so that there is a variety of points of view being put forward and we are not in danger of having a group-think approach. I am not convinced we have to adjust that, but it does rely heavily on the power of the disclosure and transparency. On the whole, I tend to think it has worked with the MPC with a balance of a small majority of internals but a very significant and well-respected independent element. Therefore, my tendency is to think that that could also work in the arena of the FPC.

Hector Sants: I do not particularly want to add anything more to the FPC points, but you did also ask about the PRA so, maybe, I could just respond to that. The PRA is a micro-prudential supervisor; so the central purpose of the PRA board would be to make rules insofar as it can in the European context, and also to oversee and, where appropriate, make individual firm supervisory decisions.

Given that one of the essential thrusts of this legislative proposal was to integrate micro-prudential supervision with the central bank with all the advantages that brings, not least of which are around managing issues of potential failure of individual institutions which we have just been talking about, it seems to me that, if you have an independent chairman and a fully independent PRA board, then effectively you have gone back to a separation between the micro-prudential regulator and the central bank. If the thrust of the government proposal is to have the benefits of the integrated model, it would seem somewhat strange then to set up the PRA board in a way that it could operate entirely independently from the Bank executive.

Chairman: I would appeal for pithy answers and even pithier questions. I know I can rely on Baroness Drake.

Q933 Baroness Drake: I will try to be very pithy. We have heard varying views expressing varying levels of optimism and pessimism as to whether CRD IV and the new European rule book will give the FPC sufficient flexibility over regulatory requirement so that it can meet its statutory objective. Lord Turner, you have expressed the concern that the FPC has. How optimistic are you that the outcome of the European consultations would give the authorities the flexibility they need?

Chairman: On a scale of 1 to 10.

Lord Turner of Ecchinswell: Five. We made a clear point of view that, in principle, there should not be maximum harmonisation. There should be harmonisation of minimum standards with national regulators able to go above. What we have is a set of complex flexibilities achieved through pillar 2. We have continued to argue this case that this is not the appropriate way. The Government are continuing to do it. It is five out of 10 in terms of the expectation.

Hector Sants: Could I add a very important point for clarity? There is sometimes not full transparency as to the problem here. There are two components to the problem. There is both what is in the primary directive text, but there is also what subsequently comes out of the process called binding technical standards, which provide the detail and the substance of the way that individual regulators work. There is both a risk that the primary directive text does not give sufficient probability—I would broadly agree with Lord Turner's assessment of that—but, even if we secured a sufficient flexibility in the directive text, we would not know for sure whether we would be able to operate this in the way that is envisaged until we had seen where these binding technical standards land.

There is a risk here not just to the ability of the FPC to discharge its function in relation to its goals, but to the core proposition of the PRA in the sense that, if it does not have discretion to tailor capital and liquidity arrangements to the individual risk of an individual institution, it won't be able to operate effectively against its mandate. There are a lot of question-marks here arising from the European proposition in relation to both micro and macro regulation.

Q934 Baroness Drake: Which, presumably, would imply, if you did not get that flexibility, a greater shift back to rule-based regulation rather than judgment-based regulation.

Hector Sants: There are two points. We need to be careful about what we mean by "judgment-based regulation". At times people are not entirely clear. I prefer the words "forward-looking regulation" in order to contrast it with the way that regulation was being carried out here pre the crisis. All regulation has an element of judgment. The question is the degree to which that judgment is based on hard, observable facts as opposed to the degree to which it is based on a view as to what might happen in the future.

The central proposition is in relation to the way the FSA was working pre the crisis. For the record, we are now working in an entirely different way, though I will not go down that avenue for a second. Pre the crisis, the FSA was only intervening on observable facts: i.e. after the fact. The premise of the new approach is to say, "If we think something might go wrong in the future, even if the bank or the institution has a different view to us, then we would intervene to put in mitigants, capital or liquidity or to dissuade them from taking that action." Forward-looking is the key phrase, rather than judgment. If we can't then intervene on a firm, specific basis to say, "If you go down that track you are going to require a lot more capital or a much larger liquidity buffer", we would not be able to operate in that way of making a firm, specific judgment. Without firm, specific discretion operating through the Pillar 2 environment, then you could not operate effectively the proposition that we have in our proposal.

Q935 Baroness Drake: I have one final question on that point. Others have taken that debate further and said that the way in which the UK engages and gets its view across in discussions in the EU environment is really important. Although there are provisions in the Bill for PRA to provide the representative for certain bodies and the FCA for others, some have expressed the view that the Bill should provide for a statutory committee for international co-ordination of the UK view. Is your view that there should be more within the Bill? Do you think the Bill is sufficient in the provisions it has for ensuring efficient engagement with the European bodies?

Hector Sants: The principal challenge is not whether the individual regulators as envisaged in the Bill—the PRA and the FCA—are going to be adequately focused on influencing Europe through the ESAs. I undoubtedly think they will be and the FSA is very successful in that regard at the moment. The principal issue is that the important and substantive questions in relation to European regulation are not determined in the ESA environment but in the political environment. Therefore, what is vitally important is that Government take the lead in focusing on these financial regulation issues and co-ordinate all other bodies to ensure that you are seeking to influence across the whole spectrum of the various arenas and fora where decisions are made. Effective intervention has to be a fully co-ordinated event between Government and individual authorities. There is an argument for ensuring that Government are doing that. Whether the right place for that is in a Bill is a matter for the Government and Parliament. It is not really about improving the focus of the regulators. They are perfectly focused. It is about ensuring the UK as a whole operates effectively.

Chairman: Baroness Wheatcroft, do you want to come in at this point on the judgment-based issue?

Q936 Baroness Wheatcroft: Thank you, Chairman. You said that regulation and the way you regulate have changed dramatically. One of the themes that has cropped up with many of the people who have given evidence to us is that the way of regulating may have changed but the people have not changed very much. Therefore, there is a concern that the culture change that is required might be difficult to bring about. Do you have any concerns about that? Do you think you do have the right people to do the sort of judgment-based regulation that we are now talking about, even though you have given us a new definition or at least a different definition?

Lord Turner of Ecchinswell: Broadly speaking, people under-estimate the extent of the very radical change which has occurred in the FSA over the last three or four years in any case, including quite a lot of change of people. Hector can respond to it in more detail.

Hector Sants: It is not actually correct to say that the people have not changed. The people have radically changed, both in quantum and quality. If we remind ourselves that originally, and the Northern Rock report gives that sort of information, the average large bank in the UK would have had four or five, with a maximum of six or seven, individuals in the supervisory team involved with it, we are now operating more in the 15 to 20 space. If you add in the specialists from our risk department, there is a higher number than that. In order to move to that, we have hired over 2,000 people since March 2008, so the vast majority of the regulatory staff in the FSA come from an industry background and the majority of our staff are recent people.

Having said that, I do not disagree with you that there is a cultural challenge. There are a couple of points. First, it follows that, as we have massively expanded and changed the mix of staff over the last couple of years, they are relatively inexperienced as supervisors. The tenure is quite low. The firms rightly reflect to these Committees that the experience as supervisors is not as high as we would like. We now need more continuity and we need to have the benefit of that experience coming through in the judgments that they make.

Secondly, going back to an earlier point, 80% to 90% of our prudential rule book does already originate from Europe. I would imagine, even allowing for a good outcome to the European process, that almost all the rule book of the PRA will be a European rule book which we won't write at all. It will just be accessed by a link on a computer. The European approach is much more rules-based. We will never entirely get away from rules. That is the European way of doing things and we are in Europe. We will always have to work with that process and the firms will still always be making the point that it is a pretty large rule book. That is the approach that European regulation takes. I myself would not have a rule book anywhere near as long as we do have. Long rule books inhibit judgement based regulation.

Q937 Baroness Wheatcroft: The subject of risk-weighted assets came up earlier. There is a degree of judgment involved in determining whether the banks are applying the right risk weighting. Are you concerned that you have enough ability and talent to cope with the bank that is trying to fool you?

Lord Turner of Ecchinswell: This is the wider point of risk weighted assets, which I don't know if you want to go into. As you know, when we went from Basel I to Basel II the world created an incredibly complicated way of working out risk weights, which is actually one of the things that we need large numbers of experts to interface with. You end up with a bank, the size of our biggest banks, which will probably have 100 or more different sub-models which are working out its risk weights.

There is a very wide issue as to whether the world was right to go down that path in its entirety. Indeed, there is more work to be done by the Basel Committee as to whether we, in future, should make changes. For each category of asset we should probably combine a modelled approach with an absolute minimum approach, which is a category specific leverage ratio. That was not in the transition from Basel I to Basel II but is something that, at international level, we need to come back and debate. As long as there is a modelled element within it, at least above a minimum, we must have a very complex engagement to check the logic of those models. It is quite an intensive activity. We believe we have the right people to do that. A lot of the problems which occurred, particularly on the trading books, were because the world placed its confidence in mathematical assumptions to do with value at risk which turned out to be untrue. We know that they are untrue and we are much more challenging now than we were in the past. There is major unfinished business at a global level about whether we have the balance right between firms modelling their own risk weights and the establishment by regulators or international authorities of minimum weights in particular categories.

Hector Sants: Back to your people point, before the summer of 2007, as you rightly say, there was extremely limited capacity in the FSA to take a view on these complex risk-related issues. There was no material resource to do that. It was not doing that for the reasons we touched on earlier in terms of the philosophy being applied. With the change in philosophy,

which we have already started to implement but will take further—I entirely agree that there is much further to go down this track—we have created a specialist unit now to be able to do that which did not previously exist. It has a couple of hundred of people in it. The work that we have done on the major banks in the last couple of years has been seen by those who have seen it as extremely high calibre. You can address that question to Treasury officials, but I would like to think that has been the case. We do have individual expertise which did not previously exist, but I would say it is a long-term management challenge for regulators to recruit and retain such individuals. Those types of people are very much people you have to hire from industry. These are not bank supervisors in a conventional sense of bank supervisors. They are risk specialists. The pool of talent that we recruit from is exactly the same pool that the banks themselves, the consultants and the accountants, are hiring from. Therefore it is difficult to attract and retain those individuals. We have benefited from being able to recruit during the downturn which has existed in the banking industry on this side in 2008. We have however now seen our turnover in that area go up already because we are not able to offer the sort of salaries which industry does.

You are thus right in saying that equipping the regulator to form its own view, to challenge an institution, will always be a difficult staffing challenge. We have, however, made considerable progress. The staff have changed; it is not the case that these are the old staff. That is just wrong.

Chairman: We are into injury time. I move on to Mr Brown, please.

Q938 Mr Brown: I ask you about the risks posed to the United Kingdom by the operation of the shadow banking market, particularly in the United States, but of course it does not have to be in the United States.

Lord Turner of Ecchinswell: It is important that we fully understand shadow banking. We have spent a lot of time at international level over the last three years putting in place new capital and liquidity rules for banks—legally defined as banks—but we are very well aware that, if you cast your mind back to 2007-08, a lot of the initial stages of the crisis were not necessarily to do with banks but a set of things round the edge of banks, whether they be off balance-sheet vehicles, hedge funds or money market funds.

It is one of the highest priorities for the Financial Stability Board at international level over the next year to develop a specific set of proposals as to how we should appropriately regulate the shadow banking sector. The way we define shadow banking is that it is everything to do with credit intermediation, with the flow of credit in the economy, which is occurring outside the banking system but where you can observe characteristics which you normally associate with the banking system, such as leverage and maturity transformation. That is a definition which focuses on the right area.

Coming out of that, we may well have a set of proposals for changes to the capital arrangements that relate the banking system to the shadow banking system, because often shadow banking entities are themselves getting credit from the banks. The Basel Committee is looking at that. We are looking carefully at the regulation that relates to money market mutual funds, which, if they promise to investors a stable net asset value, are essentially performing a bank-like function and therefore should arguably be subject to capital liquidity requirements. We are going to look carefully at hedge funds and we are also looking carefully—and I attach a lot of importance to this—to a set of very complicated markets in

short-term secured funding. These are the Repo markets and the securities lending markets where, if you look back at what happened in September and October 2008, although that was partly a classic bank run, it was also a new form of run. It was a run in these short-term secured lending markets. We are looking very carefully at whether regulations are required in that area, in particular at establishing and imposing minimum haircuts, minimum collateral requirements, in those contracts. It is a complicated area but a very important one. It will also be an important one for the FPC and the PRA continually to keep under review to see whether there are some institutions which initially are defined as belonging to the FCA but which mutate over time to being systemically important. We need a clear process for bringing that within the coverage of the PRA when that occurs.

Q939 Mr Brown: This is a pre-legislative scrutiny exercise and so we can make recommendations as to the shape and focus of the legislation before it goes through its formal parliamentary scrutiny. Should we look again at the PRA's focus, which is currently on activities analogous to deposit-taking? It logically follows from what you have said that maybe we should try and broaden that a bit. There may be other suggestions, but the suggestion that I have in front of me is that we should alter that to "business analogous to banking activity with a potential to give rise to systemic risk". Would that phrase encapsulate everything you have said to us, or would you have another form of words?

Lord Turner of Ecchinswell: The second phrase would be better than the one in the Bill at the moment. By putting it as "analogous to deposit-taking", it has potentially narrowed the focus of it too much. I would be very happy to send you the precise definition that we are using at the international level, which is "credit intermediation but with the features of banks". That is very close to the words you have just suggested. It is business analogous to banking activity, including the credit extension part of banking activity rather than simply the deposit-taking. I agree with you. When I looked at the particular words, I am not sure that they have best captured what should worry us in the shadow banking arena. Therefore, it would be a good thing for you to look into that wording.

Q940 Mr Brown: That is really helpful. Could I invite you to reflect on it and send us your best wording so that we can reflect on it?

Lord Turner of Ecchinswell: Yes; I will certainly send that with some ideas of what the wording might be.

Chairman: Could I ask Lord Skidelsky to go straight to his question about ring-fencing?

Lord Skidelsky: I actually did want to ask Question 8.

Chairman: We had a little discussion about that earlier. We are a quarter of an hour into injury time.

Lord Skidelsky: It was a glancing discussion.

Chairman: It would be odd if we did not discuss the ICB's report.

Q941 Lord Skidelsky: On the ring-fencing question, do you regard the Vickers proposal as a resolution procedure essentially or as a prevention procedure? Is it a way of limiting the taxpayer liability in the event of a bank failure or as a way of preventing banks doing business which they should not actually be doing?

Lord Turner of Ecchinswell: Both, and both are important. The core of the Vickers proposal is to define a certain set of banking activities as being so vital to the real economy that we have a very strong interest in their continuity. Within that, it is important to think about the supply of credit, in particular, to those elements of the economy that cannot typically get it in a bond market form. Therefore, within the range of definitions that the Vickers Committee put forward about what should be in the ring fence, where there would be a choice, I would argue for putting the whole of lending to SMEs mandatory in it. It is very important for us to understand that the big harm which was done by the banking crisis of 2008 to UK citizens was not the explicit cost of new equity investment. The big harm was the macro-economic instability. Although it is important to have a mechanism which avoids the possibility of future public support for banks which would otherwise fail, it is even more important that we have created mechanisms whereby these banks are stable institutions able to keep a stable supply of credit through to the real economy. That is why I stressed earlier the importance of thinking through the relationship between the FPC and the ICB ring-fenced proposals, and whether in future the FPC will want to make statements about counter-cyclical capital which apply at that level rather than or in addition to at the group.

It is important that these are stable institutions. They will be more resolvable institutions. They will increase the range of options available to a resolver, if they want, to resolve and maintain the ring-fenced bank, while having a more free market approach to the area outside the ring-fenced bank. However, we must not fool ourselves that, simply because we have these ring-fenced banks, we can then be indifferent to what happens outside the ring fence. A non-ring-fenced, outside the ring-fenced broker/dealer investment bank like a Lehmans will still cause trouble if it goes down, whether or not it was taking deposits. Therefore, this is a useful but not sufficient answer to the problems of financial stability.

Chairman: Lord McFall has a series of questions to which we need to get the answers on record.

Q942 Lord McFall of Alcluith: I will be very quick. The answers can be largely a yes or no, and then we will get through it. The Bank of England is concerned about the FPC making recommendations but not binding on the timing and the means by which regulators implement them. Should the FPC have power to make binding decisions regarding timing and means?

Lord Turner of Ecchinswell: They should on a narrowly defined subset of the decisions. Within the tools of the FPC, we are probably going to end up defining a small number which are definite quantitative tools, like counter-cyclical capital, where I cannot see a disadvantage in the FPC being clear. When you get to the wider set of recommendations, you will then have to leave some autonomy to the PRA and FCA to interpret. It is horses for courses.

Hector Sants: We have to be very careful about mission creep and overlap between the FPC and the PRA. I entirely agree with Lord Turner that it would be perfectly sensible for defined, specific powers to be binding. Generic authority could however effectively turn the

FPC into a shadow micro-prudential regulator, which could confuse things. We thus need to be clear what these tools are.

Q943 Lord McFall of Alcluith: Should the FPC have the power to gather information directly from firms so that it does its job properly?

Hector Sants: To me that is a non-question because the PRA is part of the Bank. The FPC has the power to instruct the PRA.

Q944 Lord McFall of Alcluith: I will tell you why I ask it. It was not a non-question the last time because the Bank of England felt everything was for the regulator to do. It did not do anything. Looking at individual firms and business models, people were saying to the Treasury Committee, "Look, the Northern Rock business model was screaming for attention but nobody gave it", so that is an issue.

Lord Turner of Ecchinswell: My point of view is that this is a bit of a non-issue because the PRA is in the Bank in any case. I find it slightly odd. There is nothing wrong with it, but it would logically go through the PRA data-gathering process, because, otherwise, why would you make a duplication, and given that it is all in the Bank in any case, I find it difficult that the same problem—

Q945 Lord McFall of Alcluith: We have an all-singing, all-dancing team at the Bank. There is no disagreement anywhere really. This is the thing.

Hector Sants: Yes; but what we are going for is the central bank being at the heart of the financial system and the PRA is part of the Bank of England. The FCA has the power to instruct the PRA, so it seems to me that that covers the issue.

Q946 Lord McFall of Alcluith: I have heard all that before as well. Should the FPC have the right to direct regulators as to how they implement FPC direction, and in what time scale?

Lord Turner of Ecchinswell: That goes back to your first point. The answer is that I could imagine that for the very defined set of quantitative tools which are used on a directive basis, and then, beyond that, there is a wider set of potential tools which would be more in the category of recommendations. It is a range within it.

Hector Sants: We need to think carefully through it. If it is requiring the PRA to make a rule, there is a set of obligations around consultation and impact assessment that the PRA has to go through. It is a complex question, which is why you need to focus in on individual tools.

Q947 Lord McFall of Alcluith: If you could put something more in writing, that would be helpful. Given the PRA has something like 2,000 firms it is looking at and the FCA has something like 24,000 or 25,000 firms, it seems almost an impossible job, like looking for a needle in a haystack on occasions. Given the comments that you have made in the past five

or six months, Mr Sants, about the need for the FSA to look at the business models, which it did not do before, and also to embrace culture and ethics—because if you are going to get change it has to be within institutions—are you taking that policy and philosophy with you as you go into the Bank of England?

Hector Sants: Yes.

Q948 Lord McFall of Alcluith: Good. Will the PRA choose to set up practitioner and consumer panels? If not, why?

Hector Sants: It is right to be cautious about how we approach this, in the sense that we do not want to run any risk of suggesting that the PRA could be subject to regulatory capture. Clearly there have been some concerns that that occurred in the past. Therefore, having statutory panels that create the perception of a relationship which undermines the independence of judgment of the regulator could give the wrong type of messaging to the type of regulation we want going forward. It is vitally important, however, that the PRA should not be reaching any judgments, particularly generic judgments which require rule-making, without being in full possession of the facts and having a full understanding of the industry's views on its proposals. In practice it is our intention through non-statutory processes to achieve all the consultation that the industry is looking for. I just think we need to be careful that we do not inadvertently give the wrong type of messaging on top of that.

Q949 Lord McFall of Alcluith: Would that be for practitioner and consumer panels?

Hector Sants: If it was necessary to have a consumer input, then we would definitely seek it.

Q950 Lord McFall of Alcluith: Are accountability arrangements adequate for shareholders and other stakeholders who suffer losses and damages as a result of regulatory or supervisory failure?

Hector Sants: Is that a question about independent complaints? Do I think there should be an independent complaints process, or is it a question about liability?

Q951 Lord McFall of Alcluith: Liability.

Hector Sants: We are back to the challenges. At the moment, we are in a position where, if we act in bad faith or recklessly, then we are liable. If we make judgments which are reasonable judgments at the time, we are not. If you want a judgment-based regulator, we need to be very careful that we have not put in place a process that undermines the culture that is necessary to make those sorts of judgments. They are very difficult judgments to make. There will be times, with hindsight, when they are not seen to have been the best option to have chosen. If you create a climate where the perception is that there is a high risk of personal liability if a judgment is found, with hindsight, not to have been the best option to select, you will effectively kill off the possibility of achieving this forward-based regulation. That does not mean that we should not be fully accountable for the actions we take. There are other accountability mechanisms which can address people's concerns in

that area, which of course includes ensuring that the oversight boards—the PRA board for example—very clearly hold the executives responsible for their performance. If the executives do not perform, it can take the appropriate action.

Lord Turner of Ecchinswell: I add one thing. You included there shareholders and other stakeholders. There can be some circumstances in which shareholders might legitimately feel there could have been better regulation, but we also have to be absolutely clear that shareholders themselves have major responsibilities. A lot of what went wrong with our banking system was encouraged by a set of shareholders who thought that high levels of leverage, rapid growth of EPS and aggressive acquisitions were rather sensible things to do. We do have to record the fact that they have a pretty big responsibility themselves.

Q952 Lord McFall of Alcluith: Agreed. Should the PRA and FCA share a complaints investigator?

Hector Sants: I do not have a strong view on that.

Q953 Lord McFall of Alcluith: Fair enough. Lastly, concerns have been raised about the changes to the role of the Upper Tribunal, in that it will not be able to substitute its opinion for that of the PRA. Will there be sufficient opportunity for review and appeal of the regulatory decisions?

Lord Turner of Ecchinswell: Hector will speak in more detail, but it is important to realise that an awful lot of the PRA decisions are unlikely to go anywhere near the Upper Tribunal. I do not think a single one of the supervisory decisions about whether you required more capital, etc., has been appealed to the Upper Tribunal in the last several years. Hector can give the specifics.

Hector Sants: The most important point is that we do not normally experience appeals against prudential judgments. It has never happened, to the best of my knowledge, in the FSA. We then go back to the question of what type of PRA we want. If we want—which we do, and I believe so far that Parliament and Government are supportive of that, but obviously that is part of the debate we are now having—a regulator that makes forward-looking judgments, then it is reasonable to presume that those judgments should be made by those people best technically equipped to do it. The key thing is to ensure that the governance process gives the best chance possible to equipping the right people to make those decisions at the time they are made. That comes back, for example, to the composition of the PRA board, which is a key element in that. Asking another set of individuals who are not technical experts in that area to second-guess the judgment, as opposed to the process, would to some degree be contradictory to the basic intent of the proposition. That does not mean there should not be clear mechanism where, if good process has not been gone through in reaching the judgment, the PRA can not be properly challenged and held to account.

We just need to think through the whole philosophy of what we have tried to do here and go back to the core question: do you want the regulator only to make decisions on observed facts so that it can defend itself to the Court, or do you want it to be brave and ask the question, "I don't like that business model, it might fail in the future and I will challenge the bank's management as to whether it should persist with that business model"?

Lord Turner of Ecchinswell: My understanding of the present version of the Act is that it draws a distinction that, where the PRA, to the extent that it does, imposes an enforcement action against an individual or firm and censures it or fines it, that is subject to appeal to the Upper Tribunal in the normal fashion. It is simply saying that, where there are prudential supervisory activities, the only role of the Upper Tribunal would be to review whether the decision-making process was appropriately followed. That strikes me as a perfectly sensible set of rules for a different category of decision.

Chairman: Finally, Lord Newby on crisis regulation.

Q954 Lord Newby: Reverting back to a period of crisis, there is a big dispute about the role of the Treasury, when the Treasury should be involved and when it should be consulted. The Treasury Select Committee has suggested that in certain circumstances the Treasury ought to be able to direct the FPC to get on with it or to take action. At the moment the Bank is virtually saying, "We will talk to the Treasury when we need some money from them." What is your view about the role of the Treasury and when it should intervene in a proactive way rather than just wait to get information and requests from the Bank?

Lord Turner of Ecchinswell: It is worth making the point of how it works at the moment. We have a regular set of meetings which are at two levels. They are at what are called deputy levels, which is Hector, Tom Scholar and Paul Tucker. Then there are a fairly regular set of meetings at what is called principals level, which is the Governor, myself and the Chancellor. We discuss developing situations in a perfectly sensible fashion and where, indeed, we discuss on a forward-looking basis, in a crisis-management sense, what the different roles would have to be in those different circumstances.

My own feeling is that something like that should continue to exist in the future. People tell me from before the crisis that this did not occur and it really began from about autumn 2007 onwards, but it is what I have observed for both the period of intense crisis and several years since then. It strikes me as a workable and sensible set of exchanges of information, exchanges of points of view and sometimes working jointly on specific things that need to be thought about. You do require the element of the Treasury wherever there is public money. In particular, if at any stage in the future we need a new equivalent of the credit guarantee scheme, then the Treasury has to be involved and should be involved not merely at the point of crisis itself but enough in advance to have thought about all the possibilities.

Hector Sants: It is worth emphasising that post-crisis—and this was not occurring in the before-crisis system—we now have a very clear protocol of escalation of individual firm issues to Treasury which is linked to the intervention framework within the FSA. When our concerns about an individual firm move up our internal process, there is an agreed convention with the Treasury when we automatically inform them as to the concerns about the individual firm. The perception that somehow or other the Chancellor only gets involved when public money is possibly imminent is not the reality.

I would be wary about putting into the face of the Bill detailed provisions for how that escalation process works, but I think it is wholly reasonable for Parliament to expect there to be a clear escalation process that brings information to the Treasury and to the Chancellor at a very early stage, which is what we currently have.

Chairman: Thank you very much indeed for extremely interesting and helpful answers. I am afraid there are one or two outstanding questions on which we may need to write to you to get further detail. We are grateful to you for your time.

Examination of Witnesses

Witnesses: **Martin Wheatley**, Managing Director, Consumer and Markets Business Unit, and **Margaret Cole**, Interim Managing Director, Conduct Business Unit, Financial Services Authority, examined.

Q955 Chairman: Thank you very much indeed. I apologise for keeping you waiting. I hope we can make some speedy progress this time. Could I open the questioning by raising the issue of how far the FCA ought to have powers and responsibilities relating to competition, and how you would see that interacting with the OFT?

Martin Wheatley: Thank you, Chairman. I appreciate that time may be constrained. On any areas on which you require further written follow-up, we would be very happy to do that. Our view is that the draft legislation as currently presented does not go far enough. We have a set of operational objectives with a requirement to have regard to or take into account competition as a factor. Our view is that 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. I think a redrafting could clean up and have a much clearer demarcation line between ourselves and the OFT.

Q956 Chairman: But you would not see yourself taking over the OFT function in the financial services area.

Martin Wheatley: It largely would. Within financial services specifically it would largely remove the need for two separate authorities to be looking into competition issues.

Q957 Chairman: The OFT has said that, where a regulator analogous to you has the power, that results in them having to duplicate the expertise of the OFT, and where there is an overlap in practice neither side uses it.

Martin Wheatley: 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 places. Our ideal model is that we have a very clear demarcation line and that we would take on competition issues within financial services.

Q958 Chairman: What about the conceivable need for the OFT to investigate how the FCA operates and how your rules and so on comply with competition objectives?

Martin Wheatley: We will be subject to quite a lot of oversight. Certainly there will be oversight by Parliament, by the Treasury Select Committee and by the National Audit Office. If there was a necessary additional oversight, then that would be another level of accountability to which we would be subject. If you felt that the OFT would need to have that oversight, but we were otherwise the financial services competition regulator, then so be it and they would need to staff up and skill up to carry out that function.

Q959 Chairman: Are you saying that you have, or you don't have but would need to acquire, the skills and expertise to undertake the competition role?

Martin Wheatley: The skills and the expertise are very specialist so we would need to acquire them. We would need to build up a body of analysis, capability in competition analysis, competition economists and in competition law, which we do not have today because we do not have that function.

Margaret Cole: What we do have is a lot of in-depth knowledge of players, products, consumers and consumer dynamics in financial services markets. Although Martin is right in saying that we would have to add some specialist skills, I think we already have important specialist skills that the OFT does not have. That should make this an acceptable, clear and efficient proposition.

It is also very important to be clear that the FCA has lead authority for competition matters in financial services so that everybody is clear where the boundaries lie and that things do not fall between gaps. If the Committee would like, I could probably give an example of that but I do not want to take time.

Q960 Chairman: Please do, yes.

Margaret Cole: The best example is in the payment protection insurance area. The FSA applied the use of what I will call its orthodox or conventional regulatory tools to what was clearly a growing problem. There was a moment there where the competition authority stepped in on a super complaint from consumer groups. That was what the orthodoxy was: that the competition authorities would look at that side of things. As a result of that the FSA, in effect, stood back and let the competition authorities do their market work and decide on their remedies.

This would have been clearer and we would have greater authority to act earlier in the PPI scenario if we had been looking after the whole piece there—if we could have looked at the anti-competitive elements of payment protection insurance and if we could then have taken steps. If we had had the authority to do that, we would have behaved differently. There is an important lesson to be learned there for giving clarity around where the boundaries lie.

Chairman: Thank you very much. I do not know whether other colleagues have any questions on the competition issue. If not, we will go to Baroness Wheatcroft.

Q961 Baroness Wheatcroft: Very quickly on that one, had you looked at PPI, not as a competition issue but simply as treating customers fairly, could you not have moved on it rather sooner?

Margaret Cole: I am sure there are ways we could definitely have done things differently, but we applied the toolkit as it was thought to be available to us at the time. We did a great deal of supervisory work. We did a great number of thematic reviews. We did a large number of enforcement cases. After all of that, it was not proving that any of that work was causing a change in behaviour. It was then very much highlighted that single premium PPI was the most egregious form of this particular product. By that stage the competition authorities were looking at their wider remedies in relation to single premium PPI. That is when the moment came when we effectively looked to the competition authorities to say what the appropriate remedies were at that point. Could we have done more cases earlier? Could we have taken stronger action earlier. With the benefit of hindsight, possibly, but we were using the conventional toolkit. In the new world, having greater powers of intervention and being able to look at products in a different way at an earlier stage, enhanced by the powers that we hope to have in the legislation, will give us the authority and the mandate to take earlier action.

Q962 Baroness Wheatcroft: Whether or not you have the competition mandate.

Margaret Cole: That is correct but we would certainly prefer, as we have articulated, to have the competition mandate clearly as well.

Q963 Baroness Wheatcroft: I want to ask you about a much narrower subject that is the regulation of markets. At the moment with the way that regulation is structured under the Bill, markets will remain in one place and clearing houses in another. Does that make sense to you? Can you see the logic, as some of those giving evidence to us have maintained, of giving it all to the Bank rather than the FCA because the Bank knows and understands markets and settlements?

Martin Wheatley: The division we have ended up with is the right one. Clearly, the Bank of England has a broad, systemic responsibility. Clearing houses and infrastructure payment systems are a part of that systemic responsibility, but markets are clearly much broader than that, whether they are equity markets, OTC markets, the primary market or the secondary market. They all ultimately affect our core objective, which is running efficient markets or creating confidence in the system. There is a great deal of synergy by keeping the market's function with the broad consumer protection function. That is a debate that was gone through a year ago and we have reached the right position on that.

It is important that the role of the FCA in markets is clearly articulated and recognised. I know the question came up earlier about our ability to articulate and argue our position within Europe. In all other European regulatory structures, the market's function is very much part of the securities regulatory function. For all sorts of reasons we have ended up with the right split, but clearly it is something that needs to be co-ordinated.

Q964 Baroness Wheatcroft: But the fear is that markets are essentially wholesale rather than retail, and the FCA is going to be very much a retail organisation.

Martin Wheatley: It is an interesting question. There is a popular perception that that is the case but, as you will know, the definition of "consumer" in the legislation is a very broad definition. Clearly the retail consumer has been something that has been very heavily focused on, and for good reasons, but the efficiency of markets, the operation of markets and ultimate the services that retail consumers get are dictated by wholesale players' activities within those markets. From our point of view, it is very important that we don't lose the perspective that we are looking across a very broad range of consumers in markets, not just the retail consumer.

Q965 Lord McFall of Alcluith: Will the consumer protection powers be enhanced with the new arrangements? Will you be able to do things that you have not been doing before?

Martin Wheatley: Yes. There are some powers that will allow us to do things that we have not been able to do before, but the broad objectives, which sometimes relate into powers and sometimes translate into culture, will set the culture for an organisation that will see its role as much more strongly consumer protection and much more strongly to intervene where we see actual or potential harm. The change in the organisation will partly come from the specific legal powers but, quite significantly, will also come from the change in approach that this whole debate and the broad objectives will require us to take.

Q966 Lord McFall of Alcluith: Industry concern has been expressed to this Committee about the new consumer protection powers and the lack of guidance from yourselves. It is at an early stage, but do you envisage giving more guidance on these issues in the future?

Martin Wheatley: Yes, we will. As you know, we publish, some would say, too many guidance and consultation papers, but wherever our policy is moving we have published papers and sought input. We did that earlier this year on products and the sort of areas that we would consider to be potentially problematic in product design. We have set our stall out even now in the product space as to what we consider would be red flags for us to go and look at. In the last week, we have published guidance on what we think good practice is in the area of design processes in terms of structured products or PPI lookalike products. It is early days, but we will continue our practice of publishing guidance and rules where necessary.

Margaret Cole: I agree 100% with Martin about this. Powers are important, but what is really important is a cultural disposition to use those powers, obviously appropriately and with appropriate safeguards. The new powers that are being discussed in the draft legislation are important to us. We can make good use of those powers in the interests of consumer protection. It is also important, if possible, that they are not eroded or undermined in the process that will inevitably go forward, where Parliament will consider the powers, and views will be expressed about the use of those powers. Powers come with safeguards and safeguards are important, but it is also important that the powers that are given are powers that are usable and not fundamentally undermined throughout the process.

Q967 Lord McFall of Alcluith: Martin, you and I shared a Panel on Monday when someone challenged me on the issue of early warning notices and that they were against natural justice. Since you were on the Panel, I handed that over to you and we had a good

joint answer. It is important for this Committee that both you and Margaret elaborate on that.

Martin Wheatley: I will ask Margaret to deal with that because she has had much more experience of warning notices.

Margaret Cole: It is really important here to be very clear what the proposal is and what it isn't, and to be clear what a warning notice is and isn't. The proposal here is that brief details of a warning notice be published at the time that the warning notice is issued. That is putting into the public domain very brief information about action that the regulator is taking. That is consistent with what happens in civil process generally. It is consistent with what happens in criminal process generally. It is consistent with what happens with most other regulators. We are not talking about publishing a very long and detailed document as a warning notice, but just brief information about what is essentially the start of a case.

It is also important then to understand what a warning notice is. A warning notice is a document which marks the start of process after our own internal committee has looked at a considerable amount of evidence, which can be provided by the external party in discipline, and formed a view that there is a case to answer. A warning notice does not come at the start of an investigation, when a case is a twinkle in our eye. It comes quite a long way down the process.

We think it would be in the interests of transparency and consumer protection to make what we think is a fairly slight adjustment here: to publish brief details of a warning notice at that time. We also think it counters the suggestion we have heard—we have heard it from Parliament in fact and from the media—that we have closed-door processes. Closed-door processes and natural justice considerations are very appropriate to what we do in the disciplinary sphere, but we think there could be quite a small move here on the transparency dial that would enhance consumer protection and transparency.

There is one further point. We are concerned with the proposal in the Bill that we should consult on every occasion before we issue brief details of a warning notice. I am afraid we think this is in the category of something which erodes and undermines the use of the power. In practice, if we have to consult on every occasion before doing so, we will find ourselves engaged in satellite litigation in every single case. I do say that with some experience.

Q968 Lord McFall of Alcluith: I come back to you on that, Margaret, in the sense that firms have said there could be reputational risk to them and, if you remove that requirement to consult, then that reputational risk could be enhanced. Indeed, the Practitioner Panel told us that "statistics indicate that approximately 30% of the final notices do not bear a great deal of resemblance to the initial notice".

Margaret Cole: There are a couple of points on that. The 30% statistic is not an accurate representation. In cases where there is a dispute about the case that we are bringing the actual result is about 5% of cases. There are 5% of cases where we don't proceed to a decision notice following a warning notice. If I understand the point—maybe the Panel is making a slightly different point—the warning notice transitions over time from the warning notice to what finally is published. In fact, that is dealt with because we are not going to be publishing the warning notice but only brief details of the nature of what this case might be

about and the parties. The detail of what is about will not be published early, so that aspect of the Practitioner Panel's worry does not arise at all.

Q969 Lord McFall of Alcluith: On the issue of reputational risk, you have a balance. You have the reputational risk of firms but you also have the injustice of many thousands of consumers who, as I have noticed in the past and has been brought to my attention, have been sold inadequate products, resulting in their financial detriment. How do you get that balance right?

Margaret Cole: That is indeed the question. There are different areas of consideration here between fairness to people and firms who are in discipline and the disciplinary process, consumer protection and the general principle of transparency as far as it is possible to achieve that. This is why we are moving this issue on the dial slightly. We are bringing forward the time when we publish some information about the fact that the regulator is working on something to a slightly earlier stage in the process. It is significant in terms of messaging. It is significant in many ways, but this is a point in the process when an awful lot of work has already been done and the judgment has already been made about a case to answer.

I have no doubt that firms are concerned about their reputation in this process, but the factual reality is that firms in fact often have to make their own announcements for market reasons at a much earlier stage of the process, where an investigation itself commences. We do not make announcements at that stage, but there are other principles driving announcements being made at that stage.

I would bring you back to the fact that this is very consistent with other forms of legal process. It is consistent with criminal process, with civil process and with other regulatory process. It does not imply a judgment that the firm is guilty until the full process of defending itself has been completed.

Q970 Lord McFall of Alcluith: Some would say you could impose a product ban which this power has given to you. If you imposed a product ban you would not need the early warning notice.

Margaret Cole: Essentially, you need both. Product banning, the theory of which is that it comes earlier before the problems build up, is also a useful tool but in reality—and I am sure Martin will want to say something about this—we will not be banning products in complete isolation of some evidence base. Evidence will build up. We hope to take action earlier, but we cannot completely rule out that things will happen that we have not been able to head off at the earlier stage. Early intervention and after-the-fact enforcement are two parts of a more vigorous story of consumer protection. I do not think one precludes the other; they are both useful in tandem.

Martin Wheatley: I would like to add to that, because it is important. The product ban, were we to use it, clearly covers the industry on a particular product. Warning notices are typically firm-specific, where it may not be the product but the sales practices of a firm. They are two quite different tools and they don't really overlap except at the margin.

Q971 Lord McFall of Alcluith: Okay. It was important to get that on the record, and if there is any further information perhaps you can send it to us, because this could be a topic of controversy as we go along. There is a very wide definition of consumer. Is that good or bad—an advantage or a disadvantage?

Martin Wheatley: Clearly, there are some advantages and some disadvantages. From the consumer lobby point of view, the disadvantage would be that it is not as narrowly focused an organisation as some would like and it does not give us a very specific consumer advocate role but a role which protects a broad range of consumers. The advantage of the wide definition, as I have said, is that people's interaction with the market, whether it be mortgages, banking products or securities products, is partly dictated by their interaction as an individual consumer and partly dictated by how wholesale players operate in the market. From my point of view, the structure that we have is broadly right and we have to make sure we have appropriate responses to the full range of consumers.

Q972 Lord McFall of Alcluith: Lastly, concerns have been expressed that the consumer responsibility principle is not appropriate unless it is complemented by a similar responsibility for firms. Do you think it would be useful to have a similar responsibility for firms?

Martin Wheatley: The firms do have a responsibility, and under our rules they have responsibilities in terms of appropriateness, in terms of their conduct and in many cases they also have a fiduciary responsibility to clients. A number of these responsibilities are already built into either common law or our rules and guidance. That responsibility exists already.

Q973 Mr Laws: I want to follow up on Lord McFall's questions. On that last important issue about consumer responsibility versus firm responsibility, how would you define the responsibility that firms have to consumers?

Martin Wheatley: It would vary depending on the relationship. Very often in the retail space, if we are primarily talking about the retail space, it is a responsibility that is defined by our rules. The responsibility is in terms of appropriateness of advice and conduct, in terms of how to behave. In some circumstances, depending on the contractual relationship, there is also a fiduciary responsibility in law.

Q974 Mr Laws: Should we not have something on the face of the Bill that makes clear that there is a firm responsibility and makes clear what type of responsibility that is? There is a huge range of potential responsibilities.

Martin Wheatley: There is a huge range. It inevitably comes back to the definition of consumer, because the responsibility will differ depending on the relationship and the types of consumer.

Q975 Mr Laws: Let us think about an ordinary bog-standard man in the street. What is the responsibility of the financial sector towards that individual? How would you define that?

Martin Wheatley: Again, I will ask Margaret to come in on the legal aspect. It is defined partly in our rules and in part in law.

Q976 Mr Laws: But what is the definition?

Margaret Cole: The easiest place to see the definition is principle 6, which is about treating customers fairly. That has been the encapsulation of the agenda for firms ever since I have been at the FSA and since the principles came into being at the outset of the FSA. That captures, at a generic level, how firms are supposed to treat customers. Of course, underlying that are a lot of detailed rules about what happens in particular circumstances. There are rules about disclosure, financial promotions and conflicts of interest. They all underlie that overriding principle about the way that firms should treat their customers.

I know the Consumer Panel has raised an issue over whether fiduciary duty should be imported. I think that is quite a complex question and the Panel would hope to have a workshop about it. We would be very pleased to participate in that. There may be a case for an overriding principle to be included in the legislation, but, fundamentally, we already have the rules, the principles and the building blocks in place.

Q977 Mr Laws: You don't feel that it is a bit imbalanced at the moment and that we seem to have this responsibility principle clearly in the Bill, which is saying that consumers have to watch out and they have to take responsibility for what they are purchasing. It is a bit unclear to me what the responsibility is for firms. Would it not be helpful to be clearer about that? The words you have used about fairness are potentially vague. They could relate to things that have nothing to do with the offsetting responsibility of firms to behave in a responsible way towards consumers and to balance the issue of the extent to which the consumer can identify risks in what could be complex financial products, when sometimes consumer literacy is quite low.

Margaret Cole: Yes. I would not have a fundamental objection, drafting being appropriate, to capturing something like this in the legislation. My view is that in terms of the agenda, rules and principles that we operate under now the responsibility exists. Obviously there is a view in the industry that there is too much emphasis put by the regulator. The raison d'être of the legislation and the regulators' actions under it are around the protection of the consumer. Some would see the mention of consumer responsibility as being the counterpoint to that. It depends how you view it.

Q978 Mr Laws: In cases where a firm sells a financial product to the average man or woman in the street, and where all of the information supplied is perfectly accurate, comprehensive, detailed and so forth, could it still be possible in your view that the firm could be irresponsible in selling that product?

Martin Wheatley: Yes, absolutely.

Q979 Mr Laws: What would be a good example of that?

Martin Wheatley: The nature of this crisis that we are still in during the last seven or eight years has been the increasing complexity of products. There are many, many occasions where I have seen products that come with a 200-page set of legal terms, which are presented to a consumer who is then asked to sign a box, where the product is completely inappropriate for the individual, whether or not they have read the information.

Q980 Mr Laws: Let us assume in my case that the firm succeeds in boiling down the information about the product to a couple of very accessible pages and highlights the risks very clearly; and the consumer still says, "Fine, I am signing up for it." In that case has the firm discharged its reasonable responsibility, or could it still be expected to say, "We know we have given all that information, but actually we personally think that product is wrong for that consumer, or, frankly, it is extremely dangerous, given our own view of what is going to happen to interest rates, house prices or something else"?

Martin Wheatley: As always, it will depend on specific facts in the circumstances. If a distributor has gone through a complete explanation of the product, why they believe it is unsuitable and why they believe in the circumstances that selling an 80-year-old person a product that takes 25 years to mature may not be appropriate but none the less an individual still persists, we would have to look at the specific documented facts as to what was said by whom and what disclosures were given. It is very hard to make a general ruling on that.

Q981 Mr Laws: But the provision of information does not discharge a firm's responsibility.

Martin Wheatley: Not in itself, no.

Margaret Cole: Especially not where we are talking about a form of advised sales, where it is the responsibility of the person selling it to assess and judge the suitability of the product.

Q982 Mr Laws: I have one last question, because the Chairman will want to move on. At the moment there are quite a lot of mortgage products on the market which say, "You will pay this starter rate, which is very low; you will then move on to base rate or standard variable rate plus 4%, and at the moment that will give you a cost comparison figure of usually something else quite low because short-term rates are very low." That does not even take into account forward interest rates in the future and that somebody might have to pay 4% above, which may be nothing like the short-term rate which is used for cost comparison purposes. Isn't that a major abuse that is going on at the moment?

Martin Wheatley: It could be. Again, it depends on what is disclosed. As you know, a separate piece of work that we are doing is the mortgage market review, where we are looking at exactly that issue. Our intention is to come up with some proposals to deal with the point that you have made.

Q983 Baroness Drake: I want to come back to this point about the duty of care by the provider. There is a good quote by Lord Turner in his Mansion House speech when he said:

"In financial services the potential for the customer to be ripped off is simply far greater than in any other sectors."

The rule book today just has not stopped scandal after scandal happening: they are there. The Bill says, "Okay, we will give some more powers to the FCA and we will ask them to be more proactive in their approach." The thing that certainly seems missing to me is the behaviour of the providers themselves. As I know from my own father, selling an elderly gentleman an equity-based product is not something that should be done. What the consumer groups are saying is, notwithstanding the rules which clearly to date have not stopped scandals, should there not be something quite explicit on the face of the Bill or in other form of regulation that articulates a duty of care and responsibility which balances the consumer responsibility which is clearly in the Bill? Although the proactive response and the new powers of the FCA are very important in contributing to consumer protection, that issue of duty of care and behaviour of the provider should be more directly addressed.

Martin Wheatley: As Margaret has said, we would be very happy to have a discussion about how that could be articulated. If we could articulate that in a way that made sense within the Bill, we would be very happy that that was part of the process. The issue we face is that it is quite a hard principle to define in a legal sense. We could have it as a broad principle, and a broad principle within the Bill would be helpful to us. We would then have to interpret that within our rules and guidance. I think it would be very hard to write it in a very definitive way.

Q984 Baroness Drake: But you would not oppose the broad principle.

Martin Wheatley: No.

Margaret Cole: No; we would support the broad principle, but it would be the operationalisation of it that would be key.

Q985 Lord Newby: We have already discussed in the context of your relationship with the competition authorities the delays that occurred under PPI. I want to ask you about dealing more speedily and easily with collective problems, such as a product where generic mis-selling has been going on. These often manifest themselves to the regulator via the Financial Ombudsman Service. In the past the Ombudsman has been required to take a huge number of parallel decisions without being able to get a collective response. Are you content that the new arrangements will allow you to pick up problems that the FOS has identified and deal with them more quickly?

Further, what is your view about the possibility of third parties, consumer bodies, bringing collective redress proposals to you, which you would then have to act upon?

Martin Wheatley: There are two points. Maybe I will ask Margaret to deal with the second point on third-party redress. The question about speed of intervention is quite interesting. Some of the discussion earlier with Hector and Adair was about what a judgment-based regulator means. The answer you got, and I would reiterate it, is that all regulation is judgment-based. It is simply the degree of evidence that you need to support that judgment. In the past the FSA has needed a lot of evidence to support a particular judgment. In the future, and particularly when we are forward looking, we will need to use our judgment

based not on no evidence but less than 100% evidence. When the FOS or other groups are passing information to us, we will look to act much more quickly than in the past, where typically we have had to go and do quite a lot of supervisory visits in order to build the case to get us to a degree of comfort that we had a 100% legal case. To deal with the first part, FOS and many other groups will be, if you like, the canary in the coal mine for us. We will have to react to that much more quickly. Maybe Margaret could deal with the second part.

Margaret Cole: Subject to one point that I would just like to mention, yes, as Martin says, in the last year we have had a much better, more functional relationship and interaction with the FOS for picking up information that gives us early warning. We are going to be very focused on that in the future.

You will know that before the last election we picked up a new power to do with collective redress schemes and a version of that that you could use in individual cases. We are starting to use those powers. We have used it three times in individual cases with the involvement of the FOS. Those powers are very important and useful for us to be able to deliver widespread redress in mass detriment cases.

It is subject to one point, which is worth putting on the record with the Committee to do with redress, which seems to be widely misunderstood. Where there is a rule breach and consumers have suffered detriment, the rule breach does not automatically equate to 100% recovery for consumers. The way that our powers work is that when there is a breach of the rule we still have to establish causation between the breach of the rule and the harm that is caused to consumers. This does give rise to a disconnect in people's minds and in the minds of the media and consumers. "You have found something wrong; why can't we have 100% back?" That is not the way the redress mechanisms are set up at the moment.

Unlike the Ombudsman service, which can make decisions based on fair and reasonable principles, we are required to follow all the usual legal principles about causation and proof. That is a difference. I am not saying that that should be changed, but it is worth reflecting on whether the powers give us the scope to deliver mass redress that perhaps Parliament and consumers are expecting from its consumer protection regulator in the future. That is a point worth making.

In relation to your specific point about consumer groups and the super complaint mechanism, it is fine. It is a very good idea. What I would be very concerned about is if it starts to extend itself to give parties who should not have the benefit of such a mechanism that power, and in particular industry groups. It would be wholly inappropriate to allow industry groups to trigger the super complaint mechanism to require the regulator effectively to halt Ombudsman consideration of cases at the behest of the industry. I have heard this floated. I can give you more detail about why I am concerned about that idea, but perhaps we don't have time to go into it fully now. Certainly as far as consumer groups are concerned, we are very supportive if they have that power.

Q986 Lord Newby: As things currently stand or are planned under the legislation, will it be possible for industry groups to make that kind of complaint?

Margaret Cole: No. Under the legislation it is not, but I have heard a lot of noise that industry groups think it should apply to them. I am getting in pre-emptively with you to say that we would have quite a lot to say if there was a move to extend.

Q987 Lord Newby: I thought you were going to say “lawyers”.

Margaret Cole: Those too, but I am one of those so I have to be careful what I say.

Q988 Lord Newby: With previous mis-selling cases there have been some unscrupulous lawyers who have taken fees off people and then, in effect, tried to take collective action through the courts. That fell under the legislation before the election. Would the legislation as passed allow a lawyer to go to people who have been mis-sold, take a fee off them and then, having collected them together, come to you?

Margaret Cole: No. As I understand this now, this is about a super complaint by consumer groups. It is not about a class action mechanism for private litigants advised by law firms. You are quite right; if it was the latter I would also be very concerned about it.

Q989 Mr Brown: I want to ask you about relationships with the institutions of the European Union. There clearly are structural differences. Do you envisage that causing any problems?

Martin Wheatley: The interface with European institutions is a very time-consuming and complex one, regardless of any other changes. We all know that. It is a significant usage of our time. European institutions primarily operate along industry sector lines, not the divide that we are now providing in the UK. There are different models in different markets, but that is one of the models.

Q990 Mr Brown: We understand that. My question is, do you think it will be possible for you to cope with that?

Martin Wheatley: Yes, we have to. It will take time and effort and it will take a lot of hard work but, yes, I do.

Q991 Mr Brown: Is there a risk that something will fall between two bodies and not be dealt with?

Martin Wheatley: Honestly, yes, there is always that risk, but we work very hard with the Bank today. That risk exists today. It is not particularly different. We work very hard with the Treasury and the Bank to make sure that we cover the bases and that things don’t fall between the cracks.

Q992 Mr Brown: Do you think the United Kingdom arrangements for co-ordinating amongst yourselves are fit for purpose?

Martin Wheatley: Yes, I do.

Q993 Mr Brown: I have one final question, reverting back to Baroness Drake's question about consumer protection. Do you have a preferred form of words that would assist the Committee in formulating a general duty to protect consumers?

Martin Wheatley: If you would like us to, perhaps we could come back to you in written form.

Q994 Mr Brown: Chairman, with respect, if I could ask that you provide something to the Committee, that would be very helpful to us.

Martin Wheatley: I would be very happy to do that.

Q995 Chairman: I raise a rather complex issue. The FSA has raised concerns about how the requirement on the Financial Conduct Authority to produce an annual report would work in practice, particularly if the FCA is pursuing an enforcement action in parallel. What changes would you suggest making to the Bill to solve these problems?

Martin Wheatley: We will make annual reports, so our annual reporting process will be part of business as usual. The legislation envisages additional reporting, which is specific case reporting. The difficulty that the legislation gives us as currently drafted is that it is very imprecise, both as to what the conditions would be under which such a report would be produced and the decision-making process for such a report. We have suggested that, if we could automate, as far as possible, by identifying a number of factors, then that would make the decision process of producing a report easier. It is not to say they would be the only conditions under which a report would be produced, but it would avoid the very lengthy and difficult debate that we have had over RBS, where we have had a long discussion about the use of our powers to collect information and what usage that information can be used for.

The separate question which Margaret will talk to is how we can manage that given our primary responsibility to take action and enforce our rules against breaches of those rules.

Margaret Cole: Perhaps, in terms of the legislation, it would certainly be helpful to have the general presumption that our primary obligation to pursue enforcement and disciplinary actions for accountability of the parties that we regulate should have primacy in terms of timing. We are very concerned, for a number of reasons, about the practicalities of attempting to investigate and write reports about our activities at the same time as we have current enforcement activity where people are essentially in jeopardy. For a variety of reasons that is very difficult to run in practice, but it also risks unfairness to the parties that we are disciplining to have to answer to two separate and parallel inquiries.

We think it should be our primary duty when something has gone wrong to hold parties to account and to penalise them. That is the mechanism to trigger redress. In the worst of all possible cases, we do not want report writing to the general theme of accountability to Parliament to disturb disciplinary and redress mechanisms. If it is a question—which I think you are asking me, Chairman—of what could be put in the legislation, at the very least it is a presumption that those issues could be allowed to play out first so that we do not get into an argument every time about that.

Q996 Chairman: Thank you; that is very helpful. There is one final question from me, unless anyone else has any issues to raise. Earlier on we were talking about your specific obligation to have regard to something. You have a number of strategic and operational objectives and requirements to have regard to things. How would you balance them? Is the Bill clear enough about how this should be done, or would you prefer it to be amended?

Martin Wheatley: There are a couple of points. One which we have not specifically dealt with today so far, but an overall strategic objective where we have raised some questions, is about whether the current drafting is too broad and non-specific. The current drafting is drafted in terms of confidence and the financial system as a whole. We would suggest that it is more appropriate for us if it is drafted in terms of markets rather than the financial system as a whole, and in terms of us promoting fair, efficient and transparent markets rather than just creating confidence. That allows us a greater degree of precision.

We have also raised the point that having regard to competition is a difficult one for us. It is not quite clearly enough giving us a core competition objective. In response to the others, we would argue that they are manageable and that we can work with the drafting, if we take those two main points.

Q997 Baroness Wheatcroft: I want to ask you about those organisations that are going to be regulated by both the PRA and the FCA. There is a degree of understandable concern that dual-regulation potentially means higher costs and certainly more time-consuming regulation. Do you see any possibility for a single rule book or a single point of contact for those organisations?

Martin Wheatley: I know there is a significant industry concern that not only is it higher costs centrally, because we have two sets of teams, but higher levels of inconvenience to firms. 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.

Q998 Baroness Wheatcroft: Do you envisage that the two regulators might want to have a core of information from firms which would be the same?

Martin Wheatley: Yes. The way of dealing with that is that we have created effectively legal gateways where information given to one of the regulators will be made available to the other. It should not be the case that firms will have to give essentially the same set of information twice. We are trying to manage that process. In terms of points of contact and rule books, we just have to be realistic that over time they will diverge. That is the nature of having two regulators.

Q999 Baroness Wheatcroft: In the end, although we have talked about judgment-based regulation and that is where a lot of the focus has been, to what extent do you think, eventually, the FCA does become a rules-based organisation?

Martin Wheatley: That is an interesting question. That is clearly not the direction that Parliament and society is asking us to move in at the moment. We are being asked to move into a direction of using judgment and intervening early. The test will be, frankly, when we get it wrong and the response to when we get it wrong. We will get it wrong and the test will be whether, notwithstanding individual cases where we may make judgments that we have to fall back on, overall we are being seen as delivering the objectives for the organisation.

Margaret Cole: It would be a mistake to think that the prudential regulator exercises judgments and the conduct regulator just works on the basis of rules. Certainly we will work with rules, we will work with overarching principles and we will have to make forward-looking judgments, as Hector redefined it this morning, especially where we have to make those decisions about early intervention. Effectively, on the basis of less evidence than if you allow major problems to crystallise, we have to make judgments to act. As Martin says, that is a world in which we face greater risk. It is a world in which we will inevitably face greater legal challenge and judicial review challenges. We are already seeing that pick up. Hector made a point on the prudential side. On the conduct side, we are already bolder in the action we are taking. We already take far more enforcement action than we did four or five years ago, and we are already seeing the consequences in far more challenges to what we do. This is a different style of regulation and it comes with a different set of consequences as well.

Q1000 Baroness Wheatcroft: And different costs. Could you put a figure on how much you might see costs rise for a dual-regulation firm?

Martin Wheatley: I do not think we can. The Minister has suggested some broad costs of transition. We are still in the process of trying to work out what the costing would be. I do not think we are in a position yet to do that.

Q1001 Baroness Wheatcroft: But it will be the consumer who ultimately pays, presumably.

Martin Wheatley: Clearly, ultimately the costs of the industry are borne by the firms and those firms' costs are passed on to the consumer. We hope that the consumer benefits from the protection that we provide.

Q1002 Baroness Drake: I have a narrow question but it is broad in its impact. In 2012 there will be auto-enrolment of nine million people and rising into pensions. It is going to be done through basically turning inertia into a positive, so the whole issue of consumer responsibility does not have that clarity. We have two regulators in that space, in an auto-enrolled world. There is the Pensions Regulator if it is a trust-based provision and the FCA if it is a contract-based provision.

From the scheme member point of view, remembering it is auto-enrolment, it is the issue of how the quality standards are set and controlled for those entering the pensions market in an auto-enrolled world. It is the co-ordination between the FCA, the TPR and, if I may say, possibly even one regulator doing the issue of the quality standards for coming into that market. Do you have any comments on that?

Martin Wheatley: It is a good question. Our responsibility is looking at the sales and marketing of pensions. The Pensions Regulator oversees the occupational pension scheme and then clearly these changes and entry into the market. We have separate but complementary objectives. We will have to work very closely together with the Pensions Regulator to make sure that we both share knowledge and experience. If there are joined issues that need to be addressed, we will have to address those joined issues.

A change to the industry is coming and we need to work out and make sure that the current dovetailing of our two sets of responsibilities can continue in that new environment. It is a very valid point.

Q1003 Baroness Drake: On the entry point thereafter, once you are, in you would go to your relevant regulator, but in terms of the quality standards that have to be met in order to enter that market and provide through the employer pension provision, if that was given to one regulator to do that gateway, would that pose a problem for the FCA?

Martin Wheatley: No. It would have to be given to one regulator. That sits with the Pensions Regulator currently, but then any subsequent sales, marketing and transfers would be subject to oversight by the FCA.

Q1004 Baroness Drake: I don't think it is that clear-cut. What you are saying is that it would not pose a problem to the FCA, in your view, if a series of standards were set as the gateway for coming into that market and that rested with the TPR.

Martin Wheatley: No, it would not. We would want to have a discussion and be involved in that process.

Baroness Drake: That is very helpful; thank you.

Chairman: Thank you very much indeed for your evidence and the succinctness thereof. There may, however, be some questions which we have not addressed, and we will write further for clarification. There is also the item you are going to give in response to Mr Brown's question. Thank you very much indeed for your time and help.

Financial Services Authority – supplementary written evidence

1. Since we sent you our memorandum in September, our thinking on issues related to the Financial Conduct Authority (FCA) has continued to develop. This memorandum reflects the written evidence we have recently submitted to the Treasury Committee in their inquiry on the FCA and sets out in more detail our position on:
   - the FCA's strategic objective;
   - the FCA's proposed role in competition in financial services markets;
   - the accountability of the FCA; and
   - the new powers in the draft Bill related to reports on regulatory failure.

The FCA's strategic objective

2. In our previous memorandum we said we would favour a change to the FCA's strategic objective. On further consideration, we are concerned that the formulation in the draft Bill, 'protecting and enhancing confidence in the UK financial system', does not adequately capture the distinctive nature of the FCA's responsibilities and that it overlaps significantly with the responsibilities of the Prudential Regulation Authority (PRA) and Financial Policy Committee (FPC). The PRA's focus will be financial stability and the prudential soundness of individual firms – which is of course very relevant to the FCA's strategic objective. 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'.

The FCA's proposed role in competition

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 our regulatory approach at that time, and our understanding of the OFT and Competition Commission's respective areas of focus and responsibilities, we 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[150].

- **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

[150] **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.

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:
   - 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 size 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 4. 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 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: *(a) Securing an appropriate degree of protection for consumers.*	*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.	*(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.*

FCA accountability

17. In our previous memorandum to the Committee we recognised the need for robust arrangements to hold the new regulatory authorities to account for their performance and the achievement of their objectives. 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.

18. 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.[151] The FSA Board strongly supports this approach.

19. 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.

20. 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, on the one hand, the benefits of financial innovation and, on the other, 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.

21. 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.

22. We also believe the Treasury 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 the Treasury 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 Treasury Committee on the FCA's published Business

[151] 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.

Plan, setting out its priorities and budget for the coming year, which should offer a useful forum to discuss the FCA's future strategy.

23. 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 the Treasury 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.

Reports on regulatory failure

24. 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.

The triggers for reports on regulatory failure

25. 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.

26. 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 explained in our previous memorandum to the Committee, the FCA will not aim to eliminate all failure in financial markets nor will it seek to ensure that no consumer ever suffers loss.

27. 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 are uncertain and subjective risk 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.

28. 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 about at what level they should be set.

29. 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.

The timing of such reports, and the link to enforcement action

30. 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.

31. 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.

32. 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; and third, to give priority to enforcement action. In 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

33. 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 about 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.
    - 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.

34. 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

35. 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 view, it would be more cost effective to resolve any contentious matters in the context of an enforcement action first.

36. 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.

37. 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.

38. 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.

39. 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.

26 October 2011

Financial Services Authority – further supplementary written evidence

1. In the oral evidence session on 10 November you asked us to provide further information on issues relating to the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA). Subsequently, in your letter dated 14 November you asked some further questions relating to the PRA.

2. On the PRA, this memorandum covers:

   - further comments on the implementation of FPC directions;
   - the international definition of shadow banking;
   - further comments on whether PRA-regulated activities are sufficiently flexible to allow consideration of further risks;
   - the role of the PRA in relation to competition;
   - the duty of the PRA to secure an appropriate degree of protection for the reasonable expectations of 'with-profits' policyholders; and
   - further comments on threshold conditions (on which Paul Tucker and Hector Sants have written separately to the Committee).

3. On the FCA, this memorandum covers:

   - our preferred approach to competition and how this would work in practice;
   - our proposed approach to firms' responsibility in the draft Financial Services Bill;
   - further comments on the rule book; and
   - further clarification on pensions regulation.

Financial Policy Committee Powers

Implementation of FPC Directions

4. The FSA is supportive of the concept, as laid out by the Bank of England, that the FPC can direct the PRA or the FCA both as to means and timing. However, it is important that this is restricted to the powers to direct rather than recommend. We would, accordingly, support the Bank of England's suggested amendment.

FPC Information Gathering Powers

5. The FSA agrees with the Bank of England that the FPC should have powers to gather information directly from those firms that are outside the regulatory perimeter. However, we do not think that this would be necessary for those firms within the perimeter, given that this information can be obtained through the FCA or the PRA, particularly given that the FPC has the power to direct the FCA or the PRA to collect such data. Giving the power to the FPC to directly collect data is not consistent with proportionate and cost effective regulation. Indeed, allowing other areas of the Bank of England to collect information directly from regulated firms could well lead to confusion and extra administrative cost.

Definition of Shadow Banking

6. In a recent paper by the Financial Stability Board (FSB) dated 27 October 2011, shadow banking was broadly defined as 'credit intermediation involving entities and activities outside the regular banking system'. The report acknowledged that this was an extremely broad definition and recommended that authorities should focus in particular on those activities that involve four key risk factors: (i) maturity transformation, (ii) liquidity transformation, (iii) imperfect credit risk transfer; and (iv) leverage.[152] The Committee may find it useful to look in some detail at this report.

Prudential Regulation Authority

PRA regulated activities

7. As the Committee is aware, the design of PRA regulated activities is a matter for HM Treasury. It is important that the Bill clearly signposts that the PRA focus should be on those firms which could potentially impact financial stability and that the perimeter is not defined by the concept of deposit taking and insurance. We would envisage that the FPC would monitor the perimeter, with input from the PRA and FCA, and raise its concerns in relation to regulatory activity with HM Treasury. The PRA and the FCA could also raise its concerns directly with HM Treasury about regulatory activities if that was necessary.

8. We recognise that shadow banking throws up particularly difficult issues, partly because the phrase shadow banking covers a variety of different activities, as discussed above. It is likely that an attempt to deal with shadow banking may lead to some sort of legislative change, but depending on how you characterise the problem and, therefore, what solution you may arrive at, the level of legislative change may vary considerably.

The role of the PRA in relation to competition

9. We would not support the Bill giving the PRA a duty to have regard to competition. In the UK the banking sector is so large in relation to the economy as a whole that financial instability generated by a failure of the banking system will almost inevitably lead significant consequences for the wider economy. We agree with the government's policy to take particular care in regulating the financial services sector to safeguard UK financial stability. As a result, we believe that it would be unduly risky to require the PRA to have regard to competition. This is for two reasons.

10. First, the prudential regulator's job is to ensure that firms are run safely and soundly, and to seek to minimise the impact of their failure on the wider economy. The new regulatory system is intended to lessen the likelihood of future crises by creating a regulator whose sole focus is on prudential regulation. Exploring possible trade-offs between competition and stability would dilute the PRA's focus on prudential issues.

[152] http://www.financialstabilityboard.org/publications/r_111027a.pdf

11. Second, while increased competition might in some limited circumstances have some potential benefit in terms of wider financial stability, there is no certainty as to in what circumstances this benefit might arise, nor indeed what its impact might be. The PRA would effectively be given a remit which it would find very difficult to meet, and in relation to which the benefits themselves are uncertain in practice.

12. For those reasons, we would therefore be very wary of inserting a provision into the Bill which required the PRA to consider competition impacts either in making rules or in relation to individual firms

The duty of the PRA to secure an appropriate degree of protection for the reasonable expectations of 'with-profit' policyholders

13. The term 'policyholders' reasonable expectations' arises from the Insurance Companies Act 1982. The phrase was intended to provide a basis for regulatory intervention for the protection of policyholders in relation to non-contractual benefits but that Act did not define what the phrase 'policyholders' reasonable expectations' meant. In particular, it gave rise to a lack of clarity as to how those expectations were formed, what the substance of them was, and what actions the firm (and the regulator) should take in relation to them.

14. Even though the Insurance Companies Act has been repealed, the phrase 'policyholders' reasonable expectations' still features in our discussions with firms, and in the industry in the wider context of the fair treatment of customers. It illustrates the need to encapsulate in some way how firms should be expected to behave in relation to discretionary benefits under with-profits policies but we think that, by referring to 'policyholder expectations', clause 3F in its current form risks perpetuating this lack of clarity by reintroducing this undefined term. The concept of 'policyholders' reasonable expectations' has in any event been subsumed within the FSA's existing Principle 6 (Treating Customers Fairly Principle) and its more detailed rules on with-profits which set out the specific features of what might previously have fallen under this concept. We think it would represent an unfortunate retrograde step if this phrase were to appear in the Bill.

15. We recognise that there is a substantial and complicated overlap between conduct and prudential issues in the case of with-profits insurers, in that many actions which a firm takes to protect its prudential position can have an impact on the returns generated to policyholders. For example, a firm which changes its investment strategy to invest primarily in bonds will be prudentially more robust, but may deliver a lower level of return to policyholders than one which is less prudentially sound because it invests in more volatile securities. The judgement of where to draw the line between fairness to policyholders and the prudential soundness of the firm is always a difficult one for the regulator.

16. We should be clear that the FSA supports the general policy aim that the clause is intending to achieve – to avoid a situation where having two regulators for with-profits insurers leads to regulatory underlap, (in the extreme) leading to the risk of another Equitable Life. But the current clause does risk, as the Bank has said, perpetuating a lack of clarity and leaving the PRA and potentially the FCA open to challenge. We would therefore welcome an alternative formulation which moves

away from allocating regulatory responsibilities on the basis of the rather vague concept of what policyholders might reasonably expect.

17. We think it is important that the proposed clause gives a clear role to both the PRA and the FCA so that they – and society more widely – are able to understand what the regulators have to do to meet their objectives. The PRA is a prudential regulator, and its focus in supervising insurers will therefore necessarily be on the safety and soundness of the firms it regulates. However, wherever the line is drawn, the fact of the matter is that a great many decisions concerning the safety and soundness of with-profits insurers will also give rise to real questions of fairness to policyholders. We think it is vitally important that in taking such decisions the PRA has regard to the FCA's advice and makes significant use of the FCA's expertise in consumer protection matters.

18. In summary, it is important to recognise that it is a far more complex and risky task to operate a twin peaks model with insurers than it is with banks. In our view the objective should be to minimise the risk of confusion in this area by ensuring that there is clear lead responsibility with the PRA for all matters that relate to the soundness of the balance sheet. This conclusion draws on the lessons learned in the case of Equitable Life.

Threshold Conditions

19. We share the Bank's concern that the current Threshold Conditions do not adequately capture the essence of good supervision. We therefore would support rewriting Threshold Conditions so that they represent a clear articulation of the approach to supervision that will be taken by the PRA and the FCA. Having a clear statement of this supervisory approach would also address some concerns around what is intended by the use of the term 'judgement based supervision'. The essence of this is that the regulator should make a forward looking judgement as to what might happen in the future, as opposed to restricting interventions to breaches based on observable facts, i.e. form its own judgement as to what might happen in the future and intervene in those circumstances where its judgement is at a variance with that of a firms. This can be contrasted with the historic approach of the FSA, which was reluctant to intervene unless there were regulatory breaches based on observable facts. Rewriting the Threshold Conditions would give clarity as to the key elements which these forward looking judgements would be applied to.

20. Paul Tucker and Hector Sants have written separately to the Committee with further comments on threshold conditions.

Financial Conduct Authority

Our preferred approach to competition

21. 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.

22. 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 FSA's preferred approach

23. 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:

    - 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 – e.g. 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.

24. 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 possesses 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 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).

25. 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: *(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'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, 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

26. 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[153] below.

Example 1 – Concentrated market

27. In this example we consider a mortgage market where the largest firm has a market share of around 40%.[154] 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. The market may work reasonably well, with a range of different sized competitors competing vigorously.

28. In order to decide whether the 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;

[153] Each of these examples is hypothetical and simplified for the purpose of illustration.
[154] We have assumed this is a situation the FCA would inherit. Under our Preferred Approach the FCA would keep markets under review so that, over time, the FCA would be alive to firms increasing market share, for example through predatory behaviour. If the FCA believed that a firm may be behaving in a predatory way, it could pass on information to OFT (subject to appropriate gateways) for it to consider whether there was sufficient evidence of a breach of the Competition Act.

- 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 of prices (and how easily customers can compare).

29. 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 (e.g. limiting exit charges).
- reduce barriers to entry or expansion, enabling existing firms and new entrants to compete more effectively.

30. An alternative approach, in the circumstances outlined in paragraph 7, 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 now does), or seek an undertaking from the firm to divest a part of its business, in lieu of a reference.

31. 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 transactions between companies. We believe this is best dealt with by specialists in merger control with expertise across a wider range of sectors[155] 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

32. 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.

[155] In addition, few financial services markets are concentrated.

33. If the FCA obtained market intelligence suggesting such behaviour, it would pass this to the OFT[156] (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

34. Products, such as Payment Protection Insurance (PPI), 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.[157]

35. 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).

36. 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

37. Giving the FCA the power to deal with super-complaints from designated bodies would open 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 supercomplaints. 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 Financial Ombudsman Service will be able to bring problems to the FCA's attention and how the FCA should respond.

Firms' responsibility

[156] Or the relevant European authorities, where appropriate.
[157] Partly because firms have difficulty selling the product on a stand alone basis.

38. 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.

39. 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.

40. 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.

The new regulators' rulebooks

41. As we set out in our memorandum of 2 September, 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 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.

Pensions regulation

42. The FSA and The Pensions Regulator (TPR) have a number of complementary regulatory responsibilities which are defined under the Financial Services and Markets Act (FSMA) and the Pensions Act. The responsibilities of each regulator are currently set out in our Memorandum of Understanding. The scope of both FSMA and the Pensions Act are the responsibility of HM Treasury and the Department for Work and Pensions.

43. The FSA regulates the sale and marketing of investments, including personal pensions. We also regulate the providers of these products, for example insurance companies and SIPP operators.

44. TPR mainly regulates work-based pension schemes (that is, primarily occupational pension schemes). TPR regulates work-based pension schemes focussing mainly on employers, scheme trustees and managers, and their advisers.

45. In view of this, we do think that there is sufficient clarity for consumers about how pension products are currently regulated and that it is appropriate for these arrangements to carry over into the new regime. However, it should be recognised that in the long term, particularly if as expected we see further growth in defined

contribution schemes, there is a case for Parliament to look again at the current system of regulation around pensions.

21 November 2011

Financial Services Authority and the Bank of England – further supplementary written evidence

Evidence to be found under Bank of England

Financial Services Authority and the Bank of England – further supplementary written evidence

Evidence to be found under Bank of England

Financial Services Authority Smaller Businesses Practitioner Panel; Association of British Credit Unions Limited (ABCUL); Association of Financial Mutuals; Building Societies Association; Association of Independent Financial Advisers; Institute of Financial Planning; International Regulatory Strategy Group; Financial Services Practitioner Panel; Financial Services Consumer Panel and Office of the Complaints Commissioner – oral evidence (QQ 438-557)

Transcript to be found at Association of British Credit Unions Limited

Financial Services Compensation Scheme – written evidence

1. The Financial Services Compensation Scheme (FSCS) welcomes the opportunity to submit evidence to the Joint Committee on the Financial Services Bill.

Dual accountability and independence

2. The FSCS is pleased to note the commitment in the Bill to maintain the FSCS as a single safety net for consumers. Preserving the FSCS's independence in operational decision making will provide clarity and assurance for consumers and levy-payers, while maintaining a unified compensation scheme will enable the FSCS to draw efficiently on its critical mass of capabilities in responding to an unpredictable and fluctuating workload. A single compensation scheme also promotes increased recognition and awareness of the FSCS, which plays a part in consumer confidence and contributes to financial stability.

3. The Scheme welcomes the commitment in the Bill to give the FSCS dual accountability to the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA). This recognises the FSCS's important dual role in both supporting the orderly resolution of systemically important businesses and in protecting consumers who lose money when other financial businesses fail. Dual accountability will also help ensure a joined up compensation service for consumers and give the FSCS the access it needs to the two key players in the new regulatory framework.

4. The FSCS supports the proposals to enhance the accountability of the FSCS by requiring it to produce an annual plan and be subject to the National Audit Office, which is in line with the Scheme's commitment to openness and accountability.

5. Both the PRA and FCA will have a legitimate interest in the operational efficiency and effectiveness of the Scheme as a result of the dual accountability the FSCS has. The proposal for the FSCS to produce an annual plan will build on the long standing work the FSCS has already completed in these areas.

Liaison with regulators

6. The FSCS welcomes the debate about the regulatory framework and the important role it plays within it. We believe the time is right to learn from the lessons of the past few years and to build on the changes that are already underway. Our top priority is to enhance our ability to deliver a responsive compensation service to consumers and, in doing so, to underpin financial stability.

7. Following Northern Rock, the FSCS collaborated with the Tripartite Authorities in the reform of the banking sector, culminating in the Banking Act 2009. The Scheme has since worked closely with the Authorities in contingency planning, and implementation of the banking reforms, in particular for faster payout of depositor compensation and the special resolution regime (SRR). The FSCS is working with HM Treasury on the UK's response to the European Commission's current proposals for reform of the Deposit Guarantee Schemes Directive, the Investor Compensation Directive and its White Paper

for an Insurance Guarantee Schemes Directive. The FSCS believes that consideration should be given to the need for similar SRR powers for insurance failures.

8. The FSCS believes there is a critical need to enhance contingency planning and to maintain all the benefits of an integrated scheme for the highly developed and highly integrated UK market. The Scheme must be involved early on in contingency planning and have a seat at the table to build on the SRR approach. This is essential to provide an efficient and effective response, especially one that involves a consumer payout.

9. It is important to build on the relationships developed during the banking crisis, for example the role of the Scheme in the special resolution regime. Good progress has already been made in this regard by, for example, protocols agreed by the FSCS with the National Loans Fund and the Bank of England, and an updated Memorandum of Understanding with the FSA. Such arrangements should be strengthened and formalised following reform to ensure that the FSCS is party to contingency planning with the Authorities. In particular, we consider that FSCS should, in collaboration with PRA, have a continuing role in ensuring that the Single Customer View (SCV) files maintained by banks, building societies and credit unions to facilitate fast pay-out and supporting systems remain fit for purpose. As part of this FSCS would expect to make regular visits to businesses alongside the regulators. This would also mean that FSCS's presence would cease in itself to be taken as a sign that a firm was in financial difficulties.

10. As well as Memoranda of Understanding's between the FSCS, the FCA and the PRA. It will be important to have regular tri-lateral contact. We would therefore consider that the Bill should ensure the flexibility for full disclosure gateways between the FSCS and the FOS. This will aid clarity of responsibility and a timely response when failures happen.

11. Accountability should also be reciprocal – the PRA (and the Bank of England Special Resolution Unit) would need to commit to the participation of the Scheme in contingency planning and collaborate on the development of payout solutions e.g. the Single Customer View presently being implemented in the UK to promote faster payout. The FCA would need to work with the scheme to ensure that conduct of business and the compensation rules adequately protect the consumer e.g. that appropriate disclosure arrangements are in place so that consumers are aware of what firms and activities are, and are not, protected. This is essential to consumer protection and to enhancing consumer awareness of the FSCS protection across financial services.

Review of Gateways

12. There is much change on the horizon resulting from potential changes from European Directives in the deposits and investment and insurance areas. The draft Bill takes account of these developments.

13. In our view, detailed and comprehensive planning and sharing of information should become engrained in the regulatory relationships between all safety net players, including the compensation scheme. We would therefore suggest the Bill provides the flexibility for new disclosure gateways between the FSCS and the Financial Ombudsman Service. This will allow both organisations' to learn detailed lessons from failures.

14. Formal information sharing we believe would strengthen contingency planning and also allow the regulators to learn more quickly from trends in the marketplace and compensation.

September 2011

Financial Services Compensation Scheme; Financial Ombudsman Service; Money Advice Service; Reserve Bank of Australia; Consumer Focus; Which?; Citizens Advice Bureau; moneysavingexpert.com and Mr Paul Lewis – oral evidence (QQ 99-206)

Transcript to be found under Consumer Focus

Financial Services Consumer Panel – written evidence

Summary

The Consumer Panel welcomes the opportunity to comment on the draft Financial Services Bill, and would be happy to give further evidence to the Committee. It has commented in detail on many of the questions, but in summary its views are:

1. The Panel welcomes change that leads to more effective regulation, but work needs to be done on the detail to ensure that the changes do not lead to an ineffective and inefficient version of the current FSA.
2. If consumers are to take responsibility for their decisions, this would be more realistic if the authorised firms with which they deal have a fiduciary duty towards them and if all matters relevant to the conduct of such firms are disclosed.
3. The Panel has carried out international research which shows that in the area of regulatory transparency the existing FSA is at the more transparent end of the spectrum, but there are areas where its approach could be improved in future.
4. In order to achieve its objectives, the FPC should have a duty to consider representations made to it by the Consumer Panel. Any macro-prudential instruments considered by the FPC must be subject to rigorous cost benefit analysis which takes account of the goals of both financial stability and consumer welfare.
5. The Consumer Panel must retain its function for the PRA, in order to advise on prudential matters in general and the interests of with-profits policyholders in particular.
6. The PRA should have a specific 'have regard' to the need to minimise the adverse affects on competition that may arise from anything done in the discharge of its function.
7. Relying on increased disclosure of information is not sufficient to ensure consumer protection and the FCA must be mindful not to rely on this in carrying out its consumer protection obligations.
8. Relating to competition powers, the proposals are excessively complex. The starting point should be the assumption that the FCA is the lead on competition issues in financial services. It should refer to the Competition Commission only if structural change needs to be considered.
9. The proposed new powers relating to financial promotions are welcome. In conjunction with the product intervention power this will assist the FCA in preventing inappropriate products reaching the market. The Panel believes there should be a presumption in favour of publication of action in the case of misleading promotions. Additionally, the FCA should have the ability to publish information of disciplinary action without consultation with the firms involved, where it considers there is a risk of serious consumer detriment.
10. The FCA should have the ability to publish information received for the purposes of its functions under FSMA, where it considers this appropriate.
11. The FCA's third operational objective should be amended to 'promoting efficiency, *access* and choice in the market for certain types of services'.**Responses to**

Questions

1. Is the separation of prudential and conduct regulation into a "twin peaks" system the right approach?

The Panel welcomes change that leads to more effective regulation, but believes work needs to done on the detail to ensure that the changes do not lead to an ineffective and inefficient version of the current FSA. The need for legislation to implement the twin peaks structure gives us an opportunity to look again at the Financial Services and Markets Act (FSMA) to make sure it works.

In particular, the FCA needs to get conduct supervision right to help the financial services industry rebuild trust. There is still some way to go before it will become clear whether the benefits of the transition to 'twin peaks' will be realised in practice. The Panel has responded separately to the FCA's approach document, which it believes is a step in the right direction, and is pleased that the FSA is already starting to put consumers at the centre of its thinking. But it still wants evidence that the FCA will be different to the FSA, with an appetite to use its new powers, a willingness to intervene before problems get serious and a recognition that the root causes of detriment need addressing as well as the symptoms.

The Panel has concerns that the issues of coordination and authority in the way the FPC, PRA and FCA work together may simply replace the multiple objectives that caused confusion in the current structure. These processes and responsibilities must be clarified and resolved. This is discussed further in the response to question 4. The cost and effort of moving to twin peaks needs to provide something better for consumers.

2. What lessons can be learnt from the approach of other countries to regulation of the financial sector?

The Panel has published research into the specific area of transparency as a regulatory tool, which is relevant to a number of the areas addressed by the Bill. Its objectives were to benchmark the performance of the FSA and to identify the most interesting international examples of the use of transparency as a regulatory tool. Seven countries were reviewed - Australia, Canada, France, Germany, Japan, Sweden and the United States.

The research found that in some areas the FSA's arrangements place them at the more transparent end of the spectrum, although there are areas for potential improvement.

Relevant points from the research include:

The transparency of regulators' governance procedures

The FSA emerges as above average, but certainly not the leader, in terms of the transparency of its governance processes. It provides somewhat anodyne summaries of its board minutes and details the attendance record of board members. The only other countries where board minutes are released are Sweden and the US. In both these cases the level of detail provided appears to be greater, and more insightful, than that provided by the FSA, especially in the US. Easily the most extensive initiatives in transparent governance are from the US, largely under the influence of the many so-called 'Government in the Sunshine' Acts at state and federal level. Examples include the prior release of board agendas and non-confidential board papers and the holding of open board/commission meetings including the live and archived web-casting of such meetings.

Publication of complaints data
The publication of firm-specific complaints data makes the FSA one of the more transparent regulators, but examples were found that provide considerably more detail and analysis of complaints. A particularly important consideration is the extent to which information is truly helpful to consumers unless it is provided alongside market share or similar data to put it in to context. The decision of the FSA not to insist on directly comparable context data is a weakness in this area.

Disclosure of information during the enforcement process
Although in some respects the FSA is not currently out of line with international practice, the enforcement process in the UK is different to other countries. This leaves more scope for extending information disclosure across the process. A limited number of instances of information being released before the end of enforcement processes were found. Some organisations release details of those sanctioned once the regulator's own processes are complete but before the respondent has decided whether to appeal. This is discussed further in the answer to question 17.

Disclosure of complaints data about financial promotions
The Panel recommends stronger action in this area by the new regulators (see also the answer to question 17). Internationally, there is considerable diversity in the methods used by regulators to enforce compliance of financial promotions, ranging from purely reactive to very proactive approaches. The most proactive methods used to enforce compliance were found in the US.

Further details of this research are available on the Panel's website[158].

3. Is it appropriate to make such major changes to the regulatory system by way of amending legislation, rather than starting afresh?

No comment

4. Are the accountability and governance arrangements for the Bank of England, FPC, PRA and FCA satisfactory?

Financial Policy Committee
The Panel has concerns about the structure and functioning of the FPC as currently conceived, and in particular the lack of diversity in the membership, in that the majority of members are directly connected to the Bank of England. A more robust structure would include a wider range of experience, with the majority of members not from the Bank, in combination with an adequately resourced independent secretariat.

The FPC will seek to achieve its main objective by identifying, monitoring and taking action to remove or reduce systemic risks. These systemic risks include in particular unsustainable levels of leverage, debt, or credit growth, where 'credit growth' is defined as the growth in lending by the financial sector to individuals and businesses in the UK, and 'debt' is debt owed to the financial sector by individuals and businesses in the UK.

[158] 158 *Transparency as a regulatory tool: a international literature review*, by John Leston for the Consumer Panel, October 2010

As part of its concerns about the breadth of knowledge and experience of the FPC, the Panel believes it should have adequate information from a consumer perspective on factors which may be influencing the levels of debt and credit growth and which contribute to the sustainability of these levels.

As it stands, there is no direct consumer representation on the FPC. This could be resolved by requiring it to consider representations made by a body such as the Consumer Panel, in the same way the FCA will be required to do.

It proposes the following section to be inserted into the Bank of England Act:

'The FPC must consider representations that are made to it by the Consumer Panel in accordance with arrangements made under section 2J of FSMA section.

The FPC must from time to time publish in such manner as it thinks fit responses to the representations'

The Panel has a breadth of experience in the areas of consumer debt and credit. It has in the past carried out its own research into, for example, mortgage arrears[159] and the experiences of consumers with overdrafts[160], as well as providing input and advice to the FSA and others on the consumer credit regime, mortgages, insolvency, banking services, credit and store cards.

Prudential Regulation Authority (PRA)
The Consumer Panel believes its function should be retained for the PRA. The justification given for its removal is that PRA will be taking decisions on prudential matters, and that the PRA will be required to consult the FCA to take advantage of its expertise on consumer issues.

The Panel believes this reasoning is wrong on two counts. First, it believes prudential matters are as valid a subject for direct consumer input as conduct of business issues. This is particularly the case given that the PRA will have sole responsibility for insurance and for securing an appropriate degree of protection for with-profits policyholders.

Additionally, although the FCA will have consumer expertise, in its relationship with the PRA it will inevitably be balancing a number of different viewpoints, including industry as well as consumer. There is serious risk that the consumer interest will not be given proper consideration.

The PRA will have a statutory duty to put into place arrangements for engaging with practitioners (although what form this will take has still to be decided) – to delegate responsibility for consumer input to the FCA is to place the interests of consumers on a lower footing than that of the industry.

The Panel has in the past been acknowledged as a credible, authoritative and constructive body advising the FSA on prudential as well as conduct of business issues. It is currently in a

[159] *Mortgage Arrears*, Financial Services Consumer Panel, June 2009
[160] *Overdraft Complaints*, Financial Services Consumer Panel, June 2008

unique position in that it can represent consumer issues while regulation is being developed, before that regulation reaches the public domain. To discontinue a relationship which already exists is to leave a gap in the regulatory jigsaw.

Financial Conduct Authority (FCA)
The Consumer Panel regards its continuing input to the regulatory process as a key aspect of the new regime, and is content that the wording of section 1L is a sound foundation for such input to the FCA.

The Panel is in favour of a drive towards greater transparency of regulation, and as such supports new section 1M(2) requiring the FCA to publish a response to representations received, regardless of whether it is in favour of such representations.

However, as noted elsewhere, it believes that a similar duty for the PRA and the FPC should be an integral part of the regulatory process.

Coordination processes
The Panel is concerned that there is little detailed information on coordinating the activities of the PRA and the FCA with the European Supervisory Authorities – in particular to ensure the PRA has input to and receives information from ESMA and the FCA input and information regarding the EBA and EIOPA. Details of structures and communication strategies need to be included in the MOU covering international cooperation.

Cost benefit analysis
The Panel agrees that there should be no significant reductions to the existing FSMA requirements to consult on rules. It is appropriate that regulators will continue to conduct cost benefit analysis of rules originating from Europe, on the basis that there are in practice few, if any, instances where there is absolutely no discretion or room for interpretation when implementing such rules.

The Panel strongly believes that the existing FSMA requirement to conduct a cost benefit analysis, where this is defined as an estimate of the costs together with an analysis of the benefits that will arise from a new rule, is a sounder foundation for regulation than the proposals for an analysis of costs and benefits, which may well lead to less quantification and worse decision making. At the very least, the existing definition of cost benefit analysis should be retained.

Our preference would be for a statutory requirement for the PRA and FCA to estimate both the costs and benefits of proposed new rules: the new legislation should be taken as an opportunity to improve rather than water down the evidence base used in consultations.

The Panel's view is partly informed by its experience of the FSA's current Mortgage Market Review. The statutory requirement on the FSA to estimate costs, which it had failed fully to do in its July 2010 consultation, puts the Panel in a far stronger position to press the FSA for a "robust and credible CBA", a request to which the FSA has now responded.

5. Are the FPC's objectives the right ones? Is the concept of financial stability adequately understood for the FPC to be able to perform against its objectives?
and

6. Should the FPC be limited in the actions it can take which might affect the growth of the financial sector?

The relatively narrow objective of the FPC, focusing on financial stability, should not restrict its ability take account of the wider impact on the economy and society of its actions.

The Panel proposes that the FSA should pro-actively engage with the interim FPC to subject each macro-prudential instrument to a rigorous cost benefit analysis which takes account of the goals of financial stability and consumers' welfare. This preparatory exercise would facilitate the selection of preferred macro-prudential tools that would contribute most to financial stability while inflicting least direct damage on consumers, judged in terms of the impact on the availability and cost of financial services, including mortgages. Except in circumstances of immediate crisis, we would also expect the FPC, once fully operational, to consider in consultation with the FCA the consumer welfare implications of macro-prudential interventions.

7. How will the interaction between macro-prudential and monetary policies be handled by the FPC and the MPC?

No comment

8. Has the right balance been struck between the powers of the FPC and the powers of the Treasury?

The Panel is concerned about lack of diversity in the membership of the FPC. It will be a sub-committee of the Court of the Bank, chaired by the Governor of the Bank. In addition, a majority of the members and the Chairman will be drawn from the executive management of the Bank, with one non-voting representative from the Treasury. In our view this does not provide the necessary checks on the decisions taken by the Bank's executive management. For further details of the Panel's views, please see its submission to the Treasury Committee Inquiry into the Accountability of the Bank of England[161].

9. Can Parliament take an informed decision about the proposals for the FPC without details of the macro-prudential tools at its disposal?

It is difficult to comment without further details of the macro-prudential tools. As outlined in the response to questions 5 and 6, any macro-prudential tools should be subject to cost benefit analysis which takes account of the goals of financial stability and consumer welfare.

10. Does the draft Bill adequately deal with the risks posed by the shadow banking system?

No comment

11. Are the PRA's objectives clear and appropriate?

Insurance objective

[161] Consumer Panel Response to the Treasury Committee Inquiry into the Accountability of the Bank of England, March 2011

The Panel welcomes the proposals that the PRA's objectives will now make specific reference to its responsibilities with regard to insurers.

This reflects the different priorities, timescales and business models of the insurance industry when compared to the banking industry. It particularly welcomes the requirement to secure an appropriate degree of protection for those consumers who are or may become policyholders.

Regarding the PRA's objective to regulate policyholder reasonable expectations (PREs) for with-profits policies, the Panel has in the past been broadly supportive of the FSA's approach to protecting the interests of with-profits policyholders[162]. However, the reference to the term 'policyholder reasonable expectations', is unhelpful in this context. There is no universally accepted definition of the term, and its use could lead to potential confusion. We would recommend that section 3F(1) refer only to 'an appropriate degree of protection for policyholders'.

Competition
The Panel agrees that competition should not be a primary objective for the PRA, but does have concerns that its actions could potentially have a damaging effect on competition and consumer welfare. It is important that issues such as barriers to entry are considered, as well as the concerns of large institutions. Therefore it proposes that the PRA's regulatory principles should include:

"The PRA must have regard to the need to minimise the adverse effects on competition that may arise from anything done in the discharge of its functions".

12. Are there any risks in the Government's proposed 'judgement-based' regulation?

The Panel supports judgement-based intervention if it leads to action before actual crystallisation of consumer detriment, and particularly if it leads to an increase in the cases where the spirit as well as the letter of the rule has been applied (thus increasing the effectiveness of regulation and decreasing the resource necessary to enforce it).

13. Is the Government's proposed approach to 'orderly' firm failure satisfactory?

Currently the guarantee provided for depositors through the Financial
Services Compensation Scheme is directly linked to the authorised institution within the group providing the account, rather than to the account brand – it is limited per authorised firm. For example, Smile, Britannia and Unity Trust Bank are all part of the Co-Operative Bank plc group and in order to ensure that all their deposits were covered in full by the FSCS, customers with accounts at more than one of these banks would have to know that this was
the case, and ensure that the total monies held did not collectively exceed the current limit of £85,000.

It would be far more logical and sensible from a consumer perspective for the compensation limit to be applied per brand or per company within a group. That is how accounts are sold

162We have previously commented on this area in our response to CP11/5*** *'Protecting with-profits policyholders'* http://www.fs-cp.org.uk/publications/pdf/cp115_with_profits_final.pdf

and the basis on which customers buy them. It would also make for clearer statements about the level of consumer protection in the event of a future bank failure. The resistance to this is largely due to the "moral hazard" introduced by encouraging proliferation of brands under a single authorised entity. The way to resolve this is to require all banking brands to be separately authorised, something those outside the industry would expect to be happening already.

We would also support measures to speed up the process of honouring claims. Progress which has already been made by some firms to ensure that the depositors of a deposit-taker in default will have access to at least a proportion of their funds within seven days is welcome, but this could be even faster, as is the case in other countries.

14. Given that the PRA and the FCA will inherit FSA staff does the draft Bill do enough to ensure a new regulatory culture and a more proactive approach to regulation? Will these two new bodies have staff with the appropriate skill and expertise?

The Panel is concerned that the FCA and PRA will need considerable investment in staff resources to deal with its supervisory responsibilities. It is not clear that the funding envisaged for the FSA and PRA will be sufficient to discharge these functions, and it is important that they should be allowed to raise a realistic budget.

As well as the amount of resource, the Panel is concerned about the balance of skills. To achieve its objectives, the FCA in particular will need not only staff with consumer and policy expertise and experience of financial services, but also economists. Getting this balance right matters both at Board level and also throughout the entire organisation. It is essential not just to the work of the organisation, but also to address the potential problem of regulatory capture, which is a failing the FSA has been accused of in the past.

15. Are the FCA's primary objectives appropriate? Is significant emphasis given to the promotion of competition?

Consumer protection objective
The consumer protection objective is of particular relevance to the Panel. It agrees with the requirements for the FCA to have regard to risk issues, experience and expertise. It particularly welcomes the requirement to have regard to consumers' needs for advice and accurate information, but would point out that information disclosure in itself is not sufficient to ensure consumer protection. Information must be supplied in a format, and quantity, that consumers need and can use to make informed decisions.

We would not argue with the need for consumers to read key information and answer questions honestly, but there is an unacceptable view in some sectors of the industry that complex and potentially detrimental products can be widely promoted, provided they are transparent through good disclosure. This is accompanied by an expectation that consumers can, and should, acquire the skills, knowledge and understanding required to deal with this complexity and choice, which places an unreasonable burden on the consumer and is not an approach adopted by other industry sectors.

There is evidence indicating that providing more information can be counterproductive. The FSA's 2008 report on behavioural economics[163] suggests that 'attention is a scarce resource and processing power is limited' and makes reference to research that indicates that introducing additional information, even if accurate, may lead to worse decision-making outcomes. Further evidence[164] suggests that 'information overload' can lead to procrastination and poor decisions. Therefore the Panel would strongly recommend rigorous testing of any initiatives involving consumer-facing information to ensure it achieves its desired outcomes.

The Panel welcomes the requirement that the FCA must have regard to information supplied by the consumer financial education body (Money Advice Service (MAS)) in the exercise of the consumer financial education function. In support of this it recommends that the Financial Capability Baseline Survey[165] be rerun, either by the MAS or the FCA. However, the presence of the MAS should not absolve the FCA from responsibility in improving the financial understanding of consumers and helping them to engage with the market.

Competition objective

The Panel has previously stated that it believes the FCA should have an objective to promote effective competition that improves consumer outcomes in retail and wholesale markets. We have concerns that section 1B(4), 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 enough obligation.

In order to exercise a competition function effectively the FCA's powers and authority have to be equivalent to those of the sector regulators. The fact that this will not be the case, or the potential for there not to be a super-complaint process, seems a retrograde step, inconsistent with a strong competition mandate. The case for the FCA to have concurrent powers, as do other industry regulators, is to use its expertise to carry out market investigations, with reference to the Competition Commission only if structural change needs to be considered.

The Panel believes that the proposals for competition are overly complex, particularly when compared with other sectors. It recommends a more straightforward framework for the competition environment which should include the following elements:

1. The starting point should be that the FCA should (in line with its duty to discharge its general functions in such a way which promotes competition), be the lead on competition issues in financial services. Like other industry regulators it has the expertise and information derived from supervision, and can utilise this information to make informed judgements.
2. The FCA should refer competition issues to the OFT/ Competition Commission when rules cannot be made to solve a problem and structural changes may be needed.
3. It should be possible to address supercomplaints regarding financial services to the FCA, with consumer bodies, including the Panel, able to apply for designated status.

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[163] *Financial Capability: A Behavioural Economics Perspective*, FSA July 2008

[164] *Consumer Decision-Making in Retail Investment Services: A Behavioural Economics Perspective*, Decision Technology Ltd for European Commission October 2010

[165] *Financial Capability in the UK: Establishing a Baseline*, FSA March 2006

16. Are the responsibilities of the FCA towards the regulation of markets appropriate?

The efficiency and competitiveness of wholesale markets are critical for people with savings and pension funds invested in them. In particular, the proportionality of costs is important as higher transaction costs in these markets mean higher charges for consumers which have an adverse impact, especially when compounded over a lifetime of savings. The Panel has previously stated that the FCA needs the power to intervene to drive down these transaction costs, and remains concerned that it will still lack sufficient tools to do this.

17. Does the draft Bill strike the right balance between the responsibilities of consumers and firms? Are the FCA's new powers in the area of consumer protection appropriate?

Fiduciary duty

The Regulatory Principles in clause 3B of the Bill include 'the general principle that consumers should take responsibility for their decisions'. It is recognised that different consumers have differing degrees of experience and expertise (clause 1C(2)(b)). Given this, it would help consumers take responsibility if authorised persons had an explicit fiduciary duty towards their clients.

A fiduciary is someone who has undertaken to act for and on behalf of another in a particular matter in circumstances which give rise to a relationship of trust and confidence. Fiduciary duty implies a stricter standard of behaviour than the comparable duty of care at common law. The fiduciary has a duty not to be in a situation where personal interests and fiduciary duty conflict, a duty not to be in a situation where his fiduciary duty conflicts with another fiduciary duty, and a duty not to profit from his fiduciary position without express knowledge and consent. A fiduciary cannot have a conflict of interest.

The recent US Dodd-Frank Act[166] provides authority for the Securities and Exchange Commission to impose regulations requiring "fiduciary duty" by broker-dealers and investment advisers to their customers. Although the Act does not create such a duty immediately, the Act authorises the SEC to establish such a standard and requires that the SEC study the standards of care which broker-dealers and investment advisers apply to their customers and report to Congress on the results within 6 months. The SEC is due to propose rules later this year.

For consumers with limited experience and expertise, dealing with a provider of financial services which has a fiduciary duty would reduce the chances of detrimental outcomes when such consumers take responsibility for their decisions. It would be desirable to extend this approach to the generality of relationships between consumers and authorised persons.

An important outcome of the FSA's Retail Distribution Review is that independent financial advisers will no longer be able to take commission from product providers but will be paid a fee agreed by their clients, so that the adviser acts clearly as agent for the client. It would be desirable to extend this approach to the generality of relationships between consumers and authorised persons.

Therefore the Panel proposes that a further sub clause be added to clause 3B(1):

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[166] Dodd-Frank Wall Street Reform and Consumer Protection Act 2010

'the principle that, where appropriate, authorised persons should have a fiduciary duty towards the consumers who are their clients'.

The reference to 'where appropriate' allows the fiduciary duty principle to be disapplied in certain cases if, after consideration, it were to be judged by the FCA to be inappropriate, for example on account of unintended consequences.

Product intervention power
In its response[167] to the FSA's recent discussion paper, the Panel set out the consumer outcomes we would like to see from a system of regulatory product intervention:

1. Consumers should be able to buy straightforward outcome products that deliver what they promise including value for money, through all distribution channels including execution only.
2. Those unable or unwilling to pay for a full independent advice service should have access to a process for delivering simplified advice with appropriate levels of consumer protection.
3. Consumers should have access to a wide range of financial products that meet a diverse set of needs and aspirations, that have been subject to appropriate internal and regulatory scrutiny both at the design stage and during subsequent product development, such that regrets and complaints to FOS are minimal.
4. Consumers should have access to fair redress and compensation if things go wrong.

The Panel notes that any FCA actions will need to avoid conflict with those of the European Supervisory Authorities, which also have product intervention powers, and recommends that details of arrangements to avoid such conflict are detailed in the MOU between the UK bodies outlining the approach to international coordination.

The Panel has responded separately to the FCA approach document. It has concerns in some areas – in particular that the FCA regulatory toolkit will be restricted and will not cover areas such as product kitemarking, product approval, and product authorisation other than for those products authorised under the current FSA regime. This seems contrary to the desire to take full advantage of the opportunity to develop a new approach to conduct regulation.

New financial promotions power
The new provisions to give the FCA powers to take action in the case of misleading financial promotions, and to have a duty to publish the fact that it has done so, are a significant move towards improving regulatory transparency and enabling early action to prevent detriment. The Panel supports this. It believes that the regulation of financial products should be no different in this respect to the regulation of other products, and that the FCA's powers should be increased in line with regulators in other sectors. Early publication of action would encourage good consumer outcomes within the market and act as deterrent to poor behaviour.

A presumption in favour of publication of specific and identifiable action in the case of misleading promotions should be included in the Bill, with appropriate timescales.

[167] Financial Services Consumer Panel Response to DP11/1: Product Intervention, April 2011

Early publication of disciplinary action
The Panel supports the new power to enable the regulators to disclose the fact that a warning notice has been issued in relation to proposed disciplinary action. It is important that the wording of this power, as outlined in Schedule 8, paragraph 24 ('after consulting the persons to whom the notice is given'), does not imply that consent must be obtained to publish information from the party under investigation.

It is also a cocnern that the requirement to consult, and to allow firms to make representations, could slow the process and allow consumers to continue making potentially irreversible decisions based on unsuitable or misleading information. We therefore propose there should be a mechanism for the FCA to initiate, and publish details of, immediate regulatory action without consultation with the firms involved, where it considers there is risk of serious consumer detriment.

In addition, the FCA should be able to use information collected in pursuit of its regulatory objectives, (such as complaints data) where appropriate, to inform consumers and promote good behaviour. Section 348 of FSMA currently restricts the FSA's ability to publicly disclose confidential information which is not already lawfully publicly available, relates to the business or affairs of any person and is received by the FSA for the purposes of its functions under FSMA. Currently a person who contravenes s.348 can be fined or imprisoned for a period of up to two years.

The Panel believes the threat of such action acts as an excessive restraint on publication of information which should be in the public domain, and conflicts with the new principle of openness and disclosure. It is difficult to see how this principle can be exercised while the existing s.348 exists, therefore while publication should still be subject to rigorous safeguards, the punishment for infringing s.348 should be reduced to a civil penalty.

Additionally, the Panel seeks assurance that regulations could be made under s.349(1), in the light of the principle of transparency, that would allow the FCA to publish information it considers would assist consumers to accept responsibility for their actions and would encourage firms to avoid misconduct for fear of disclosure and reputational damage.

18. Are the prudential regulatory responsibilities of the FCA towards FCA-only regulated firms given sufficient emphasis and detail?

No comment

19. Will the new regulatory arrangements reduce the risk and cost of dealing with miss-selling of financial products?

The Panel very much hopes that the new regulatory arrangements will substantially reduce the risk and cost of miss-selling. Past major miss-selling episodes, most recently of payment protection insurance, are an indictment of both the industry and the regulatory regime. Failure to eliminate such miss-selling in the future would indicate a design fault in the new arrangements. It will be important to ensure no weakening of the FCA's powers during passage of the Bill, in particular of the presumption of transparency, since early exposure of shortcomings of authorised firms will both help consumers take responsibility for their

decisions and induce good behaviour by firms. It will also be important for the new FCA to take full opportunity to use its powers to nip miss-selling in the bud.

20. Are the proposals for co-ordination between the PRA and FCA clear and adequate? What would be the advantages and disadvantages of having a Single Point of Contact and/or a joint rule book for dual-regulated firms?

The Panel has particular concerns about the coordination processes between the FCA and PRA in relation to the European supervisory authorities, and wishes to see concrete proposals for coordination in this area.

21. How do the proposals in the draft Bill fit within the new European regulatory regime? What freedoms and constraints will the UK have to operate within that regime?

The proposed new structure does not fit well with the European regulatory structure, where all three European supervisory authorities have responsibility for both prudential and conduct of business issues. A possible solution to this issue would be to have a joint European/international team which operates and communicates with both the FCA and PRA. There is a precedent for such a structure at European level, where directorates-general have been split in the past, and the new regulators could learn from these experiences.

22. Does the draft Bill contain any proposals or omissions, not covered by the questions above, which cause concern?

Access to financial services

It is no longer possible to function outside the financial services system, not only in relation to transactional services but increasingly in pensions and insurance, as responsibilities in these areas pass from the Government to consumers. Access to financial services is a precondition of functioning in society and needs to be intermediated. The Panel believes that the FCA's third operational objective should be amended to:

'promoting efficiency, *access* and choice in the market for certain types of services'

The FCA will be well placed to drive real progress in this area.

Appendix - the Consumer Panel

The Consumer Panel is a statutory body under the Financial Services and Markets Act 2000 and was initially established by the Financial Services Authority in December 1998. The Panel advises the FSA Board on the interests and concerns of consumers and reports on the FSA's performance in meeting its objectives.

The emphasis of the Panel's work is on activities that are regulated by the FSA, although it may also look at the impact on consumers of activities outside but related to the FSA's remit. More information about the Panel's work is available on its website at http://www.fs-cp.org.uk/ .

September 2011

Financial Services Consumer Panel; Association of British Credit Unions Limited (ABCUL); Association of Financial Mutuals; Building Societies Association; Association of Independent Financial Advisers; Institute of Financial Planning; International Regulatory Strategy Group; Financial Services Practitioner Panel; FSA Smaller Businesses Practitioner Panel; and Office of the Complaints Commissioner – oral evidence (QQ 438-557)

Transcript to be found under Association of British Credit Unions Limited

Financial Services Consumer Panel – supplementary written evidence

Consumer Panel Memorandum on Bank of England accountability, the FSA's Regulatory Decisions Committee (RDC) warning notice process and information as a regulatory tool

Further to our appearance before your committee and in particular on reviewing the draft transcript I thought it would be useful to write to clarify the Panel's views in relation to the s11 powers of the Panels and with regard to warning notices and the RDC process.

Ensuring an accountable Bank of England by maintaining s11 of FSMA
As we discussed in the hearing, the current Bill does not provide sufficiently independent governance or accountability in the areas which will be the responsibility of the Bank of England. Consumers, industry and Parliament are all potentially shut out of the decision making process when it comes to decisions taken by the Financial Policy Committee (FPC) and Prudential Regulatory Authority (PRA), decisions which although targeted at the stability of the system and firms could interact and have a significant impact on consumers and the economy.

The Panels are therefore united in the view that the present arrangements for consulting consumers and the industry in the preparation and evaluation of regulation, which appear to have worked well for the last decade, need to be maintained. At present, the FSA is obliged to consult the Panels representing both consumer and industry concerns under s11 of FSMA. Given the structure of the FSA, this means that the Panels are directly engaged with both conduct and prudential issues and with the interaction of the two, as in the regulation of mortgages. The Panel believes that the s11 power should be retained in the new legislation with respect to all three regulatory bodies and not just the FCA, to ensure that there is no accountability shortfall. Consumers and industry have an important role to play in ensuring that regulation is effectively scrutinised before it is introduced and that collaboration between the two regulatory authorities is effective and constructive.

The RDC and Warning Notices
The RDC process is detailed diagrammatically in the attachment. When under investigation, a firm is consulted at various stages in the process and has the opportunity to respond, including in advance of the case being referred to the RDC for a decision on whether to issue a warning notice. The complexity of the process means that cases can take nine to eighteen months to resolve from warning notice to decision notice. However, many straightforward cases are resolved sooner than this in an average of around four months.

The Panel believes that along with other measures to promote transparency in the new legislation there should be a presumption that a warning notice will normally be published. This view is shared broadly by the FSA and HM Treasury and we support the proposals in clause 391 of the Draft Bill which will allow for early disclosure of warning notices. However, our concern is that the duty to consult specified in the proposals essentially amounts to the firm under investigation having a veto which will mean that warning notices are never in fact published.

The basis of the Panel's concern is exemplified by the PPI misselling scandal. Despite firms being under investigation by the FSA, secrecy meant that consumers continued to take out PPI policies, with firms facing disciplinary action. This meant more consumers suffered loss and the eventual bill for compensation was higher than it would have been otherwise. If the FSA's disciplinary action had been disclosed at an early stage consumers would have understood the problems sooner, firms would have acted faster to resolve the enforcement action and fewer policies would have been missold.

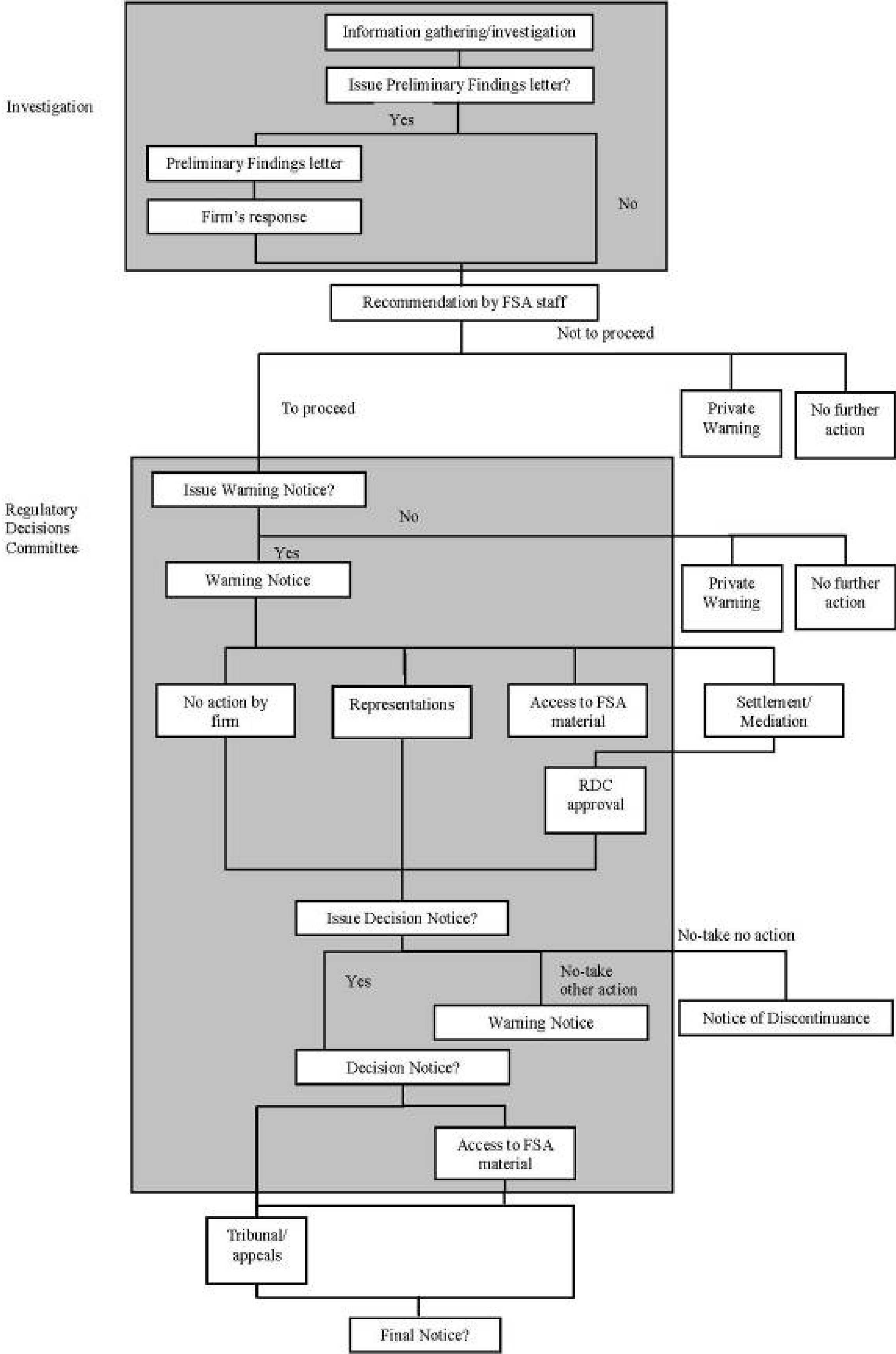
Consequently, the Panel believes that it is vital that warning notices are disclosed as early as possible so that consumers can take action to protect themselves and that firms are encouraged to settle quickly and to behave better. It also creates an incentive for firms to avoid warning notices in the first place and deters them from inappropriate or questionable behaviour, which may warrant further investigation.

Information as a regulatory tool
The inability to publish warning notices is one aspect of the restrictions FSMA places on the FSA's freedom to publish information which would help it achieve its regulatory objectives. We are pleased that, Clause 3B(1) of the Draft Financial Services Bill supports early disclosure, however the detail within the Bill does very little to increase the FCA's powers in this respect. We believe that the information gateways which allow for greater disclosure in the secondary legislation need amendment as does s348 and Part 23 of FSMA, to provide the FCA with an explicit ability to publish and disclose such information to inform consumers and promote good behaviour, subject to a new internal mechanism similar to the FCA's financial promotions powers under s137P. Under such a system, the FCA would have a duty to publish confidential information if it considered it appropriate, once the firm has been notified and representations heard.

Objections to early disclosure have also been raised on the basis of limitations imposed by MiFID. However, we have been advised by our lawyers that there is flexibility in s54(5) of MiFID such that it does not prevent the FCA from transmitting confidential information in accordance with national law, as long as that information has not been received from an authority of another EU member state.

As an addendum to our proposals, we are seeking the abolition of the criminal penalty for disclosure of confidential information under s352 of FSMA. The Panel believes that the existence of a blanket criminal penalty for FSA staff going about their business and disclosing information is excessive. Moreover as a criminal penalty is not specified at the European level and HM Treasury is already proposing to remove a similar criminal penalty existent under the Money Laundering Regulations we believe that this change would help to encourage a more transparent approach by the regulator. It is difficult to envisage a culture of openness when regulatory staff are looking over their shoulder for fear of imprisonment when they are doing their job and keeping the public informed.

11 November 2011
Diagram illustrating the RDC Process and its role in enforcement


Investigation
Information gathering/investigation
Issue Preliminary Findings letter?
Yes
Preliminary Findings letter
Firm's response
No
Recommendation by FSA staff
Not to proceed
To proceed
Private Warning
No further action
Regulatory Decisions Committee
Issue Warning Notice?
No
Yes
Warning Notice
Private Warning
No further action
No action by firm
Representations
Access to FSA material
Settlement/ Mediation
RDC approval
Issue Decision Notice?
No-take no action
Yes
No-take other action
Warning Notice
Notice of Discontinuance
Decision Notice?
Access to FSA material
Tribunal/ appeals
Final Notice?

Financial Services Practitioner Panel – written evidence

EXECUTIVE SUMMARY

The Financial Services Practitioner Panel is the statutory Panel set up under FSMA to represent the interests of practitioners to the FSA. As such, we have a close understanding of policy development at the FSA, and have taken a keen interest in the Government's plans for regulatory reform. The details of the Panel's remit, and its current membership is at Appendix 1.

Our latest biennial survey of regulated firms which was published in early 2011, showed that the overwhelming majority of firms across all sectors agreed that strong regulation is for the benefit of the financial services industry as a whole. We are keen to ensure that this regulation is effective both from the point of view of overall confidence in our industry and in terms of costs to the industry in funding the regulators and for compliance within firms.

Overall we do see clear benefit in the legislation establishing the FPC to address macro-prudential risks, and believe this will help to avoid any similar future crisis. However this could probably have been achieved as an addition to the current regulatory structure. We are concerned about the cost and disruption caused by the Government's changes, and the potential weaknesses of the "twin peaks" model as set out in our answer to Question 1. However, much is being done to mitigate those risks, and we have taken an active interest in the development of the plans within the FSA since the Government first announced its intention to change the regulatory system.

The key points of the Panel's submission are summarised below. The Panel would welcome:

1. More specific details on co-ordination between regulatory authorities, including a general duty to coordinate being included in the regulatory principles and in areas including systems and controls and review of business models.
2. Increased focus on cost management and controls.
3. A requirement for the PRA (as well as the FCA) to establish a statutory Practitioner Panel.
4. Governance structure to counterbalance the concentration of powers in the Governor of the Bank of England.
5. Introduction of a 'have regard' to competitiveness in the regulatory objectives.
6. Input from industry in the development of the FPC's macro prudential tools.
7. Re-emphasis of the need for proportionate regulation and greater clarity on how judgement based regulation will be implemented.
8. Encouraging a culture for the new regulatory bodies which places great emphasis on recruiting and retaining high quality staff with commercial expertise.
9. The FCA's increased safeguards to ensure that the broad definition of 'consumer' does not result in inappropriate retail approaches being applied to wholesale markets.
10. Clear communication channels between the FCA and the Bank of England in respect of markets, in particular so that there is strong influence over and involvement with the European equivalent authorities.
11. Greater emphasis on the responsibilities of consumers in respect of conduct regulatory matters.

12. Greater clarity on the FCA's risk appetite, which should be communicated as soon as possible
13. Safeguards over the publication of early warning notices.

We would be happy to give further evidence to the Committee on any aspect of the changes. The Panel's answers to the Committee's questions are set out below.

1. Is the separation of prudential and conduct regulation into a "twin peaks" system the right approach?

The Panel recognizes that there are arguments both in favour of and against the introduction of a twin peaks regulatory system. There are also a number of ways of implementing such a system, as has been seen by the discussion around the different consultations. We would like to highlight that it is how the new system is implemented – including the transition period, the adoption of new cultures in these regulators, and systems in place for cooperation – that will be just as important as the overarching regulatory system adopted.

From the industry's perspective, we wish to ensure that the potential disadvantages of any system are mitigated. In the twin peaks system, our key concerns are around coordination and cost. A move to a regulatory system which relies on several separate regulatory bodies for prudential, conduct and system-wide supervision must ensure that it has arrangements in place so that no regulatory issue 'falls between the cracks', i.e. that no potential issues are lost. It will also be just as important to ensure that there is no regulatory overlap, with unnecessary duplication of regulatory responsibilities, causing confusion within firms as well as duplication of costs in any system going forward.

In terms of costs, the industry wishes to see that any initiatives that carry additional costs can be justified on the basis of value for money. The Panel strongly supports high quality regulation, but it is important that efforts and monies are targeted in the areas where they make the biggest difference. As such, the Panel urges that there is clear monitoring of costs as well as cost benefit analyses of new initiatives going forward. We are concerned that in the organisation of the PRA, there is no opportunity for the industry to suggest more cost efficient means of working as there are not current proposals for statutory Panels and regular engagement with the industry, as with the FCA. We are not suggesting accountability to the industry, but believe that the current lack of any statutory engagement with industry at the PRA creates a weakness in the system.

2. What lessons can be learnt from the approach of other countries to regulation of the financial sector?

No answer submitted

3. Is it appropriate to make such major changes to the regulatory system by way of amending legislation, rather than starting afresh?

No answer submitted

4. Are the accountability and governance arrangements for the Bank of England, FPC, PRA and FCA satisfactory?

We believe there is a strong case for including a statutory Practitioner Panel not only for the FCA but also for the PRA going forward. We are not asking for the PRA to be accountable to the industry, but there should be a forum for regular engagement and dialogue with the industry, embedded within its operations. Including some form of a statutory Panel with close links to the FCA Panel would have key advantages in allowing practitioners to identify when regulation in one area (say mortgages) may have unintended consequences in another area. It would further monitor effective coordination between the different regulatory bodies and be able to provide valuable industry input on a regular basis. A standing Panel would also be able to draw on its 'corporate memory' in providing advice. We have prepared a detailed paper on the need for statutory practitioner representation at the PRA which is included at Appendix 2 to this paper.

The Panel further notes that the current arrangements for the FPC, the PRA and the Bank of England concentrate a lot of power in the hands of the Governor of the Bank of England. There are very few checks on this power, or indeed the power for the Bank of England overall, and we would encourage a re-think in this area.

We are also concerned about the balance of FPC membership, which is currently dominated by the Bank of England. The Government has undertaken to consider this further in the White Paper published in June 2011. We have urged the Government to ensure that there is more industry experience to ensure that measures suggested are practical, viable and will not cause unexpected knock on effects in the industry when implemented.

5. Are the FPC's objectives the right ones? Is the concept of financial stability adequately understood for the FPC to be able to perform against its objectives?

We believe that the concept of financial stability is generally adequately understood for the FPC's purposes, although we have previously highlighted that, unlike the MPC's inflation target, financial stability is very difficult to measure.

However, in addition, we would urge that the FPC's objectives are supplemented by a 'have regard' to the competitiveness of the UK industry. UK firms compete in a global environment, and a lack of regard of regulatory actions on the relative competitive impact of our industry compared to those of competitors situated abroad could have significant long term implications for the presence of London as a financial centre and the UK as a whole as a centre of excellence for financial services. Ongoing financial stability needs the support of an industry which is competitive in the global marketplace. We believe that, at the very least, there should be an understanding that if the regulators have the choice of two options for action of equal merit, they should select the action which has the least adverse effect on competitiveness.

6. Should the FPC be limited in the actions it can take which might affect the growth of the financial sector?

As discussed under question 5, the FPC should have regard to the competitiveness of the UK industry. This could mean that its actions may be limited in cases where the impact on the growth of the financial sector is significant. At the very least, it should include a requirement to let regard for competitiveness be the deciding factor in the choice between two otherwise equal choices.

We would also suggest that the Committee reflect on whether the FPC should not only consider growth of the financial sector, but also look at whether actions may undermine and reduce the size of the financial sector, or where its actions would seriously hinder the ability of financial firms to serve the interests of its customers.

7. How will the interaction between macro-prudential and monetary policies be handled by the FPC and the MPC?

In answer to this question, we would only note that monetary policy is easier for the MPC to measure with an inflation target than the FPC's objective of financial stability. It will therefore be important to ensure that the clearly measurable outcome of the MPC does not mean that monetary policy dominates the policy agenda in the Bank of England.

8. Has the right balance been struck between the powers of the FPC and the powers of the Treasury?

This is not a question where we can give much input. However, the Practitioner Panel is concerned about the concentration of power and accountability in the Governor of the Bank of England, so maybe it would be useful for the Committee to consider the balance with the Treasury and Parliament in the proposed set up.

9. Can Parliament take an informed decision about the proposals for the FPC without details of the macro-prudential tools at its disposal?

The Panel is concerned about the lack of detail as yet on macro-prudential tools, and believes that Parliament will need more detail – not necessarily on what these tools will involve, but on how they will be developed and used in the future.

The role of the FPC going forward will be key, both in directing the other regulatory bodies as well as in deploying its own macroprudential instruments. It is important that there is further clarity also on the exact powers these tools will give the FPC to direct the activities of firms through the PRA and FCA. We would be interested to see how input can be given to the FPC in highlighting mistakes or unintended consequences of any actions it takes – from the regulators themselves and from those affected by the FPC's directions.

These tools will have significant prudential and conduct implications for firms, but unlike in the FCA and PRA, industry has no way of inputting into the usage of these. The Panel would also strongly encourage the Bank of England to reach out to industry in the development of these tools, as we believe this could provide valuable help and expertise in this process.

11. Are the PRA's objectives clear and appropriate?

The PRA's overall objectives seem clear and appropriate. Our main concern is to ensure as much coordination as possible with the FCA. We would like to see that, as well as the general duty to coordinate, the duty to coordinate is also added to the regulatory principles. The Bill rightly recognises that cooperation between the regulatory bodies will be key in ensuring there is no overlap/underlap of regulatory activities. We believe that if the duty to coordinate was also in the regulatory principles, there would be more coordination on a day-to-day working level between the PRA, FCA and FPC.

12. Are there any risks in the Government's proposed 'judgement-based' regulation?

We believe that the key risk in the Government's proposed judgement-based regulation is that inconsistency of approach develops. This is from the level of individual supervisors within the PRA, through to comparison with those who are prudentially regulated at the FCA and through to UK regulators becoming out of line with international rule based regulators. It is vital to ensure that there are appropriate, clear rules in regard to oversight of judgement based regulation in order to ensure consistency between judgements, as well as a system of appeal for firms should they believe that a judgement is mistaken.

It is also harder to measure if a regulatory approach is proportionate under judgement-based regulation. It is important not to lose sight of the principle that the cost of regulation should be proportionate to the benefit, as well as the principle that the overall regulatory burden carried by any individual financial institution should be proportionate to the risks it poses.

The Panel sees the advantages of judgement-based regulation, but given the points above, would like to emphasise the importance of checks and balances (in the form of appeals processes and strong management oversight procedures) in any such system going forward.

13. Is the Government's proposed approach to 'orderly' firm failure satisfactory?

Whether the proposed approach is satisfactory is dependent on the current development of recovery and resolution plans. The Panel has been in discussion with the FSA in this area and followed the recent publication of the Recovery and Resolution plans consultation with interest. However, it notes that many issues remain outstanding (waiting for agreements on an international level) and that the details still need to be developed.

As such, the Panel will reserve its judgement on this issue until these plans are further progressed.

14. Given that the PRA and the FCA will inherit FSA staff does the draft Bill do enough to ensure a new regulatory culture and a more proactive approach to regulation? Will these two new bodies have staff with the appropriate skill and expertise?

The Panel has repeatedly emphasised the importance of the regulator recruiting staff with commercial expertise who are able to understand and challenge firms' actions effectively. This will continue to be the case in the new regulatory structure.

We believe that it may be more difficult for the FCA to change its culture, as it is growing out of the FSA and will remain in the same building. However, both of the new bodies will have new and challenging objectives, with narrower roles for staff in both regulators. This in itself will go a certain way to changing working cultures, but does not mean that the regulators can lose sight of the importance of recruiting and retaining high quality staff with commercial experience. This is especially a concern in light of the higher turnover (especially of senior staff) seen in the FSA since the announcement of a change to the regulatory structure.

15. Are the FCA's primary objectives appropriate? Is significant emphasis given to the promotion of competition?

The Panel supports the proposed objectives for competition for the FCA as appropriate. However, as discussed for the FPC under question 5, we believe that all the regulators should have an additional regard to the competitiveness of the financial services industry as a whole. We believe that, at the very least, there should be an understanding that if the regulators have the choice of two options for action of equal merit, they should select the action which has the least adverse effect on competitiveness.

The Panel is also concerned that the FCA's broad definition of consumers along the line that has been proposed does not make sufficient distinction between retail and professional consumers of financial services. Although we welcome partial assurances that different types of consumers will still receive different regulatory protection and treatment, there are great concerns around ensuring that this is the case in practice. It is vital to recognise that retail consumers need much higher levels of protection than professionals, the latter having much greater understanding of risk and the nature of the products they propose to buy. A failure to ensure such a distinction could have serious implications for innovation and efficiency in wholesale markets.

The FCA's universal definition of consumer is also likely to encourage a tendency towards "one size fits all" approach to regulation. This is something that we have fought hard with the FSA on, as we believe the financial services industry is too complex for policies to be applied across sectors without serious consideration of their effectiveness in different arenas.

16. Are the responsibilities of the FCA towards the regulation of markets appropriate?

The split of responsibilities in the regulation of markets between the Bank of England and the FCA will be challenging, particularly as this structure does not map neatly into the European regulatory structure. Given the importance of European Union regulation in this area going forward, it is vital to ensure that the voice of UK markets in Europe remains strong. There will need to be clear communication channels between the FCA and the part of the Bank responsible for markets infrastructure, otherwise there is a risk that a vital part of the UK market will not have a voice in European developments as the FCA will hold the UK seat on ESMA.

Within the FCA, there is a need to ensure that the FCA's responsibilities towards markets are not subsumed by the FCA's consumer protection role. We are pleased that this has been recognised to a certain extent with the creation of a Markets Panel. An additional way to help mitigate this risk would be to have legislation specify that the FCA must produce an annual report, or undertake annual Value for Money studies, of how it is undertaking its market responsibilities specifically.

17. Does the draft Bill strike the right balance between the responsibilities of consumers and firms? Are the FCA's new powers in the area of consumer protection appropriate?

The Panel is concerned about the balance between the responsibilities of consumers and firms for the FCA. Although consumer responsibility is listed in the regulatory principles,

the Panel remains concerned that there is still not enough emphasis in the White Paper or Bill on the need to retain a balance between consumer and firm responsibility. For example, the FCA Approach document does not address how it will deal with consumer responsibility. The FSA has had a similar remit towards consumer responsibility, and yet it has never been properly defined how the regulator should carry this out. The current legislation is an opportunity to set out clearly the balance between consumer protection and responsibility. If the FCA is not to be a zero-failure regime, then it must declare where the responsibilities of consumers, as well as firms, lie. The Panel would strongly encourage greater clarity in this area.

Overall we would urge that it is made clear that the FCA should, as a regulator, be seen as unbiased and fair. We have some concerns that, in seeking to show that the FCA will be different from the FSA, it will look to focus on criticism of the industry. This will not help to instill confidence in the industry in the long term.

18. Are the prudential regulatory responsibilities of the FCA towards FCA-only regulated firms given sufficient emphasis and detail?

The Panel does not believe the prudential regulation role of the FCA has been given sufficient emphasis and detail as yet. Given that the majority of firms will be FCA-only regulated, this is a significant omission. As the FCA Approach document, published in June 2011, gives very little detail of its plans for prudential regulation, it is difficult to comment on this area at the moment.

19. Will the new regulatory arrangements reduce the risk and cost of dealing with miss-selling of financial products?

The regulatory arrangements in themselves will not make much difference to the risk and cost of dealing with mis-selling, but what will be important is the way that the regulator carries out its role, and the people it employs. The FSA has been moving towards earlier intervention, and we understand that the FCA will carry this forward.

It is not clear at the moment whether the FCA will aim to reduce the risk of mis-selling to zero. We have asked the FCA to be clearer about its risk appetite, so that an acceptable level can be agreed by all. The cost implementation of trying to catch all potential instances of mis-selling would be huge, and may stifle the market. It would also require hugely greater resources than are currently envisaged for the FCA.

Much of the change in emphasis for the FCA has focused on the new intervention powers that it will be given. However, we believe that the problems more often arise when products have been developed correctly for a specific target market, but are later sold to a wider market, and so the sales become inappropriate.

20. Are the proposals for co-ordination between the PRA and FCA clear and adequate? What would be the advantages and disadvantages of having a Single Point of Contact and/or a joint rule book for dual-regulated firms?

As discussed under question 11, the Panel believes there should be a duty to coordinate in the regulatory principles. Without this, there is a concern that the duty to coordinate may

be lost in the day-to-day work of the regulatory bodies. There are a number of areas which will cut across the responsibilities of both regulators (including systems and controls and business models), and without strong arrangements to ensure coordination, there could be significant regulatory overlap/underlap with efficiency and cost implications both for the regulators and for firms.

This is also one of the reasons we advocate statutory Panels for both the PRA and FCA, with strong links between them going forward – to provide engagement and feedback on coordination between the regulatory bodies.

21. How do the proposals in the draft Bill fit within the new European regulatory regime? What freedoms and constraints will the UK have to operate within that regime?

The proposals in the draft Bill can be made to fit with the new European regulatory regime, although not in a smooth manner. The Panel regards liaison with Europe as increasingly important, and would encourage regulators to seek to ensure that interaction between UK and EU regulators continues to be a top priority also during and after transition.

22. Does the draft Bill contain any proposals or omissions, not covered by the questions above, which cause concern?

The Panel does have serious reservations around the publication of early warning notices, although it welcomes the additional safeguards proposed in the new FCA document and the Bill. Our concern is that even with the requirement to consult the relevant person before publication, there are serious potential regulatory and legal, as well as moral, implications of proposals to publish such notices before a person has been proven guilty.

Whilst we remain sympathetic to the supposed rationale behind the proposal – to ensure that consumer detriment is minimised in cases where the regulator suspects a person/product of being not being up to standard – this could have significant negative implications for both firms and consumers. In cases where consumers hold a given product and then see a warning notice, they may feel compelled to sell at a fire-sale price. Should the product subsequently be shown to be safe, consumers may have suffered financial detriment, in addition to the detriment of restriction of product choice (since the product is then unlikely to be able to be sold in any case).

APPENDIX 1

ROLE AND REMIT OF THE PRACTITIONER PANEL

1. The role of the Practitioner Panel is to advise the Financial Services Authority on its policies and practices from the point of view of the regulated community. It has statutory status under the Financial Services and Markets Act 2000 (FSMA). As such, the Practitioner Panel is given access to the FSA's plans for new regulatory policies, and so is able to provide an important sounding board for the FSA before the ideas have been made public.

2. Members of the Practitioner Panel are drawn from the most senior levels of the industry, with the appointment of the Chairman being formally approved by the Treasury, to

ensure independence from the FSA. The members are chosen to represent the main sectors of the financial services industry as regulated by the FSA. The Panel currently has senior practitioners from the retail and investment banks, building societies, insurance companies, investment managers, financial services markets, custodians and administrators.

3. The Chairman of the FSA's Smaller Businesses Practitioner Panel (SBPP) sits ex officio on the Practitioner Panel to ensure co-ordination, but debate on issues specifically affecting smaller firms are covered by that Panel. The SBPP is submitting a separate response to this Consultation.

4. The names of the members of the Practitioner Panel as at 1st September 2011 are as follows.

Russell Collins (Chairman)	Partner, Deloitte LLP
Graham Beale*	Chief Executive, Nationwide Building Society
Joe Garner*	Head of UK Retail Bank & Deputy Chief Executive, HSBC Bank plc
Paul Geddes*	Chief Executive, RBS Insurance
Colin Grassie	CEO, Deutsche Bank UK
Mark Harding	Group General Counsel, Barclays Bank PLC
Simon Hogan	Managing Director, Institutional Equity Division, Morgan Stanley
Garry Jones	Group Executive Vice President & Head of Global Derivatives, NYSE Euronext
Guy Matthews	Chief Executive, Sarasin Investment Funds (SBPP)
Helena Morrissey	Chief Executive Officer, Newton Investment Management
John Pollock*	Group Executive Director, Protection & Annuities Legal & General
Andrew Ross	Chief Executive, Cazenove Capital Management
Malcolm Streatfield	Chief Executive, Lighthouse Group
Paul Swann	President & Chief Operating Officer, ICE Clear Europe
Doug Webb	Chief Financial Officer, London Stock Exchange Group

Appendix 2

THE NEED FOR A STANDING BODY OF PRACTITIONER REPRESENTATIVES AT THE PRA

INTRODUCTION

This briefing is written on behalf of both the Practitioner Panel and Smaller Businesses Practitioner Panel, the current practitioner panels for the FSA. It is based on our knowledge and understanding of the contribution that the Panels make to regulatory policies, and we would like to contribute further to the ongoing debate concerning the need for statutory standing bodies for the proposed PRA. We recognise that these opinions might be viewed as being self serving; however, we do not believe that we have particular vested interests in the Panels continuing: members of the Practitioner Panel serve to make a personal

contribution to the regulation of financial services and are unpaid (while the members of the SBPP receive only a small fee) and normally serve a maximum of two terms of three years each.

THE CURRENT PROPOSALS

The White Paper on regulatory reform published in June 2011 (“A new approach to financial regulation: the blueprint for reform”) correctly distinguishes accountability (for example, to Boards/Court and Parliament) from engagement with stakeholders (for example, to Practitioners, Consumers). The White Paper is clear on the need for statutory Practitioner, Smaller Business Practitioner and Markets Panels for the FCA. However, whilst the White Paper proposes to give the PRA a statutory duty to put in place arrangements for engaging with practitioners, as drafted there will be no specification of what those arrangements might be. Therefore the arrangements would be at the discretion of the PRA and the Bank of England. The White Paper also indicated that the Government will continue to consider these arrangements in the light of further consultation and PLS.

As the current statutory practitioner panels of the FSA, we wanted to set out what our experiences indicate are the advantages of having a statutory standing body of practitioners with strong links to the FCA Practitioner Panels, possibly in the form of a statutory Panel, and also what we see as the disadvantages of not having such a forum for the PRA.

We believe that engagement with the industry at an early stage of policy development has significant benefits for regulators as well as firms. The Government has recognised this in the proposed structure for the FCA, but not in the PRA, although the reasons for the distinction are not articulated clearly and the distinction seems to us to be misguided , particularly as each body has the same policy-making functions. We believe that such a structure for industry consultation via a standing body is not relevant only to the FCA: it should also be incorporated into the set up of the PRA.

We do not accept that setting up a standing body for the PRA would increase the risk of “regulatory capture” given the powers and responsibilities of the regulators enshrined in the legislation. In this regard, we welcome the comments of Hector Sants in his speech to the PRA conference on 19 May 2011: “Avoiding regulatory capture does not mean, however, that the PRA will not engage with the firms it regulates. In particular in making its rules, the PRA should do so in full understanding of both their impact and the industry’s perspective. It will accordingly set up the necessary consultation mechanisms to ensure the right people in industry are involved. Where necessary this could include standing advisory committees. Furthermore when it makes its rules it will set out their purpose in a clear and straightforward manner.”

DISADVANTAGES OF NO STATUTORY STANDING BODY/PRACTITIONER PANEL

We believe that there are distinct disadvantages in not having a statutory Practitioner Panel with strong links to the FCA Panels at the PRA, even if there were to be either standing bodies or ad hoc groups gathered together for specific aspects of PRA regulation at the discretion of the PRA and the Bank. The main disadvantages of non statutory ad hoc groups or standing bodies are as follows:

- Groups drawn together for specific issues will only be focussed on that part of regulation and so may not recognise the impact that such an action may have on other aspects of the system, its interaction with other rules already in place or in

prospect or the opportunities for coordination and economies of scale in implementing different changes at the same time. For example, there has recently been considerable debate about the fit between Basel III (and its requirement for banks to lengthen the maturity of their liabilities) and Solvency 2, which may make holdings of bank term debt more expensive, and hence less attractive, to insurance companies. These linkages could well be missed by two single sector groups.

- The division of regulatory issues into Conduct and Prudential at the FCA and PRA, whilst it may be a useful construct for supervisory purposes, is somewhat artificial: from the viewpoint of practitioners (and government), it is the cumulative impact of regulation that matters, especially in regard to maintaining financial stability, protecting consumers and ensuring the UK has an internationally competitive financial services industry.
- The 'corporate memory' of the Panel means that they may recognise links and repetitions that may not be obvious to ad hoc groups, and would be able to look at the impact of proposals when combined with FCA rules or proposals if there was strong linkage, or even some common membership with the FCA Panels. Although standing bodies might achieve this, we believe that a statutory basis with a link to the FCA Panels would make the standing bodies much more effective.
- Deciding when an ad hoc body is needed or not could result in not having industry input precisely when it could be most beneficial, for example in making the case to the European Union regulatory bodies for regulations which can be properly applied in the UK, given its unique financial markets which is evidenced at the moment in the debate on maximum harmonisation of bank capital rules;
- Setting up various bodies will be time consuming and potentially inefficient. It also runs the risk of "missing the boat" insofar as engagement with EU policymaking is concerned.

REMIT OF A STATUTORY PRA STANDING BODY/PANEL IN THE NEW REGULATORY STRUCTURE

There are particular areas in the PRA's remit which would provide opportunities for engagement with a Practitioner Panel as follows:

- The PRA's future approach documents set out PRA responsibilities in regard to policy making. It says that the PRA will seek to ensure, wherever possible, that its policies and rules are straightforward, clear in intent, robust and support timely interventions. The PRA's policy documents will explain the underlying purpose of its policies and rules. And the PRA will, wherever possible, include clear statements of purpose when setting rules to ensure that firms and the market more generally understand the reasons behind the policy. All these commitments would benefit from a regular and informed dialogue with a specific group of practitioners who also have links to the FCA Panels.
- The PRA's (new) policyholder objective with regard to insurers gives the PRA a broader remit which needs to be considered and may require wider debate on the implications of proposed policy changes.
- The PRA's responsibility for designating Significant Influence Functions (SIFs) would benefit from debate with practitioners.
- The PRA will be the gateway to European and international regulation, and practitioner engagement on negotiating issues could be useful to the PRA.

- The PRA Panel could assist in providing feedback on the practitioner experience of coordination between the two regulators, particularly if it was set up with close links and some common membership with the FCA practitioner panels.

POTENTIAL REMIT REGARDING THE FPC AND BANK OF ENGLAND

The potential for engagement directly or indirectly with the FPC on financial stability issues as they impact on the PRA should also be considered. We believe this is particularly important in respect of the proposed macro-prudential policies. It can be illustrated by considering those in the interim FPC's first minutes of June 2011. The FPC made several recommendations including specific ones on banks' forbearance practices and on funding structures such as collateral swaps employed by exchange traded funds. In our view, the assessment of the impact of such policies in advance, but more importantly ensuring the implementation of such policies, would benefit from the expertise and knowledge of practitioners, especially understanding the transmission mechanisms and indirect effects, which will be crucial to their success.

In a speech at the British Bankers' Association's Annual Banking Conference on 29 June 2011, Paul Tucker (Deputy Governor for Financial Stability), talked of the broad approach of the PRA. He said that the supervisor will not "... treat firms as islands. They are part of a system. So, at the very least, supervisors will need to look laterally across peer groups of firms for oddities, and stress test firms' resilience against short-term and longer-fuse threats from the environment. They will, therefore, need to draw on market intelligence on industry trends from the Bank's Markets area; insights from the operators and overseers of the clearing, settlement and payment systems; and analysis from the finance and monetary researchers in the Bank. Conversely, the Financial Policy Committee will – and already has – drawn on briefings from the supervisors as well as the Bank's existing staff. In other words, this is going to be about making connections, pulling together a varied range of inputs. A measure of the Bank's success when prudential supervision transfers will be how well we knit them together".

We believe that "pulling together a varied range of inputs" is precisely what the FSA Panels have done over the years and that input from a standing body of senior practitioners linked also to the work of the FCA Panels, would contribute to this market intelligence and industry expertise.

ADVANTAGES TO A PRACTITIONER PANEL

We propose a single Practitioner Panel for the PRA – which would also incorporate the views of smaller firms who will be swept into regulation by the PRA. Such a Panel would have the following advantages:

1. Consideration of practical impact of policy changes

The Panel provides an overview from those who will have to implement any policy changes, and if it were also linked to the FCA Panels, would be able to give feedback in the light of FCA policy debates as well. The Panel would be able to review potential areas for misinterpretation of judgement-based regulation requirements on both sides. It would also be able to help the regulator to understand what is required to implement policy proposals successfully, whilst avoiding any unreasonably detrimental impact or unintended consequences on firms, and so assess costs versus benefits in accordance with regulatory principles. The Panel would also be able to look at how prudential requirements interact with conduct requirements from the firms' perspective and the impact on businesses and

consumers more widely. We also feel that, adding smaller businesses representation into a PRA Panel would enable discussions about proportionality of application of rules and requirements across different sizes of firm.

2. Ability to review cumulative impact of PRA and FCA on firms

A vital area of concern in the new system is to see that there is effective coordination of regulatory requirements between the PRA and FCA. The PRA Panel should have a strong link to the FCA Panels to enable it to provide commentary and appropriate advice on the coordination of regulatory requirements between the two new regulators.

3. A forum with a remit to help the regulator to look ahead

With a regular forum, the members can look ahead to the impact of regulatory developments and initiate its own enquiries of the regulator if it sees a potentially adverse impact or prudential risk. There is no wish to 'capture' regulators through this system, but to provide forward looking advice on issues to look out for. Decisions on how to use these insights are unambiguously for the regulator alone.

4. Well informed and quality membership

If the Panel is statutory, it is given an authority and credibility which enables CEO level people to be persuaded to give up valuable time to become members. Such individuals are more likely to be able to see the wood for the trees than specialists with a narrower focus. Cross sectoral membership provides a focus on effective regulation rather than the sectoral interests of trade associations, which have a separate and important place in discussions with the regulator (and incidentally seemed to support the role of a standing body of practitioners in some of their comments). The members can sign confidentiality requirements, allowing early debate on the pros and cons of new policy developments. They also build up a knowledge of regulatory policy developments through membership over a period of 3-6 years which helps them to bring regulatory perspective to the debates. In addition, individual and high level advice can be given to the regulator on specific subjects through ad hoc sub groups with Panel chairmen and members outside the formal meeting process.

5. Transparency and public accountability

Although we recognise that the Government has said that the PRA's arrangements for consulting practitioners should be transparent, it will be simpler and more practical for a regular Panel to achieve these transparency requirements: the Panel can be required to produce an annual report (as the FSA Panels do currently) and possibly report to the Treasury Select Committee on the PRA (and FCA) engagement with firms. In addition, the PRA Panel could join the FCA Panel in continuing a similar project to the Practitioner Panel's biennial survey of regulated firms which has proved a useful tool for the FSA and provides feedback on perceptions of the regulator's performance against its objectives.

6. Contribution to EU and international negotiations

Such a Panel could additionally contribute to effective EU and international representation for PRA, by providing a means of facilitating proactive and early involvement of the industry in EU developments. Panel members could provide advice on ensuring that EU rules deliver the desired objectives in as efficient and effective way as possible, such as the precise way in which stress tests are conducted, the different options to increase prudential capital or the interactions between the market structure and payment mechanisms and individual firms. Directives and regulations, even on capital and liquidity matters, include a wide range of specific measures on which industry input is extremely useful to ensure they achieve their intended effect and avoid adverse unintended consequence.

CONCLUSION

We believe that it will be crucial for the PRA to have a statutory standing panel of independent practitioners who regularly engage with the PRA in policy formulation and implementation. The group should have strong links to the FCA Panels. An alternative but less welcome structure would be for the FCA Practitioner Panels to have a remit and responsibility to look at certain prudential issues from the PRA.

September 2011

Financial Services Practitioner Panel; Association of British Credit Unions Limited (ABCUL); Association of Financial Mutuals; Building Societies Association; Association of Independent Financial Advisers; Institute of Financial Planning; International Regulatory Strategy Group; FSA Smaller Businesses Practitioner Panel; Financial Services Consumer Panel and Office of the Complaints Commissioner – oral evidence (QQ 438-557)

Transcript to be found under Association of British Credit Unions Limited

Financial Services Practitioner Panel – supplementary written evidence

Practitioner representation at the PRA

Thank you for giving me the opportunity to represent the Practitioner Panel's views in the oral evidence session of your Committee on 20th October 2011.

The Committee seemed particularly interested in the level of consultation, feedback and external engagement that there will be for the PRA. As you know, this is an area where we feel that there is not an appropriate balance between the engagement being proposed for the PRA and FCA, and we would like to see a statutory practitioner panel for the PRA.

We have prepared the attached briefing paper on the advantages that could be gained by including a requirement for a Practitioner Panel in the Financial Services Bill, which we believe may be useful to you in considering any recommendations for your report.

In addition, we were interested to hear the opinions of the Governor of the Bank of England about a statutory panel in his oral evidence session with the Joint Committee. We would respond to the points he made as follows.

The Governor said that he was not in favour of fixed membership as opposed to ad hoc consultation groups. The enclosed paper gives a number of reasons why we believe that a fixed membership Panel providing pre-consultation advice has advantages over individual consultations. The most important reasons are that the Panel members have made an ongoing commitment, are able to look across the regulatory developments and sectors and bring wider experience of regulation policy into the debates.

The Governor said he wanted to get away from FSA processes which are bureaucratic, legalistic, and do not generate particularly useful responses. We do not believe that the Panel is a bureaucratic process, and that is not feedback that we have received from those consulting us to date. As I have pointed out previously, our Survey of practitioners[*] suggested they see value in the Panel's efforts; other respondents on the draft Bill have also mentioned the panel in a positive light. We have also sought and been given a reaffirmation that the FSA Board does indeed find the contribution of the practitioner panels useful.

The Governor said the PRA and Bank should not be accountable to industry. We agree that the regulator cannot be accountable for its policies to industry, but we do not think that having such a Panel would make it so. We believe that such a Panel could provide high quality expertise on the most effective way of implementing regulation, as we believe that effective, high quality regulation is of benefit to both industry and society as a whole. This expertise would be provided in an advisory capacity. Such a Panel would also be in a better position to provide commentary on the effectiveness of the regulator from a practitioner point of view to Parliament, as we have done to the TSC recently on regulatory reform and the RDR.

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[*] Financial Services Practitioner Panel - Sixth Survey of the FSA's Regulatory Performance – February 2011

The Governor also said that such a Panel would be the "slippery slope to regulatory capture". This does not have to be the case, as decisions on how to act on the insights given by the Panel would unambiguously be for the regulator. In addition, if there was a regular Panel with a responsibility to publish an annual report and give evidence to Parliament, there would be more transparency and oversight of the discussions than if the PRA was taking the opinions of ad hoc groups of practitioners chosen by the Bank.

BRIEFING ON PRACTITIONER PANEL FOR THE PRA

THE CURRENT PROPOSALS

The Draft Financial Services Bill does not specify that the PRA must set up a regular means of engagement with practitioners as in the current set up for the FSA, and as is proposed for the FCA.

We believe that the legislation could be improved by making the following changes to the wording of new sections 2J (2) and 2K (1), with insertions flagged in bold type:

2J The PRA's general duty to consult

(2) Those arrangements ~~may~~ ***should*** *include the establishment of ~~such panels as the PRA thinks fit~~* ***a Practitioner Panel to provide a regular forum for policy debate with a cross section of senior representatives of those firms regulated by the PRA and to consider the cumulative impact of regulation by the PRA and FCA on firms.***

2K Duty to consider representations

(1) The PRA must consider representations that are made to it in accordance with arrangements made under section 2J, ***but the PRA will not be accountable to practitioners for its decisions having considered the representations.***

WHY THE CHANGE IS NEEDED

We propose a single Practitioner Panel for the PRA – which would also incorporate the views of smaller firms who will be swept into regulation by the PRA. Such a Panel would have the following advantages:

1. Consideration of practical impact of policy changes

- Pre-publication debate and engagement at an early stage of policy development can help the PRA to avoid any unreasonably detrimental impact or unintended consequences on firms, without going as far as regulatory capture:
- Smaller businesses representation on the PRA Panel could raise issues of proportionality of application of rules and requirements across different sizes of firm.
- The cross-sectoral membership of such a Panel provides a different perspective to that of trade associations and individual firms: the Panel can see patterns across the industry and highlight the potential impact on other parts o the system, or rules already in place. The Panel may also suggest opportunities for coordination and economies of scale in implementing different changes at the same time.
- Such a Panel would – as now – not be involved in individual firm issues, or in crisis and emergency decisions taken by the PRA.

2. Ability to review cumulative impact of PRA and FCA on firms

- A strong link between the PRA and FCA Panels would be able to investigate the coordination of regulatory requirements between the two new regulators – it is often the cumulative impact of regulation that is significant;
- Many aspects of a firm's operations – particularly its business plan and key staff – will look across prudential and conduct, and so it will be important to have Panels which are able to consider all aspects of the regulatory requirements for firms, and advise on the conduct implications of changes to prudential requirements.
- It will be more difficult for the FCA Panels to do their job effectively in certain areas if they do not have access to the parallel policy making debate at the PRA.
- The new Markets Panel for the FCA will provide specific input from the wholesale and markets perspective, and this will provide a perspective which may well also be useful for the PRA to access. A single practitioner panel for the PRA could encompass membership linked to the Markets and Smaller Businesses Panels as well as the Practitioner Panel at the FCA.

3. Build knowledge through regular meetings

- A single Panel will develop a 'corporate memory' which enables it to recognise links and repetitions that may not be obvious to ad hoc groups. Individual members also build up knowledge which brings regulatory perspective to debates.
- It would be able to look at the impact of proposals when combined with FCA rules or proposals if there was strong linkage, or even some common membership with the FCA Panels.
- A regular forum would enable members to look ahead to the impact of regulatory developments and initiate its own enquiries of the regulator if it sees a potentially adverse impact or prudential risk.
- If the PRA has to decide whether an ad hoc body is needed or not and set up various different bodies, this will be time consuming and potentially inefficient. It also runs the risk of "missing the boat" by not setting up a group and having industry input precisely when it could be most beneficial, with the implementation of European proposals or in changing the way that the regulator operates without changing the rules.

4. Well informed and quality membership

- A statutory Panel has more authority and credibility than ad hoc groups, which will make it possible to recruit CEO level membership, who bring greater expertise and look for the bigger picture in regulatory developments.
- Cross sectoral membership provides a focus on effective regulation rather than the sectoral interests of trade associations, which have a separate and important place in discussions with the regulator.
- The members can sign confidentiality requirements, allowing early debate on the pros and cons of new policy developments.
- Individual and high level advice can be given to the regulator on specific subjects through ad hoc sub groups with Panel chairmen and members outside the formal meeting process.

5. Transparency and public accountability

- A regular Panel can be discrete and discuss pre-publication policy proposals and yet achieve the Government's transparency requirements: the Panel can be required to produce an annual report (as the FSA Panels do currently).

- It will not be enough for the Treasury Select Committee just to ask selected practitioners whether they believe the regulators are working well: Parliament will need to ask people who have taken an ongoing interest in the detailed development of regulation and who are able to give an informed opinion on the performance of the regulators.
- The Panel could also look at the Budget of the PRA and provide feedback on the cost effectiveness of its policy decisions to the Court.
- The Panel could provide a check on how operationally independent the PRA is, particularly as the Governor is Chairman of both the PRA and the Bank of England.
- The FSA's Practitioner Panel has conducted a biennial survey of the views of regulated firms to provide feedback to the regulator, and this could be continued for the PRA and FCA if they each had Panels.

6. Contribution to EU and international negotiations

- Panel can help to ensure that the PRA's implementation of EU requirements deliver the desired objectives in as efficient and effective way as possible;
- Panel can provide industry advice and support on representation of UK position in EU negotiations by the PRA.

CONCLUSION

A panel of practitioners for the PRA could play a key role in helping prudential regulation to be as effective and as simple as possible to implement. Such a Panel would also provide a balance and link to the FCA Panels and so be able to comment on any problems on coordination with the regulators.

23rd November 2011

Futures and Options Association – written evidence

1. Introduction

1.1 The FOA is the industry association for more than 160 international and EU firms and institutions which engage in derivatives business, particularly in relation to exchange-traded transactions, and whose membership includes banks, brokerage houses and other financial institutions, commodity trade houses, power and energy companies, exchanges and clearing houses, as well as a number of firms and organisations supplying services into the futures and options sector (see Appendix 1).

1.2 The FOA supports the overarching objectives of the draft Financial Services Bill, including the establishment of a Financial Policy Committee (FPC), a Prudential Regulation Authority (PRA) and a Financial Conduct Authority (FCA), but it does have a number of observations and concerns, which are summarised as follows:

(a) With regard to the accountability and governance arrangements (see further Q.4) the FOA believes that:

(i) it is inappropriate for the PRA to have absolute discretion in terms of whether or not to establish a Practitioner Panel and this should be established under the Bill;
(ii) it is inappropriate for the PRA to have absolute discretion in the setting of regulatory scope and that, at least in high level general terms, this should be set by Parliament;
(iii) the governance of the FPC is "too heavily weighted" towards the Bank of England and should therefore be the subject of further review;

(iv) as with the FCA, complaints against the PRA should fall within the scope of the independent Complaints Commissioner so that both authorities are subject to the same degree of independence and commonality as regards process and the appointment of complaints investigators;

(v) each of the regulatory authorities should be required to take into full account the objectives, scope and regulation and factors which are required to be considered by each of them to ensure that decisions are balanced and properly reflective of the responsibilities of each authority;

(vi) if a balanced approach is to be taken in terms of financial stability and facilitating growth in the financial sector, the principles required to be taken into account by the FPC when making recommendations should apply equally to the Bank of England when considering those recommendations (see further Q.6);
(vii) the National Audit Office, in undertaking value-for-money studies of the PRA and the FCA, should have its remit extended to include the setting of fees by both authorities.

(b) If the full social economic effect of the application of macro-prudential tools is to be taken into proper account by the FPC, it should be required to consider

specifically the social implications of its actions and the risk of widespread public disaffection or unrest, as well as the purely economic consequences (see Q.5).

(c) While the FOA is supportive of judgement-based regulation, risks of inconsistency and lack of quality in decision-making will need to be addressed (see Q.12)

(d) For reasons given in response to Q.15, the FOA believes strongly that the FCA (and the PRA) should be required to take into account the need to sustain competitiveness.

(e) The FOA remains concerned that, while the description of the FCA being a "strong consumer champion" has been abandoned, the FSA's recent discussion paper "Financial Conduct Authority: Approach to Regulation June 2011" gives little recognition for the need to proportionate regulatory treatment for providers of financial services, suggesting that a proper balance might not be preserved between the interests of consumers and regulated service providers (see Q.17).

(f) While the FOA notes the assurances that wholesale financial services business is critically important and will be effectively and proportionately regulated, the FOA remains concerned that the consumerist overlay of the FCA could result in high-cost consumer protections being applied to wholesale market regulation, so a stronger emphasis on the need for proportionality would be helpful (see Q.17).

(g) The FOA supports the new powers of product intervention, but believes strongly that they should only be exercisable where there is evidence of "significant consumer detriment" and that considerable care needs to be taken to avoid undue legal or economic uncertainty in the area of product development and innovation (see Q.17).

(h) Prudential regulation should not be punitive but fairly and authentically risk-based and should recognise specially that small and medium sized enterprises or fundamentally differentiated firms that do not pose a significant risk to the system and which will be FSA-only regulated firms are not regulated as if they did pose such a risk (see Q.18).

(i) The FOA remains deeply concerned over the power given to the FCA to issue an early "pre-trial" publication of intended disciplinary actions. If this is to remain a power of the FCA, it should be subject to strict statutory safeguards in recognition of the fact that their issuance will be covered by statutory immunity and that the potential for reputational damage and commercial loss for firms and the consequences for shareholders could be significant (see Q.22).

1.3 The FOA has attached at Appendix 2 to this response a few comments on the draft Bill.

2. Responses to Specific Questions

Q1. Is the separation of prudential and conduct regulation into a "twin peaks" system the right approach

2.1 The FOA supports the Government's "twin peaks" approach, but continues to question the cost/benefit of splitting a unified regulatory authority into two separate

authorities – although the FOA recognises that this is firm Government policy. The fact is that regulatory failure as a cause of the crisis was not structural, i.e. there were regulatory failures in jurisdictions with fragmented specialist regulatory authorities, unified regulation and even dual regulation. It is for this reason that the FOA suggested that there should be a "pause" once the FSA has been internally reconstructed to create a "shadow" PRA and FCA to make absolutely sure that the benefits of externalising that approach outweigh the costs of losing unified regulation.

Q2. What lessons can be learned from the approach of other countries to regulation of the financial sector?

2.2 The FOA believes that the lessons of other countries' approaches to regulation, where relevant to the UK, have been absorbed into the restructuring of financial services regulation and that this should be a continuing process.

Q3. Is it appropriate to make such major changes to the regulatory system by way of amending legislation rather than starting afresh?

2.3 The FOA believed that amending legislation was the preferred course, although the extent of the amendments and cross-references could make the legislation complex and difficult to read to other than professional service providers such as lawyers and accountants. It is important that primary legislation of this nature, which impacts not just on regulated firms but consumers, is intelligible and readable and this may suggest that a standalone act may be more desirable, but this is not an issue in respect of which the FOA feels particularly strongly.

Q4. Are the accountability and governance arrangements to the Bank of England, FPC, PRA and FCA satisfactory?

2.4 Yes, save that the FOA would make the following observations:

(a) It does not seem appropriate for the PRA to have absolute discretion in terms of whether or not to establish a practitioner panel. It is worrisome that the same approach has not been adopted towards the PRA as has been taken with regard to the FCA – bearing in mind that the reasons for establishing and retaining the Practitioner Panel in relation to, firstly, the FSA and now the FCA, apply with equal force to the PRA.

(b) The scope of the PRA should not be a matter to be determined within its absolute discretion but by Parliament, albeit in general high-level terms, leaving the detail to be addressed in consultation with the FCA (and the FOA welcomes the fact that firms will have, firstly, the opportunity of making representations and, secondly, a right of appeal).

(c) The governance of the FPC appears *"too heavily weighted"* towards the Bank of England and the FOA welcomes the Government's intention to give this concern further consideration over the period of pre-legislative scrutiny.

(d) The FOA believes that both the FCA and the PRA should be subject to the same complaints framework and the same processes and standards of independence in the appointment of a complaints investigator i.e. complaints against either organisation should fall within the scope of the independent Complaints Commissioner – yet, for reasons that are not entirely clear, a fundamentally different approach has been adopted in the handling of complaints against the PRA.

(e) The PRA and the FCA should be required by statute to take into full account the objectives and scope of regulation of the other authority and the factors which that authority is required to take into account. This will help to ensure that the PRA, in exercising its power of veto over proposed actions by the FCA, will adopt a balanced approach and that of joint decisions will be proportionate to the objectives of each of the authorities and the factors to be taken into account by each of them.

(f) The FOA supports the proposal that the National Audit Office should undertake value-for-money studies of the PRA and the FCA, but believes this should be extended specifically to cover the setting of fees by both authorities to ensure that they are not based on unnecessary duplication and would not have a disproportionate impact on the economics of financial services business.

(g) In view of the potentially very high reputational and commercial consequences for firms that could flow from a significantly more controversial and commercially-interventionist regulatory authority, the FOA believes that the current scope of application of statutory immunity applicable to FSA should be reviewed to ensure that limiting the right of civil redress continues to be fair and proportionate.

Q5. Are the FPC's objectives the right ones? Is the concept of financial stability adequately understood for the FPC to be able to perform against its objectives?

2.5 The FOA:

(a) supports the FPC's primary objective providing systemic risk and the factors to be taken into account by the FPC when fulfilling that objective;

(b) believes that, if the social economic effect of the application of macro-prudential tools is to be taken into full account, the FPC must surely be required to consider the social implications of its actions as well as the purely economic consequences.

Q6. Should the FPC be limited in the actions it can take which might affect the growth of the financial sector?

2.6 The FOA believes that the principles to be taken into account by the FPC to ensure that a balanced approach is taken in terms of financial stability and facilitating growth in the financial sector, should apply with equal force to the Bank of England in reviewing the recommendations submitted to it the FPC to ensure that they are taken into account in the whole of the decision-making process.

Q7. How will the interaction between macro-prudential and monetary policies be handled by the FPC and the MPC?

2.7 This question falls outside the remit of the Association.

Q8. Has the right balance been struck between the powers of the FPC and the powers of the Treasury?

2.8 The FOA believes that the right balance has been struck.

Q9. Can Parliament take an informed decision about the proposals for the FPC without details of the macro-prudential tools at its disposal?

2.9 The FOA does not believe that Parliament is able to make such a decision without understanding the macro-prudential tools at the disposal of the FPC e.g.

(a) it is essential that Parliament is able to determine at this stage the adequacy of the powers at the disposal of the FPC to ensure that, as far as reasonably possible, they are adequate to deal with any future crisis;

(b) it is difficult to see how Parliament can make a judgement on the effectiveness and adequacy of statutory "checks and balances" and principles of good regulation without knowing the details of the "tools" at the disposal of the PRA.

Q10. Does the draft Bill adequately deal with the risks posed by the shadow banking system?

2.10 The FOA believes that the answer to this question is better addressed by the BBA and AFME.

Q.11 Are the PRA's objectives clear and appropriate?

2.11 Yes, although HM Treasury's power to set additional specific objectives in future should not be generated solely by any "future widening of the responsibilities of the PRA" (para 2.47 cm8083), but by experience in terms of the operation, policy and processes of the PRA;

Q12. Are there any risks in the Government's proposed 'judgement-based' regulation?

2.12 The FOA believes that such a framework of regulation is the correct way forward, but there are risks that will have to be addressed, e.g.:

- judgements must be properly evidence-based;
- supervisors must have sufficient expertise and "adjudication" skills;
- regulatory judgements must be coordinated and circulated amongst internal staff and between the PRA and the FCA (reflecting the need for common approaches);
- there must be consistency in making decisions in similar circumstances; and
- the subjective nature of judgement-based regulation should not undermine the right of firms to be able to reasonably predict the consequences of their actions nor must it become a prosecutors' "charter".

Q13. Is the Government's proposed approach to 'orderly' firm failure satisfactory?

2.13 Yes, but the regime must be sufficiently flexible to accommodate changes based on experience over the exercise of the new powers and to give full rein to FCA in dealing with client money/asset issues.

Further, there is clearly a balance to be struck between the exercise of the PRA's powers to establish a Proactive Intervention Framework in order to facilitate the recovery of firms and the possibility that adverse publicity of this nature could seriously reduce the prospect of "orderly" recovery.

Q14. Given that the PRA and the FCA will inherit FSA staff does the draft Bill do enough to ensure a new regulatory culture and a more proactive approach to regulation? Will these two new bodies have staff with the appropriate skill and expertise?

2.14 The FOA would reiterate the points made in para 1.2 in this response in terms of the establishment of a new regulatory culture and a more proactive approach to regulation.

Like any other large organisation, the PRA and the FCA will always have staff of mixed quality. While competitive salaries may continue to be a problem, it is clearly intended that they will look to recruit staff with appropriate skill and expertise; and this is aided by the fact that there are new training programmes in place. However, the current prevailing uncertainty is making it difficult not just to recruit staff but to retain existing good-quality staff; and a 'judgement-based' framework of regulation will require a higher degree of analysis and technical competence than has perhaps existed in the past.

Q15. Are the FCA's primary objectives appropriate? Is significant emphasis given to the promotion of competition?

2.14 Yes, but the FOA is particularly concerned over the omission of including "competitiveness" as a factor. As the Government has rightly observed in the Introduction to Cm8083, the financial services sector is *"one of the key sectors of the UK economy"* – an objective which is heavily dependent on the industry being allowed to be strongly competitive domestically and internationally. Further, it is difficult to see how the new authorities can perform a much more commercially interventionist role, take decisions on commercial matters and review business models, without being required to take into full account for financial institutions to be competitive.

In Cm8012, the Government asserted in several paragraphs the key importance of *"reducing the burden of regulation and improving the quality of regulation",* exploring in full the opportunity for non-regulatory and self-regulatory solutions (para 3.66-7) and paying regard to the *"potentially negative effects of excessive regulation on market efficiency and consumer choice"* (para 4.9). Unfortunately, FSA's DP scarcely mentions the need for proportionality or monitoring regulation to ensure that it does not become *"excessive"*. An inappropriate outcome in this area could be devastating for the UK's global role in financial services and for the Government's express objective of maintaining *"a competitive world-leading financial services industry in the UK"* (para 3.16 in Cm8083).

For these reasons, while the FOA strongly supports the six statutory regulatory principles set out in the draft Bill, it would urge the joint Committee to reconsider the importance of including competitiveness as a factor to be taken into account by the authorities in fulfilling their regulatory objectives.

Q16. Are the responsibilities of the FCA towards the regulation of markets appropriate?

2.15 The FOA welcomes the fact that the supervision of markets by the FCA will largely be a continuance of the same approach currently adopted by the FSA, and that its primary focus will be on the integrity and efficiency of markets and providing a level playing field for market participants.

2.16 The FOA welcomes the proposal that the FCA will have a new role in promoting competition and that competition concerns will be placed "at the heart of the new conduct regime". The FOA believes this is important because of the growing internationalisation of the marketplace which will lead to convergence in the providers of essential market services. However, the FOA does not believe it is appropriate – and this appears to be the view of both the FSA and HM Government - that the FCA should become a price regulator. Nevertheless, it should be able to monitor behaviours relevant to market competitiveness and (as set out in S.1E of the draft Bill) "efficiency and choice" in market services.

Q17. Does the draft Bill strike the right balance between the responsibilities of consumers and firms? Are the FCA's new powers in the area of consumer protection appropriate?

2.17 The FOA is concerned, as expressed in para 1.2(a) in this response, that a proper balance might not be preserved between the interests of consumers and regulated service providers.

While it is entirely right that retail investor protection and fair dealings should be at the heart of the FCA, FSA's recent Discussion Paper "Financial Conduct Authority: Approach to Regulation" (June 2011) gives little recognition to the need for proportionate regulatory treatment for providers of financial services and its view that the role of the FCA should be seen through a "consumer prism" suggests that the concept of being a "strong consumer champion", although discarded, will remain embedded in the policy approach of the FCA.

2.18 The FOA would emphasise its concerns that the new powers of product intervention should only be exercisable where there is evidenced and significant consumer detriment and that if those powers are not exercised according to clear and transparent and justifiable criteria, the degree of consequential legal uncertainty will exacerbate the risk of product innovation in the UK and prejudice the position of service and product providers.

2.19 The scale and importance to the UK of wholesale financial services business is such that it must be "*effectively and proportionately regulated in a way that recognises the particular characteristics of participants in these markets*" (para 1.39), but the FOA is concerned that this may not be delivered on the ground and that high-cost retail consumer protections could begin to dominate wholesale business, making it uncompetitive internationally and unduly costly. Stronger emphasis on proportionality would be helpful.

Q18. Are the prudential regulatory responsibilities of the FCA towards FCA-only regulated firms given sufficient emphasis and detail?

2.20 The FOA recognises that the harmonising impact of the Basel Accords and the EU Capital Requirements Directives leaves limited room for prudential regulatory flexibility – but where there is such flexibility, it should be exercised in order to ensure that prudential regulation is a fair and accurate expression of risk posed by a firm's business profile, the risk posed by it to the system, the nature of its client base and a range of other factors relevant to its risk profile. At present, it remains unclear as to if and how that differentiated prudential regulatory treatment will be applied.

2.21 It is absolutely critical that prudential regulation is not punitive, but fairly and authentically risk-based. This includes ensuring that small and medium sized enterprises, or fundamentally differentiated firms that do not pose a significant risk to the system, are not regulated as if they did pose such a risk, i.e. this is a critical area where one size does not fit all. That needs to be recognised in the nature and extent of applicable prudential regulation to what is a very large cross-section of very differentiated *"FCA-only regulated firms"*.

Q19. Will the new regulatory arrangements reduce the risk and cost of dealing with missselling of financial products?

2.22 The FOA believes that the new powers of intervention and withdrawing financial promotions will play a significant part in dealing with the misselling of financial

products. However, as it is put in Cm8083, product intervention should not become "*a substitute for regulation of the sales process*" (para 2.99). The FOA notes that the exercise of such powers is "*unlikely to be appropriate in relation to wholesale customers*" (cm8012).

Q20. Are the proposals for co-ordination between the PRA and FCA clear and adequate? What would be the advantages and disadvantages of having a Single Point of Contact and/or a joint rule book for dual-regulated firms?

2.23 The FOA welcomes the strong emphasis given by the government on information-sharing and close cooperation between the FPC, the PRA and the FCA, particularly against the potential cost implications of dual regulation for systemically important institutions, but is concerned that the Bill does not seem to incorporate "timeliness" as a critically key element in the sharing of information (and in an international context, information is not always exchanged on a timely basis!).

There is a clear advantage to having a high-level Single Point of Contact in each authority for the pooling of systemically important information. On the other hand, the diversity of the number of organisations, markets, products and instruments regulated particularly by the FCA, means that there will be a number of functional/specialist points of contact for pooling more technical information.

With regard to the possibility of a joint rulebook for dual-regulated firms, the FOA believes that this should be an advantage, but establishing a joint rulebook at this stage may be both too early and unnecessarily time-consuming. It should not become a distraction from delivering on the core changes that will be driven by what is a major exercise in regulatory restructuring or an add-on compliance burden for firms.

Q21. How do the proposals in the draft Bill fit within the new European regulatory regime? What freedoms and constraints will the UK have to operate within that regime?

2.24 The Government recognises that effective UK input into the setting of European and international standards is critically important to sustaining the role of the UK as an internationally attractive financial services centre. However, this will require significant engagement from Ministers, senior government officials and the regulatory authorities. Further, in view of the voting structure on ESMA, it will be critical for the government to build up voting "coalitions" within key EU institutions.

In view of the fact that there is no precise match (ie functional v. sectoral) between the new UK regulatory infrastructure and the European Supervisory Authorities, it is essential – and this is recognised by the Treasury – that there is full prior consultation between the full UK regulatory authorities and that, wherever appropriate, each authority takes advantage of the right of the UK member authority to be accompanied by a non-voting observer.

Q22. Does the draft Bill contain any proposals or omissions, not covered by the questions above, which cause concern?

2.25 The FOA does not support the power to issue early "pre-trial" publication of intended disciplinary actions, but if it is intended to retain this power, then, as a minimum, it should be subject to statutory safeguards, namely:

(a) that any firm which is to be the subject of any such notice should have the right to comment on its wording prior to publication; and the FCA should be required to take any such comments into full consideration;

(b) that the FCA should be required to summarise in any such notice the firms' defence to the allegation in question, recognising that there has been no finding of guilt, and that there is an overriding obligation for fairness in public disclosures of this nature.

NB. It should be remembered that, no matter how much reputational damage may be caused and no matter how inadequate the evidence founding the allegation in question, the issuance of such a notice will be protected by statutory immunity (see para 2.4(g) in this response). This should place a very high duty of care on the FCA in terms of not taking action that could generate serious commercial or reputational loss to firms for which there will be no right of redress. The FOA questions whether, in these circumstances, there should be some form of independent scrutiny to ensure that the inherent conflict in public and private interests is properly addressed and that the decision to issue a notice is made on good grounds.

While the FOA supports the obligation on the FCA to publish, as appropriate, a Notice of Discontinuance, this will do little to correct any damage that may have been caused to the reputation, jobs and share price of the firm in question.

FOA MEMBERS

FINANCIAL INSTITUTIONS

ABN AMRO Clearing Bank N.V.
ADM Investor Services International Ltd
Altura Markets S.A./S.V
Ambrian Commodities Ltd
AMT Futures Limited
Bache Commodities Limited
Bank of America Merrill Lynch
Banca IMI S.p.A.
Barclays Capital
Berkeley Futures Ltd
BGC International
BHF Aktiengesellschaft
BNP Paribas Commodity Futures Limited
BNY Mellon Clearing International Limited
Capital Spreads
Citadel Derivatives Group (Europe) Limited
Citigroup
City Index Limited
CMC Group Plc
Commerzbank AG
Crédit Agricole CIB
Credit Suisse Securities (Europe) Limited
Deutsche Bank AG
ETX Capital
Fortis Bank Global Clearing NV - London
GFI Securities Limited
GFT Global Markets UK Ltd
Goldman Sachs International
HSBC Bank Plc

ICAP Securities Limited
IG Group Holdings Plc
Investec Bank (UK) Limited
JP Morgan Securities Ltd
Liquid Capital Markets Ltd
Macquarie Bank Limited
Mako Global Derivatives Limited
MF Global
Marex Financial Limited
Mitsubishi UFJ Securities International Plc
Mizuho Securities USA, Inc London
Monument Securities Limited
Morgan Stanley & Co International Limited
Newedge Group (UK Branch)
Nomura International Plc
ODL Securities Limited
Rabobank International
RBS Greenwich Futures
Royal Bank of Canada
Saxo Bank A/S
S E B Futures
Schneider Trading Associates Limited
S G London
Standard Bank Plc
Standard Chartered Bank (SCB)
Starmark Trading Limited
State Street GMBH London Branch
The Bank of Nova Scotia
The Kyte Group Limited
Tullett Prebon (Securities) Ltd
UBS Limited
Vantage Capital Markets LLP
Wells Fargo Securities International Limited
WorldSpreads Limited

Exchange/Clearing Houses
APX Group
Bahrain Financial Exchange
CME Group, Inc.
Dalian Commodity Exchange
European Energy Exchange AG
Global Board of Trade Ltd
ICE Futures Europe
LCH.Clearnet Group
MEFF RV
NYSE Liffe
Powernext SA
RTS Stock Exchange
Shanghai Futures Exchange
Singapore Exchange Limited

Singapore Mercantile Exchange
The London Metal Exchange
The South African Futures Exchange
Turquoise Global Holdings Limited

SPECIALIST COMMODITY HOUSES
Amalgamated Metal Trading Ltd
Cargill Plc
ED & F Man Commodity Advisers Limited
Engelhard International Limited
Glencore Commodities Ltd
Koch Metals Trading Ltd
Metdist Trading Limited
Mitsui Bussan Commodities Limited
Natixis Commodity Markets Limited
Noble Clean Fuels Limited
Phibro GMBH
RBS Sempra Metals
Sucden Financial Limited
Toyota Tsusho Metals Ltd
Triland Metals Ltd
Vitol SA

ENERGY COMPANIES
ALPIQ Holding AG
BP Oil International Limited
Centrica Energy Limited
ChevronTexaco
ConocoPhillips Limited
E.ON EnergyTrading SE

EDF Energy
EDF Trading Ltd
International Power plc
National Grid Electricity Transmission Plc
RWE Trading GMBH
Scottish Power Energy Trading Ltd
Shell International Trading & Shipping Co Ltd
SmartestEnergy Limited

PROFESSIONAL SERVICE COMPANIES
Actimize UK Ltd
Ashurst LLP
ATEO Ltd
Baker & McKenzie
Barlow Lyde & Gilbert
Berwin Leighton Paisner LLP
BDO Stoy Hayward
Clifford Chance
Clyde & Co

CMS Cameron McKenna
Complinet
Deloitte
Dewey & LeBoeuf LLP
FfastFill
Fidessa Plc
FOW Ltd
Freshfields Bruckhaus Deringer
Herbert Smith LLP
Hunton & Williams LLP
International Capital Market Association
ION Trading Group
JLT Risk Solutions Ltd
Katten Muchin Rosenman Cornish LLP
KPMG
Mpac Consultancy LLP
Norton Rose LLP
Options Industry Council
PA Consulting Group
Progress Software
R3D Systems Ltd
Reed Smith LLP
Rostron Parry Ltd
RTS Realtime Systems Ltd
Sidley Austin LLP
Simmons & Simmons
SJ Berwin & Company
SmartStream Techologies Ltd
SNR Denton UK LLP
Speechly Bircham LLP
Stellar Trading Systems
SunGard Futures Systems
Swiss Futures and Options Association
Traiana Inc
Travers Smith LLP
Trayport Limited

APPENDIX II

ADDITIONAL COMMENTS ON THE DRAFT BILL

Additional Comments on the Draft Bill

N.B. The FOA anticipates that law firms and other legal experts will be commenting in detail on the draft legislation and the comments that follow are largely driven by general rather than legal/ constitutional concerns over the drafting.

1. In view of the fact that the Financial Policy Committee will be advising the Bank of England on the Bank's Financial Stability Objective, the FOA questions the degree to which the Bank will itself be influenced by the various factors which the FCA is required

to take into account, e.g. avoiding a significant adverse effect on the capacity of the financial sector to contribute to the growth of the UK economy (clause 9C(4)) or prejudicing the objectives of the FCA or the PRA (clause 9E(2)). If the Bank is not itself subject to similar constraints, it will be free to reject any FPC recommendations that take them into account. This seems to break the chain of accountability and the obligation to take into account proportionality and other statutory principles of good regulation.

2. The FOA notes the restriction on the scope of recommendations that may be made to the Bank by the FPC, namely, that they may not be made *"in relation to a particular financial institution"* (clause 9M(3)(a)).

   The FOA believes that this constraint will impair the ability of the FPC to fulfil its role in terms of identifying, monitoring and tacking action to remove or reduce systemic risks, or to protect the resilience of the UK financial system, including addressing systemic risks *"attributable to structural features of financial markets, or to the distribution of risk within the financial sector"* (clauses 9C(2) and (3)), in which certain CCPs have a critical part to play in the whole financial system.
3. Clause 1B(8) outlines the general functions of the FSA, which do not, but, in the view of the FOA, should expressly cover the key regulatory functions of supervision and enforcement, i.e.:

   (i) it cannot be implied that they are covered because they are carried out pursuant to made rules under clause 1B(8)(a);

   (ii) the functions described largely in this sub-paragraph are more *"legislative functions"* than *"general functions"* (cf. para 1(2) of Schedule 1ZA on page 200 of the draft Bill); and

   (iii) supervision and enforcement are functions carried out pursuant to the arrangements described in para 9 of Schedule of 1ZA on page 202 of the draft Bill, but they are not the arrangements themselves.

4. Clauses 1I and 1K provide for the establishment of a Practitioner Panel and a Markets Practitioner Panel, but the FOA would emphasise that the preponderance of individuals appointed to each panel should be drawn from the specific interests represented by each panel, i.e. the majority of members of the Practitioner Panel should be drawn from authorised persons and those of the Markets Practitioner Panel should be drawn from market infrastructures.

   It is noted that CCPs are not, but clearly should be, included in the list of eligible persons under clause 1K(5)) – and not left to the discretion of the FCA under clause 1K(6). It should make no difference that clearing houses will now be regulated by the Bank of England, insofar as there is a strong integration between the functions of clearing and execution.

5. Clause 1N provides that the Treasury may appoint an independent person to *"conduct a review of the economy, efficiency and effectiveness with which the FCA has used its resources in discharging its functions"*, but specifically excludes *"the merits of the FCA's general policy or principles in pursuing its strategic objective and its operational objectives"*. While it is not clear exactly what is covered by the words *"the merits of…"*, any review of the *"economy, efficiency and effectiveness"* of FCA's discharge of its functions cannot be comprehensively

addressed, unless it includes how it has implemented the principles of good regulation in relation to the discharge of those functions.

The FOA would urge HM Treasury therefore to consider revising (3) to read *"the review is not to be concerned with the merits of the FCA's general policy or principles in pursuing its strategic objective and its operational objectives, other than where and how they have taken into account in the discharge of any functions that are the subject of the review"*.

6. With regard to clause 2B, the FOA notes:

   - that the definition of *"PRA-regulated activities"* may be the subject of an Order made under s.22A of FSMA 2000 (see s.6 on page 91), but would emphasise the importance of Parliament being able to set the scope of the PRA and assumes, therefore, that any such Order will be the subject of affirmative Parliamentary oversight and believes that such Orders may be necessary to bring clarity to the scope of the PRA; and

   - that there is no equivalent definition of *"FSA-regulated activities"* and, while it is presumed that this is because it will cover all regulated activities, other than those to be covered by the PRA, believes that this should be stated expressly in the legislation.

7. Clause 2J(2) states that the PRA's arrangements for consulting PRA-authorised persons *"may"* include the use of such panels as the PRA thinks fit, but does not believe it is appropriate or desirable that the PRA should have absolute discretion in this matter. The FOA would emphasise the importance of establishing a Practitioner Panel on the same terms as the draft Bill requires the establishment of a Practitioner Panel to interface with the FCA for reasons set out in para 3.11 in this response). It continues to be unclear as to why a differentiated approach in this matter should be adopted as between the PRA and the FCA. The FOA believes that reasons for this kind of differentiation should be given, bearing in mind the circumstances surrounding the establishment of the existing Practitioner Panel, as mentioned in para 3.11 in this response.

8. With regard to clause 2L(3), the FOA would repeat its observations in para 5 above in relation to the FCA, and believes that it is entirely appropriate for the PRA's general policy or principles to be taken into account when determining whether or not it has discharged its functions with *"economy, efficiency and effectiveness"*.

9. The FOA believes strongly that clause 3B should include, as a regulatory principle, recognition of the need for firms to be competitive for reasons set out in paras [?] to [?] in this response.

10. Clause 138J provides for PRA consultation in relation to the *"making"* of any rules by the FCA. Depending on how the word *"making"* is defined, it may not necessarily cover the disapplication or withdrawal of any rules, and while it can be assumed that most amendments would be achieved through newly *"made"* rules, it is possible that may not always be the case. For this reason, the FOA believes that the term should be extended to include *"making, amending or withdrawing"* any rules of the FCA.

11. It is noteworthy that the definition of *"market in the United Kingdom"* in clause 140A defines such issues as what is meant by its location and what is meant by references to a *"feature of the market in the United Kingdom for goods or services"* (which is construed as

any structural or conduct issue). It does not actually define what is meant by a *"market"* which, in general terms, is an organised and regulated centre or network for the trading, in this context, of regulated financial instruments.

12. The FOA notes and welcomes the checks and balances outlined in clauses 312E to 312K on the power of the FCA to set and issue financial penalties on recognised bodies, but is concerned that no such checks and balances seems to apply in relation to regulated firms. For example, the obligation to publish a statement of sanctioning policy in draft form in order to allow representations to be made as regards any such proposed statement of policy is particularly welcome, but should surely be relevant to the sanctioning policy of regulated firms. The FSA's approach to "credible deterrence" and the imposition of increasingly high sanctions calls clearly for the issuance of such a policy – if only to address the tensions between proportionate sentencing i.e. sentencing that fits the crime and deterrent sentencing.

13. The FOA notes in clause 42 the listing of those "cases" under which the Bank of England must notify the Treasury of a possible need for public funds to cover financial institutions but makes no reference to CCPs, which are clearly going to become organisations of systemic importance and which, in the event of a significant default, may well require public funding to a comparable or even greater degree.

14. With regard to clause 17(6), the FOA would urge that, if the FCA decides not to adopt any recommendations of an investigator looking into a complaint against the FCA, it should be required, in addition to the matters set out in sub-para (6), to provide the investigator and the complainant with a statement of reasons as to why it has come to that decision.

15. Should the reference to *"the FCA's functions"* in clause 25(1), read *"the FCA's general functions"* or all its functions beyond those general functions, in which case have those other *"functions"* been clearly defined in order to determine the scope of statutory immunity?

16. In clauses 23 to 25, the FOA believes the observations made on the importance of maintaining the existing complaints scheme to cover complaints against the FCA, are equally applicable to complaints against the PRA. Each scheme should reflect exactly the same level of independence, in terms of both appointment of investigators, functions and processes, as will apply to complaints against the FCA (and no reason for differentiated treatment appears to have been given).

    The FOA also repeats the point made in para 14 above about the PRA providing a statement of reasons if it decides not to follow any of the recommendations of the investigator (in parallel with similar observations made as regards the situation pertaining to the FCA in the same circumstances).

17. With regard to clauses 29 to 35, the FOA repeats the points made in relation to the FCA's approach and policy towards the issuance of penalties.

18. With regard to clause 166A, bearing in mind the potentially significant costs that may have to be borne by an authorised person, particularly in the case of a protracted investigation or in the context of small and medium sized enterprises, the FOA believes it is appropriate to have a reasonableness test that will have to be observed by the FCA in requiring a firm to appoint an external skilled person to gather information.

September 2011

Sir John Gieve – oral evidence (QQ 643-691)

THURSDAY 27 OCTOBER 2011

Evidence heard in Public   Questions 643 - 691

Members present:

Mr Peter Lilley (Chairman)
Mr Nicholas Brown
Baroness Drake
Mr David Laws
Lord McFall of Alcluith
David Mowat
Lord Newby
Mr David Ruffley
Lord Skidelsky
Baroness Wheatcroft

Examination of Witness

Witness: **Sir John Gieve,** Deputy Governor of the Bank of England, 2006-09, examined.

Chairman: Sir John, good morning. Thank you very much for agreeing to appear before the Committee. You have found yourself in the centre of the banking crisis in the course of your career, as well as having a distinguished role in the Treasury before that, so we are very interested to hear your experience and subsequent reflections on the issues that concern the Committee. Baroness Wheatcroft will lead off.

Q643 Baroness Wheatcroft: Sir John, in some of your speeches you have been quite clear that you do not see a need for the change in the structure of regulation, but that is what is happening: we are getting change and are moving towards a twin-peak structure. What particular flaws do you see in that?

Sir John Gieve: I did not think a change in the structure was necessary because there is no perfect structure. Each way you draw the diagram, it has strengths and vulnerabilities. The vulnerabilities in the current arrangement are that you segment responsibilities. The danger is that everyone concentrates on their heartland and does not give enough attention to the borderline issues, and co-ordination becomes a problem. That was absolutely true in the run-up to the crisis.

The proposed arrangement gets over some of those problems. It puts the Bank of England at the centre of financial stability and therefore does not let it minimise its role in that respect, which we did.

There are still vulnerabilities and you need to take measures to mitigate them. One is that we still have a tripartite arrangement. We have three bodies that need to co-ordinate closely: the Treasury, FCA and the Bank. Second the Bill concentrates a lot of powers in the Bank and, particularly in a very hierarchical organisation—which I think the Bank has tended to be that—that leaves you vulnerable to group-think, narrowing of vision, house views and so on, so you need to work very hard on that.

Q644 Baroness Wheatcroft: To some extent that will depend on the structure and membership of the FPC where, presumably, at the moment group-think and the hierarchical nature of the Bank prevail. Do you see potential conflict between the MPC and FPC? We have had a bank that has been governed by one task. Will the division of that task, giving back to the Bank in a big way responsibility for financial stability, cause some conflict?

Sir John Gieve: No structure is perfect, but you can generally make it work if you approach matters in the spirit of co-operation and co-ordination. There are two questions here: one is how I would tinker around with the Bill you have, which broadly is likely to be passed; the other is whether I would design this structure. My view is that there is a weakness in the proposed structure. The three committees, the PRA, FPC and MPC, are separated out, and then there is the Court, which covers some quite substantial responsibilities for infrastructure and money market operations as well as pay and rations. That does not seem ideal. I would have split it slightly differently into a micro and macro committee with the management of the credit cycle through interest rates and quantitative measures, like counter-cyclical regulatory measures, on one side, and the financial regulator looking at individual institutions, but also at the structure of those institutions, on the other side, but you are not starting from there.

Q645 Baroness Wheatcroft: I am afraid we are not starting from there. I know that there are details of those issues about which others will want to ask you as we move on. There is one aspect of the twin-peak structure we are exploring about which I would like to ask you. You talked about the importance of co-operation. How do you think this is going to work for those firms that are dual-regulated? As we have taken evidence, increasingly we have found nervousness about whether the two bodies that will be looking after them will co-ordinate, or whether the costs and the work will simply double up.

Sir John Gieve: That is a risk. One of the advantages of having it all in one place in the FSA was precisely the cost, the fact that one person understood each bank and so on. The two new bodies have very different attitudes, so I do not think they will end up doing the work twice. The new structure is likely to lead to a more challenging attitude on the prudential front—the Bank has made that plain—and on the market conduct/consumer protection front. On the whole, that is probably a good thing.

In terms of collecting data and the bureaucracy of regulation, I hope these two bodies can operate on a pretty open basis and share the data they both need. It will take an effort, but it should be possible.

Q646 Baroness Wheatcroft: Are you confident that the proposed MOU will affect that, or would it be possible to try to write something into the Bill?

Sir John Gieve: The Bill is littered with MOUs and directions from one room in the Bank to another room in the Bank and all that sort of thing. It is useful to have MOUs, but the Bill does not lack provisions to make binding or non-binding recommendations to each other. What matters here is that each institution sees it as part of its role to make the three institutions more effective, not just to focus on its narrow bit of the picture.

Q647 Chairman: Harking back to Northern Rock and the subsequent more general banking crisis, in your experience were the UK authorities in any way constrained by regulations agreed at EU level?

Sir John Gieve: I did not think so.

Q648 Chairman: You did not, but did others feel constrained?

Sir John Gieve: I remember that it came up in a Select Committee hearing about whether the Bank was required to operate openly and announce its operations because of some legislation. I cannot remember whether it was or was not. It did not seem to me that was the critical issue at the time, because there were other reasons why we had to be open. The first was that just three months before the crisis Northern Rock had announced to the markets that it had a wide range of sources of funding, so it could not easily go on trading when it had only one, and that a rather special one. Secondly, we thought it would leak, which of course it did.

Q649 Chairman: Looking at the present, do you think the European and international regulatory frameworks would be a constraint on either the Bank or wider authorities when operating under the Bill in a sensible way?

Sir John Gieve: In general, regulation has to be done increasingly on an international basis. We should welcome the fact there are international rules, but they bring some constraints on what we can do. It does not make any sense for London in particular, as an international centre, to operate on completely different standards and rules from other international centres. You create all sorts of perverse incentives. In general, the G20, Basel and European equivalent is a positive move in which Britain has played a big role in drafting over many years.

What constraint does that put on the authorities here and what happens in the UK? There are three particular dangers: first, if Europe gets out of line with the rest of the world. The centre of British policy for the last 30 years has been to try to get policy set in Basel, G7, or something involving the Americans and Japanese, and get the Europeans to accept that. That has worked remarkably well, but there is always pressure to go off piste.

Secondly, there is branching in: the home host arrangements within Europe. In BCCI and again with the Icelandic banks we saw that as a weakness. You can have financial companies operating here which are not subject to regulation. Where they operate from

outside the EEA you can force them to subsidiarise. That gives you some authority over the Americans, Japanese and so on, but it gives you no authority over big players like Deutsche Bank and new and potentially disruptive players. Europe has taken some steps to put in place a supranational constraint on that, a sort of appeal mechanism to the three new committees which can, in certain circumstances, say that Iceland, or the future equivalent of Iceland, is not doing the job and, therefore, something must happen. I am not altogether convinced that that is adequate, and from a different angle it is very much resisted by the stronger countries. But so long as companies have the right to enter in branch form and operate under somebody else's regulation and supervision that limits the powers of the British authorities.

Thirdly, there is the question about maximum as well as minimum harmonisation. I think it would be batty to make it a maximum. In legislative terms it has certain simplification to pass regulations rather than directives and so on.

Q650 Chairman: That is a very interesting point which had not struck any of us. You said that if it was made maximum as well as minimum it could be implemented by regulations rather than directives; is that right?

Sir John Gieve: I am not an expert on this, but regulations are directly applicable and therefore set the maximum as well as the minimum, unless there is a specific provision allowing authorities to go beyond it. The technicality is not the important thing. It is important that Britain and other countries retain the right to do extra.

Q651 Chairman: It has been universally assumed—I took it for granted—that setting and co-ordinating a minimum internationally is a good thing, because otherwise if banks could operate in countries where a lower level of capitalisation was required they would have an advantage. It has now emerged that banks in continental Europe seem to operate with a far higher level of gearing than British banks and yet they do not seem to have swept the board. Is it such an advantage to be able to run risky operations in the way they seem to have been allowed to do with a higher level of gearing than British banks?

Sir John Gieve: That may be true now; I am not sure it was true in 2007 when some of our banks were very highly geared. Is it an advantage? Economic incentives never work perfectly, but over a long time if they are tilted they tend to have a cumulative impact. You could see that in the way banks behaved towards sovereign debt. For example, zero weighting has been very important in the way they constructed their balance sheets. You can see it in mortgage-related debt which was lower weighted, and so on. It is a real risk. If we set higher capital requirements as recommended by the ICB for investment banks, particularly based in the UK, that will put them at a disadvantage. I take it that the ICB's more or less explicit judgment was that if we wanted to maintain London as an international financial centre it was important to restrict the part of it for which we took any fiscal responsibility.

Q652 Lord Newby: Perhaps I may ask about the role of the Governor under the new arrangements. The Governor is going to be chair of the FPC, PRA, MPC and the Court. He is taking on a lot of new responsibilities.

Sir John Gieve: Not the Court.

Q653 Lord Newby: Not the Court, but the other three. He is therefore taking on additional responsibilities but not ceding any. Do you think he is being given too much power under the new regime?

Sir John Gieve: All of that is a very heavy burden, especially when you add in that he is chair of the Basel Committee, deputy chair of the European System of Central Banks and is on the G7, G20 and so on. His life could be one long series of committee meetings. On the whole, it does put too much weight on one person's shoulders and it would be good, assuming the Bank will have these new responsibilities, to delegate up or down a bit.

Q654 Lord Newby: Do you have any specific suggestions about how that might work? Of the plethora of things he will have to do, if you had to reduce it in any respect which do you think it would be most appropriate for him not to do, as it were?

Sir John Gieve: Within the structure that has been set up, the obvious thing is to give one of his Deputy Governors a proper job and make them chair of something. The PRA would be the obvious one. That is a bit awkward because you have a Deputy Governor who will be chief executive, and so on. None the less, I would delegate that. The Governor's role is very odd. Mostly, we move to a chairman and chief executive arrangement and in this case we have not. We have an executive chairman except in the Court, and the relationship between the chair of the Court and the Governor is not the normal chairman and chief executive relationship. Within the structure we have got one obvious thing to do would be to make Paul Tucker chair of the PRA.

Q655 Lord Newby: We have concentrated specifically on the role of the Governor, but you have touched on the broader accountability and governance arrangements that the new structure will establish. Other than possibly giving the Deputy Governors these additional roles, do you think that other parts of the accountability and governance arrangements as proposed are satisfactory?

Sir John Gieve: They have changed since I was at the Bank. The Court has been slimmed down and is said to be working better. I am a bit out of date on what it looks like from the inside. There is a problem with the Court, because the Governor and executive team are not really responsible to it for the most important things they do. The structure suggests that the Court is the steward of how the Bank is performing, whether it is performing adequately and it should be holding the Governor to account and in some sense have the authority to tell him to do something differently. That is what it looks like on the diagram. But the Court does not have oversight of or authority over many of the important things that are happening in the Bank and which the Governor is doing. In a way, he is much more accountable to the Chancellor and Parliament than to the Court. That is unsatisfactory, but it would require quite a radical change to address that.

One obvious thing you could do is make your macro-economic committee, which in my view should cover macro-prudential as well as monetary policy, the top committee and have the Governor as chair of it, and then delegate down some of the authority over particular aspects of the Bank's operations and hold them to account through that committee. That would make the Court more like a normal public sector quango board as well as a private sector board. If you do not do that you have to make the external stewardship mechanisms

much stronger; one option is for the Treasury to do it. In my experience, the Treasury rather backed off after the Act which established the independence of the Bank and the FSA. They became very frustrated by us, but they did not intervene in the run-up to the crisis to address the fact that there was a lot of concern that the institutions were not working properly. Nor was there full Parliamentary accountability. As far as Parliament was concerned, there was accountability in the sense that the Governor and his staff came to give an account of themselves, but there was not any authority over the Governor. There is a bit of a gap there. I do not know whether that makes sense.

Lord Newby: It does make sense.

Q656 Mr Brown: Perhaps I may follow Lord Newby's line of questioning. Should the FPC be a committee of the Court?

Sir John Gieve: I do not think it really matters hugely whether or not it is. There is gain from having some cross-membership. In practice, the FPC will be largely independent of the Court and its main accountabilities will be elsewhere. I do not see any harm in having members of the FPC on the Court. It will make the Court better informed and engaged in at least part of the Bank's important work.

Q657 Mr Brown: Is the Court as currently structured fit for this purpose?

Sir John Gieve: I have just talked about that. I think there is a fundamental problem with the Court, in that it should be the non-executive dominated body holding the executives of the Bank to account. I do not think it really can do that because large areas of the Bank's responsibilities are out of its range. The FPC is largely out of its range, although it has an appointing role and a review function. When I was there certainly the people on the Court were excellent; it was not that they were all hopeless time-servers. There were some very strong people there, but the odd arrangement where the Court does pay and rations plus quite a lot of things—infrastructure, money markets, an oversight role and resolution—still does not give it authority over or very much insight into what is going on in monetary or financial stability policy. That leaves it unable to do the full stewardship role.

Q658 Mr Brown: Do you think membership of the FPC is drawn from too narrow a base?

Sir John Gieve: It has not been appointed yet.

Q659 Mr Brown: You can see the way it is going.

Sir John Gieve: It is very important to have people who understand financial markets. In my ideal arrangement you would have a slightly broader macro-policy committee, which brought people with an understanding of financial markets into the MPC as well.

Q660 Chairman: And effectively have just one committee dealing with both money and credit?

Sir John Gieve: Yes, and then have the PRA dealing with the structure and resilience of the financial system, not just the individual banks. The FPC's remit is a good one; it explicitly says there are two halves to it. One is to make banks resilient against shocks, ie to ensure that they do not over-gear and so on individually; and that the structure of the financial system itself is resilient, so the network effects will not be destructive of stability. That is the sort of thing that Vickers has been addressing. That is one side of it. The other side is to keep the credit cycle under control, so it is really about protecting the economy from the banking cycle and cyclical variations through things like loan-to-value ratios, capital, liquidity and margin requirements and so on. It seems to me that that second part cannot easily be cut off from decisions on interest rates. Interest rates are the price of credit and these are quantitative restrictions on credit and they are bound to intertwine. I am going off on my ideal structure again.

Q661 Mr Brown: But in general terms from what sort of world do you think the people who serve on this committee will be drawn?

Sir John Gieve: It is important for the FPC, because as currently drafted it has a dual mandate, to have people who have a macro-economic view and can take a view on the credit cycle as well as people who understand financial markets, how banks work and so on. It needs to have both groups on it.

Q662 Mr Brown: You mentioned earlier the accountability arrangements and accountability to Parliament. The Bill does not propose any structural change in accountability to Parliament; it is through Treasury Ministers, essentially the Chancellor of the Exchequer and his ministerial team, and to the Treasury Select Committee with the Governor's regular reporting to it, but nothing else. Do you think that is adequate? These are big new powers and decisions being handed over to the independent structure of the Bank.

Sir John Gieve: It was already independent; it is just a slightly different body.

Q663 Mr Brown: I am not quarrelling with its independence.

Sir John Gieve: It is all a question of how you use them. Most of the serious mistakes that happened under the tripartite arrangement were before the crisis, not in the crisis. The grinding of the gears and difficulties of co-operation in the crisis got a lot of attention. They are quite exciting and can make for good stories, but what went seriously wrong with the tripartite arrangement occurred before that. We allowed fiscal policy to run out very badly; we did not stop the housing and credit boom in Britain in the run-up to the crisis. Therefore, the crisis, which was largely centred abroad, hit us when we were badly prepared.

To come back to accountability and stewardship, one reflection is that the Treasury, having set up this machine, did not actively manage it. It ran down its forecasting and economic capability. It also ran a very thinly staffed financial services operation which concentrated

mainly on European legislation. Parliament certainly did hold the Governor and MPC to account, in that it made them give accounts—that worked—but it really did not have the authority to do more than hold up what they said to public view. You could change that. There are now confirmation hearings and you could strengthen that. That would give the Select Committee more authority, but it would cut across traditional ministerial relations. The alternative is that the Treasury has to play a more active role in stewardship over the bodies it has created as to whether they are working, gaps are appearing and the individuals doing the jobs are up to it.

Q664 Mr Brown: Is not our core problem not with the regulator and the different structures but the regulated and the cultural behaviour of some of the financial services institutions that we are trying to keep on straight lines?

Sir John Gieve: Yes. We have a regulator only because we need to change the behaviour of the regulated.

Q665 Mr Brown: Maybe a better question is: what should we do about that?

Sir John Gieve: I do not have a new idea as to how better to regulate the financial sector. It has to be a mixture of capital and liquidity requirements, which are increasing; structural changes which make it easier to manage the failure of banks and other institutions, and incentives. That is the bit where more work is to be done, as Andy Haldane said the other day.

Q666 Chairman: You said you thought the problem lay not so much with the events during the crisis as the run-up to it—the failure to control the growth of credit and the credit cycle—implying that the MPC focused on monetary policy and either ignored or did not have the tools to control the credit cycle. Does that mean you see scope for potential conflict between the FPC and MPC when each has separate responsibility for different things?

Sir John Gieve: As to the history, clearly excessive credit growth comes in as credit growth in aggregate at a macro level, but it also appears as leverage in the banking system, or shadow banking system. You could say that the FSA was responsible for that and the MPC was responsible for the first. But if you had asked the FSA whether it was their job to control house prices or the growth of credit they would have said it was macro and it was the job of the MPC. It is for the MPC to control that. We saw it as our job. We just did not think it was necessary. At the bottom of this was an intellectual mistake, and not just in Britain. We did not have the tools, but we did not ask for the tools either.

Coming back to whether there could be conflict, there should not be a terrible conflict because half the committees are made up of the same people. The co-ordination will be eased by the fact that the Governor and his attendant Deputy Governors and so on will be in both, but they will to some degree be addressing the same problem in different places and that is not ideal. It puts quite a lot of weight on the Governor and his deputies to do the co-ordination out of committee, if you like.

Q667 Chairman: The scope for conflict may be minimised by overlap of personnel, but is there scope for intellectual conflict between the objectives of the MPC controlling inflation and the FPC controlling stability and the flow of credit?

Sir John Gieve: Yes, absolutely. We have a case in point at the moment. The MPC is clearly very alarmed that we are slipping back into recession and the banking system is tightening up already, partly because of worries about the euro and so on. In a different part of the forest there is clearly an agreement of some sort between the Bank and Treasury that fiscal policy needs to be tightened, and therefore no major action is possible on that front. You then have two tools to address it: regulatory tools and quantitative easing. In the last two months there was a meeting of the FPC to consider whether they could do something to address this situation through the regulatory apparatus. They decided not. That is understandable, because their remit is financial stability and they are saying, "Maybe we are coming into another great banking crisis. Is this the time to tell banks to start using their capital buffers?" No". The MPC must be aware of the fact that the macro-prudential side of policy over the last three years has been highly pro-cyclical. We have had the brakes jammed on on that front as well as the fiscal front. We have a slightly odd arrangement where we have the handbrake hard on, the foot brake on but the accelerator pressed to the floor. Perhaps it should not surprise us that we are hopping along the road in a slightly inelegant way.

Lord Skidelsky: I would like to continue that conversation.

Chairman: Feel free to do so.

Q668 Lord Skidelsky: It will emerge from the questions. The draft Bill gives the Bank of England's Financial Policy Committee responsibility for financial stability. What are the requirements of financial stability in your view? Can that term be defined satisfactorily in terms of an operational objective? If not, would it be better to have objectives that can be defined more carefully?

Sir John Gieve: It is easier to define and spot financial instability than financial stability. You can point to the conditions that are likely to give rise to financial instability and address them, particularly leverage; single points of failure; inadequate funding for key parts of the sector, and so on. Those are the things that we do address. I do not think there is a measurable number you can pick out and aim at, as we do on the inflation side. Even on the inflation side, the idea that you can sum up everything in a single number has turned out not to work very well.

Q669 Lord Skidelsky: But it is not even a question of putting a number to what you mean by stability; the concept itself is pretty elusive. Therefore, to make it an objective and give the FPC the task of ensuring it seems to me—I do not know whether it does to you—rather peculiar. I have a follow-up question. Often, the main requirement of financial stability is seen in terms of having a sustainable supply of credit, and the suggestion of Barclays Bank is to replace the proposal in the draft Bill with the phrase "to maintain a sustainable supply of credit". Do you think that would be a better objective?

Sir John Gieve: I do not, and that really would take you right into MPC territory. It would be very odd to have a separate committee charged with maintaining a sustainable supply of

credit on one side and hitting an inflation target on the other, operating mainly by the regulation of credit.

To come back to the Chairman's question of whether there is a potential tension between the objectives, the FPC's objective is an asymmetric one. There is a double negative rider that does not authorise them to do anything which in the long term will damage growth, which is an ingenious way of not putting in any objective to promote growth or the financial services sector. The result is that you have an asymmetric approach. They are trying to avoid instability; they do not have an objective to contribute to the sustained growth of the economy. That is where the potential rub point is.

Q670 Lord Skidelsky: Just to finish this off, sustainable growth of employment and the economy would help achieve the objective of financial stability, because the demand for credit is just as important as its supply in maintaining financial stability. That objective is not there, or has it been smuggled in under "having regard to the growth of the economy"?

Sir John Gieve: That is why I do not think this alignment of committees is the one I would have come up with. We are living in a world where we have a set of macro-economic objectives or at least two: one is to sustain growth and the other is low inflation. We have now a variety of tools to bring that about: monetary policy, which is traditional through interest rates; fiscal policy, which is back in the frame, and regulatory policy, so-called macro-prudential policy. If you were making a split, as I would have preferred, then you probably would have moved to a fuller mandate for the macro-economic committee than just an inflation target, but that is taking us out of the frame of the Bill.

The point you make about growth is very important, in that there are numerous ways in which the FPC will have to make trade-offs between growth and safety. Those trade-offs are given a strong bias towards safety. The intellectual justification for that is that instability is so destructive that it all works out in the end; by being super-safe you also get the best growth. I wish the world was that simple.

Q671 Mr Ruffley: Sir John, you rejoiced in the title of Deputy Governor for financial stability. You said that you did not have in the Bank at the time the macro-prudential tools, but you also said that you did not ask for them. Would you say that was your biggest mistake?

Sir John Gieve: In policy terms, probably. The mistake was that we all saw that the markets were frothy and a correction was coming but we failed to see that we were on the edge of catastrophe, so it was a misjudgment. That was the main mistake and it was one we shared with most forecasters, most of the financial sector and other international authorities. That was the big mistake. If we had seen clearly the risks building up in the system we should certainly have thought carefully about whether interest rates were a sufficient instrument on their own and have asked for powers, or just discussed it with the FSA and the Treasury and got them to use their powers.

Q672 Mr Ruffley: I am not personalising this, but I am very interested in the role of the Deputy Governor for financial stability which you fulfilled. May I take it that the Governor of

Sir John Gieve: He did not ask me just to concentrate on financial stability. I was a member of the MPC as well, and that was seen as at least as big a part of the job. Nor did he completely step out of this. The main topic of conversation in Basel and so on was not monetary policy but traditionally precisely these issues about financial markets and so on. He played a part in those. Possibly he did delegate more in this area than others. I even chaired the so-called Financial Stability Committee, of which he is a member, and that certainly did not happen elsewhere, partly because his remit to me was to focus on doing good analysis and producing a decent set of reports rather than taking action.

Q673 Mr Ruffley: History shows that not enough action was taken or warnings given when you saw the over-gearing and all the things we now know about. I just wondered whether when you were chairing the Financial Stability Committee, the Governor would be looking at the work that you and your officials were putting up to the committee. But was there any relationship between you and the Court, or you and anyone at the Treasury, who was checking, if you like, that you were doing your job, or that the Deputy Governor of the Bank of England was doing his job for financial stability? To whom were you accountable?

Sir John Gieve: I was primarily accountable to the Governor. The Court did take an interest in this, and non-executive members of the Court came to the Financial Stability Committee. We gave reports to them on a quarterly basis. I had a role too. I was on the FSA board and so I was part of the hinge between the two bodies. I was on the Standing Committee chaired by the Treasury, and we certainly discussed our reports, which were quite good in terms of identifying vulnerabilities but just not their scale. We did various contingency exercises and so on, all of which were quite useful, although not as fruitful as they could have been because the conclusions on things like deposit insurance and resolution regimes always went in the "one day desirable" rather than "unavoidable today" box.

Q674 Mr Ruffley: The Bill that we are looking at manifestly places a huge amount of power in the hands of the Governor and the Deputy Governors. What troubles us is what happens if you get it wrong and there is a misjudgement. Who is overseeing what is done? You mentioned there were quarterly meetings with the Court. Was there anybody at the meetings with the Court who had experience of financial regulation? Were there any experts taking you and your officials through your paces when you were producing these reports?

Sir John Gieve: There were such people on the Court: there was the chairman of the FSA; a banker, Bob Wigley; Paul Myners; and Andrew Likierman, who was on the board of Barclays. There were people who knew quite a lot about the financial sector. They found this very interesting. Looking back on it, you say: why did they not do something about it? The answer is that there was shared group-think, if you like; there were risks and tensions but we did not judge we were on the edge of the cliff. I think that answers your question.

Q675 Mr Ruffley: There were quarterly meetings and, as far as you were concerned, there was sufficient expertise present in the Court members who were scrutinising those quarterly meetings, and you were all just the victims of group-think. Is that a fair summation?

Sir John Gieve: We were not the victims of group-think; we were participants in it. There were people on the Court who had enough background in the financial services to take an informed interest. But at that time the Bank saw its job as primarily the responsibilities it had been given in statute, which were very much in the monetary policy arena. The financial stability function had been run down over a number of years in terms of the numbers and depth of analysis because this was seen largely as FSA's job. We kept up an analytical and monitoring machine, but there was not responsibility for taking action and the Court did not push that on us. However they made a lot of intelligent comments about our analysis and they drew things to our attention. That bit of it worked quite well.

Q676 Mr Ruffley: Apart from the Court holding to account the Deputy Governor for financial stability and his officials, you have also spoken about two other alternatives, which are not mutually exclusive. One is that the Chancellor and/or Parliament should be the person or body to whom the Deputy Governor is responsible. But is not the problem that, in relation to the work of the Deputy Governor of the Bank on financial stability, Parliament is not going to be able day to day to scrutinise your reports; the Chancellor is not? In terms of the day-to-day work, realistically is it not the Court of the Bank of England that ultimately is going to be the scrutiny body? They are in the same building; they will be able to call for papers and say, "We're not quite sure about that", or, "Can we have more information about that?" Is it not a bit of a fiction to think that a Deputy Governor for financial stability could be accountable to Parliament?

Sir John Gieve: You are talking about the Deputy Governor. Clearly, a lot of his or her accountability will be to the Governor of the day. You are the deputy. That is the first point.

Q677 Mr Ruffley: Nevertheless, a deputy with specific responsibility for financial stability.

Sir John Gieve: In a more traditional structure the Court would be the board of the Bank that held the executive, including the Governor and Deputy Governors, to account. That did not work very effectively when I was there. It was better as a support mechanism than a challenge mechanism, not because the people were not good people, but mainly because they did not have responsibility for or oversight of the key business of the Bank, the Governor and Deputy Governors. Under the proposed arrangement it seems to me there is a risk that the same will be true and, although they will have more responsibility for the FPC, it will still be at arm's length, ie the decision on whether to tighten the capital requirements will be taken in the FPC and examined in Parliament, and the Court's role in examining it will not be the effective mechanism.

Q678 Baroness Drake: In response to Mr Ruffley's point, you said, "We thought that a correction was coming but we didn't see we were on the edge of a catastrophe." Why did you not see it?

Sir John Gieve: Why did we not see it? We did not understand. Here "we" is quite a big body of people, not just the Bank of England or the FSA. It certainly applies to the rest of the

regulatory community internationally. We did not see how the globalisation, complexity and lack of transparency in new markets would implode when the cycle turned. We thought that markets were working better than they were and had more defence mechanisms. We tended to give too much weight to the idea that the new markets allowed people to control and hedge risk and failed to understand how far they would amplify risk in a downturn.

Q679 Baroness Drake: If you had three categories, that is, lack of knowledge, lack of intellectual analysis and confusion over responsibilities, which would you rank as contributing most to not seeing it?

Sir John Gieve: I think lack of knowledge. Lack of insight was the absolutely key mistake here, but structural weaknesses in the workings of the tripartite arrangement may have contributed to that.

Q680 Lord McFall of Alcluith: Sir John, you will remember that during the crisis when the principals of the TPA came along I asked them if all of them had done their job and they said that, according to them, they had done it well, but when I asked the Governor of the Bank who was in charge he asked me, "What do you mean? Can you define 'who's in charge?'" I thought it was quite simple. However, does the new arrangement now bring clarity to who is in charge in identifying the problem and getting remedial action as a result; or if in future there are any crises, God forbid, could the principals come to the Treasury Committee and say they had done their job and the issue of who is in charge would still be a bit like a marshmallow?

Sir John Gieve: In terms of financial stability and taking actions to prevent the breakdown of stability, it is very clear who is in charge: the Governor is in charge and he is responsible. That is a change. There is not a question of whether responsibility is with the FSA or the Bank; it is now definitely the Bank. Ambiguity may arise if there is a crisis. Is the Chancellor in charge or not? I have not studied the Bill at huge length on this, but there seems to be a trigger mechanism in which the Bank informs the Chancellor of a potential risk to public funds. In practice, at that point the Chancellor takes over. Throughout the process from 2007 to 2011 the Chancellor chaired the meetings and set the agenda, but Alistair said afterwards that he found it very frustrating, that we were very difficult to deal with, et cetera. I can understand that. The only question is whether the Bill needs to give some recognition of that. I do not think it should go to the point of transferring all the Bank's and FCA's legal powers to the Chancellor at a trigger point, but it would be sensible to have some recognition that in a crisis where the taxpayer is at risk there is a duty for the Bank and FCA to co-operate under the chairmanship of the Chancellor.

Q681 Baroness Wheatcroft: Among all the stable doors that have been crashing, attempts to find a resolution regime had been foremost in people's minds. On top of that, we now have the ICB report and its suggestion about ring fencing. Do you think ring fencing would serve any purpose? Will it work? Do you trust the system proposed by the ICB?

Sir John Gieve: It is a sensible proposal. I do not think it will work in the sense it will make it possible to let Barclays or Barclays Capital go to the wall in a crisis. When there is a real crisis of confidence the main channels of contagion are not the mechanical question of who owes what to whom and uncertainties over that; it operates much more through confidence.

We definitely reached the stage in 2008 when we had to save everything—there was really nothing too little to save—in order to prevent a contagious loss of confidence across the system.

If we get into those circumstances again, as we could quite soon, it may well be impossible for the Government or the authorities to step aside, even with these ring fences, and say, "We're saving only this bit and letting this bit go to the wall." It will make it easier to manage the rescue and make creditors pay towards the cost of it than it was in 2008. If it is operated properly it will lead to a greater transparency in the structure of our big banks which are made up of thousands of intertwined companies, mainly for tax and regulatory reasons. If you can create greater correspondence between the businesses and legal structures that will make the handling of a crisis much easier, and would help you to deal with an idiosyncratic failure in a way that put the bills in the right place.

Q682 Baroness Wheatcroft: But if the aim is to limit taxpayer liability, given what you have said about not being able to see a massive bank go to the wall even if its basic retail banking operation is ring fenced, would you advocate the next step which is total separation?

Sir John Gieve: I do not think that would work either. Remember that Lehmans and Bear Stearns were broker dealers. At the time they and the Fed assured me that there was no safety net underneath them but when it came to a real financial market crisis they turned out to be critical. There is no way of getting out of the risk to the taxpayer by structural measures, but I still think they can be useful, and they are useful. Part of this is to get banks to pay the true cost of funds and to get the markets to think there is at least some probability they will not be saved. That will put up the cost of funds and is putting up the cost of funds. You have seen that for some of our banks their rating has already changed in response. To that extent it can put the burden in the right place.

Q683 Baroness Wheatcroft: Nevertheless, if the risks exist, as you say, do you think the regulators should take a much more draconian view of the sort of activities that we let these "too big to fail" institutions get up to?

Sir John Gieve: We are going to. That is part of this judgment-based prudential regulation. As I read it, we are going to be much more challenging on the extent of banks' operations, the speed at which they grow and so on and so forth, and quite right too. One thing to which I would pay a lot of attention, if I was doing it again, is the sheer scale and breadth of a bank's operation. It is perfectly obvious that the guys running these banks did not fully grasp what was going on inside. Their companies were just too complex and big for one board to manage, so that is a consideration. If we go ahead with the ICB proposals my guess is that we will end up with much smaller British-owned investment banks because they will suffer in comparison with countries which have not taken these measures and have not upped the capital requirements so much. That may be a price worth paying for maintaining London as the marketplace in which the deals get done.

Q684 David Mowat: We have covered a number of points on structure, but I was taken by a number of words you used in your evidence. You said the Bill was littered with MOUs; it was not your ideal structure. Where this would really matter in terms of structure is in a

crisis, because if you have MOUs defining responsibilities that are not clear, that is when you do not have time to fix it. Do you think there is an issue about structure and that because we need so many MOUs here clarity and accountability is not seen?

Sir John Gieve: I am sorry I sounded too scornful of the Bill, but there are lots of occasions when the FPC can send a binding recommendation to the PRA and the Governor and Deputy Governors will be able to stand up, walk up with it and address it to themselves further down the corridor. The need for all these mechanisms is partly because we are still trying to preserve quite a lot of segmentation of decision taking. That is why I would prefer to have fewer committees with a slightly broader remit. In another part of the forest the Bank is going to oversee infrastructure and payment systems. (Incidentally, I have an interest in payment systems; I am chairman of VocaLink.) It also has responsibility for money-market operations, which were perhaps the most contentious thing at the time relations between the Treasury, FSA and the Bank and within the Bank were most strained. It was over money market operations. These are outside the MPC, FPC and the PRA. You could simplify the structure a bit, and that would obviously result in less need for formal arrangements for co-ordinating.

Incidentally, I do not agree that it is worst in a crisis. The main mistakes happened before the crisis. We did not handle the crisis very elegantly but we got better at it, and the pressure of events led to quite a high degree of co-ordination even under the present structure.

Q685 Mr Laws: I have two quick questions. First, on the FPC and MPC you have made clear you believe it would be better if there was a single committee rather than two. Is it your basic concern that these committees are likely to come into conflict, so one might have its foot on the accelerator and the other on the brake, or is it essentially that you think they will be discussing very similar issues with similar personnel and therefore it will be simply a waste of time having two committees, which would probably be co-ordinated quite well but would be replicating a lot of the same discussions?

Sir John Gieve: It is more the second. The FPC and the PRA are doing the structure and the resilience of the financial sector, and the MPC is doing macro-economic stability. It seems to me the MPC have a real interest in measures taken to constrain growth of credit, or at the moment to ease the restraint on credit. Yet the FPC are approaching it from their angle. It just seems to me to be sensible to have one body looking at all the instruments together: QE, interest rates and the counter-cyclical regulatory policy.

Q686 Mr Laws: You have been very open with us about the misjudgments you think were made in the last decade and how, even if you had had the powers in the Bill, the MPC might not have done anything differently. If you were now sent back in time with all the knowledge of what has happened since and all the powers in the Bill, tell us what you would have done differently from, say, 2003-04 onwards that did not happen in terms of either monetary policy or macro-prudential policy?

Sir John Gieve: There are two things. One is that we should have run a tighter policy.

Q687 Mr Laws: Higher interest rates?

Sir John Gieve: We should probably have had higher interest rates and taken measures to restrain the growth of credit, not just in the housing market but in the leveraged commercial property market and so on, which caused our banks such grief. I hope we would have taken those measures.

Q688 Mr Laws: Does that not imply that there might be an inadequacy in the inflation objective, because presumably if the Bank was doing its job in terms of the inflation objective in the last decade but, on your model, ran a tighter policy overall you might have undershot the inflation target?

Sir John Gieve: Yes, we would have undershot the inflation target, and we probably should have done. One thing we learned was that a single inflation target, that number, does not quite catch thing you have to care about. With my reorganisation you would have to revisit that. I take it that part of the reason for the structure we have is that there is no appetite to revisit that MPC inflation target.

I am sure that if we had seen the sort of things that were coming we would have taken much more interest in the growth of the derivatives market and growth in credit markets and a much more aggressive stance to try to strengthen the resilience, at least of British institutions, against the collapse of those markets. As to whether it would have made any difference had we had the powers, of course it would, because I would not then have been an informed analytical observer saying, "What's happening in the financial sector? Where are the vulnerabilities?" I would be thinking, "I am responsible for minimising these vulnerabilities."

Q689 Mr Laws: You appear to be saying that if we had had this model in place in the last decade and the MPC/FPC, whatever you call it, had made the right calls it would still have needed a different objective in terms of inflation for it to work, because you are saying you would have had to have a tighter overall policy stance and undershot inflation in order to avoid the financial disasters of the last few years.

Sir John Gieve: There are three points. First, we could not avoid the disasters. London is an international financial centre. What was going on in America was far more important than what was going on here, so we would have been hit just like every other country. But we could have been hit better prepared with a stronger economy and financial system.

Second, looking back on inflation, we should probably have been running inflation nearer 1% than 2% through the years in which we were in effect importing deflation. The goods index was regularly around zero, and that was a good reason for undershooting, but we did not see it like that.

Thirdly, the inflation remit does not capture everything the Bank needs to do on the macro-economic front. If the Bank had seen two years ago that inflation would now be 4% or 5%, would they have tightened policy two years ago? I do not think so because I think, rightly, it was concerned above all to re-establish some growth in the economy. Personally, I think it would be an improvement to recognise that there is a balance of objectives here rather than hang on to the view that there is just one number that they should look at.

Q690 Baroness Drake: I suppose it comes back to the point about insight. The Bill gives the FPC the objective of identifying systemic risk arising from unregulated activities. The phrase "shadow banking" is frequently used, but that requires the FPC to have sufficient information to identify those risks and see what is coming. Do you think the Bill provides sufficient powers to the FPC to discharge that remit, in particular its powers to access information or require information from these unregulated activities?

Sir John Gieve: I know the Bank would like to have slightly broader powers to be able to demand information. I do not see why they should not get them. Looking back, though, we had enough information in 2006. It was the interpretation of it that went wrong. We are unlikely to repeat that mistake in the next 10 years. This is seared into the souls of anyone who has had anything to do with financial regulation and economic policy, so people will be very alive to it and much more risk averse in the foreseeable future. I do not know whether if we had had a completely different structure we would have done better. If you look round the world, there were all sorts of structures which, on the whole, made the same mistake, so I do not want to say that a structural change could have avoided it. The Bank might have operated better and made more noise about the vulnerabilities it did identify if it felt itself to be responsible, but the truth was that we did not have any statutory powers in this field and the mindset was one of narrowing the scope to where we had powers and explicit responsibilities.

Q691 Baroness Drake: But this Bill restricts the FPC's abilities in terms of accessing information from these unregulated bodies to a situation where the Treasury decides that a serious threat is posed. Is there an element of "after the horse has bolted", or do you think that is not an issue in the structure?

Sir John Gieve: I doubt if it is an issue at the moment. I cannot see the Treasury refusing the Bank's request to collect information at the moment. One of the ways the Bank can have an impact on growth is through the weight and cost of regulation. I guess this is intended to be some sort of restraint on that by putting the Treasury in the line. In practice, for the foreseeable future I do not see it working as much as is hoped for. Maybe when memories have dulled a bit it could, so perhaps the Bank should be given the right just to ask for the information.

Chairman: Thank you very much indeed, Sir John. I am conscious that we have slightly overshot our target, as even the Bank of England occasionally does. We are very grateful to you for coming today and answering our questions so openly and frankly.

Goldman Sachs; Deutsche Bank and JP Morgan – oral evidence (QQ 848-914)

TUESDAY 8 NOVEMBER 2011

Evidence heard in Public Questions 848 – 914

Members present:

Mr Peter Lilley (Chair)
Mr Nicholas Brown
Baroness Drake
Lord Maples
Lord McFall of Alcluith
David Mowat
Mr George Mudie
Lord Newby
Mr David Ruffley
Lord Skidelsky
Baroness Wheatcroft

Examination of Witnesses

Witnesses: **Andrew Procter**, Global Head of Government and Regulatory Affairs, Deutsche Bank, **Sally Dewar**, Managing Director, International Regulatory Risk, JP Morgan, and **Robert Charnley**, Head of Regulatory Controllers, EMEA and Asia, Goldman Sachs, examined.

Q848 Chairman: Good afternoon. I welcome our witnesses and thank them for agreeing to appear before the Joint Committee considering the Financial Services Bill. We can see who you are, but for convenience would you simply say who you are and which your organisations are?

Andrew Procter: Chairman, I am Andrew Procter from Deutsche Bank. I am the Global Head of Government and Regulatory Affairs.

Sally Dewar: I am Sally Dewar from JP Morgan responsible for International Regulatory Risk.

Robert Charnley: I am Robert Charnley from Goldman Sachs. I am responsible for our Prudential Regulatory Controllers function for Europe and Asia.

Q849 Chairman: Thank you. I start the ball rolling with a simple question. All of your organisations are subsidiaries of banks headquartered overseas. To what extent do you envisage the regulations in the Bill that we are discussing impinging upon you? To what extent do you think you will primarily be affected by the regime in your parent companies and country?

Sally Dewar: At JP Morgan, we will have multiple authorities overseeing us going forward, as we understand it, from both a prudential and a conduct perspective. The way we currently envisage it is that, from a prudential perspective, we would have multiple authorities. For our asset management business, for example, we would see that being prudentially overseen and regulated by the Financial Conduct Authority, and, for our other lines of business, by the Prudential Risk Authority. It is absolutely critical for us that there is a joined-up approach in terms of how the group overall is regulated and how all that comes together. The way the FCA and the PRA work together in terms of colleges or just oversight is absolutely critical for us.

Andrew Procter: Chairman, we are in a slightly different position. We in fact operate principally as a branch in the UK. The BaFin will remain our primary prudential regulator, which is, in effect, the same situation as applies now. It is important that there is close co-operation between the BaFin and the PRA, and, indeed, that we provide information to the authorities in the UK that they need to understand emerging systemic risk because of the prominence that we have in particular markets. On the conduct side, of course, it is the Financial Conduct Authority, and its remit fully applies to our operations here.

Robert Charnley: In our case it is very similar to Sally. We operate in the UK through a number of subsidiaries which will be dual-regulated by the PRA and the FCA. I very much echo Sally's comments in terms of the need for a joined-up approach across those two organisations, but we will be fully regulated by both.

Q850 Chairman: Moving on to a rather gloomy subject, but one which has sparked off this whole legislation, with the collapse of Lehmans, do you think the proposed legislation, together with existing legislation on the statute book, provides a sufficient framework for handling the failure of an investment bank without the sort of problems that were caused by the collapse of Lehmans? If not, what else is required?

Andrew Procter: As you say, Chairman, together with the existing legislation, the UK has been seen very much at the forefront in providing new legislation and extended powers to deal with failing banks. If we particularly take the Lehmans situation and internationally operating banks, that will not be enough. It will be essential that there is close co-operation across borders. In our case, in particular, for example, our key recovery and resolution group includes not only the German and UK regulators but all of the US regulators. This is still work in progress. It is important that they reach an agreement about the consistency of recovery and resolution planning across those jurisdictions.

There is a difference of emphasis between the US and Europe that still needs to be reconciled. There is work to be done on determination of what kind of business needs to be preserved and protected so that, in the event of failure, there is not a systemic read-across. That is still work in progress. There has been a lot of progress in agreeing the basic documentation and getting in place the key information that authorities would need in the

event of a failure. I would say we are along the path but still quite a way to go in terms of international agreement and co-operation.

Sally Dewar: If I consider it more from a domestic perspective, the construct of the Financial Policy Committee fills a very important gap in terms of the macro-economic oversight for the UK, but obviously that is not the only piece. If I think about the lessons that need to be learned from the crisis, as I saw it, one is definitely about financial stability and the macro-economic pieces. But supervision and the strength of supervision, the strength of risk management within firms and the governance arrangements all have to be reformed in order to have the full complement of the reform package that is needed. They come through multiple elements of the global reform package. It is not just the UK; it is global.

We also need to look at what is coming out of the EU in terms of the crisis management piece, as Andrew says, relating to the whole recovery resolution package that the FSB is supporting. We need to consider that in its totality when we think of whether the reform package is sufficient, but we always have to recognise at the back of our minds that the next crisis could be in a format that is entirely different. We must not lose sight of that when we are thinking about the reform.

Robert Charnley: I would perhaps only add that this draft legislation does correctly identify and establish a framework for the specific topic of resolution. I agree with Andrew and Sally that more operational work needs to be done between regulators and regulated institutions in terms of the provision of additional information to inform recovery and resolution planning efforts. That is work already under way, but I do think this draft legislation is an important element of the support framework for placing resolution as one of the central topics that needs to be addressed in the post-crisis reform efforts.

Q851 Chairman: Yet when Lehmans collapsed, despite not being a deposit-taking ordinary bank, it was said that the reason it precipitated such a widespread shock effect across the world was the sheer complexity of its interconnectedness. No one knew who the counterparties were. In what way are those sorts of problems resolved by legislation either before us or already on the statute book?

Andrew Procter: There are two key areas where things have changed. First, the interrelationship that Lehmans had with other counterparties was particularly in its OTC trading. The moves towards standardisation, central clearing and settlement of OTCs, and greater transparency there, will make a significant difference. It is important that the CCPs that support that remain strong and there is an ability for clearing members to participate and assist in the event of a clearing member's failure. So far, Europe seems to be getting that part of it right.

Secondly, there was, as you say, Chair, just a lack of knowledge and information about Lehmans, its organisational structure, its key contractors, who did what and how to keep the lights on. One of the things where most progress has been made in recovery and resolution planning across the UK, European regulators and in the United States is a shared belief in putting together a key information pack. All of the big banks—and I am sure all these three banks—will have shared the experience. An enormous amount of information has to be made available and kept up to date. It would mean that, when a liquidator arrived

on the scene, they would be in a much better position to understand what those connections were within the group and with external contractors.

Sally Dewar: I would add that the improved oversight on client assets that the FSA has already proposed, and the work that has been done on counterparties and counterparty risk management, as Andrew says, comes through very strongly in the recovery and resolution work at which both the FSA and the global authorities. as well as FSB, are looking. They are absolutely critical.

Robert Charnley: I have nothing further to add.

Q852 Baroness Wheatcroft: On the resolution regimes, how much neater and simpler are they to operate if the structure is that of a subsidiary rather than a branch structure? Equally, with regulation in most forms and insistence on capital ratios and so on, how willing would Deutsche be, for instance, if the pressure was really put on—and the Governor has not been quiet on this—to adopt a subsidiary structure, and if not, why not?

Andrew Procter: In fact, despite that being the common view, the complexity of the Lehmans winding-up is added to by the subsidiary structure. The subsidiaries in each jurisdiction are subject to winding-up in that jurisdiction. Connections between winding-up authorities, insolvency authorities, insolvency practitioners and insolvency courts internationally are quite poor. One of the streams that the Financial Stability Board is working on is improving that interconnection between insolvency practitioners. But, in fact, an insolvency would be simpler if it were all based in one jurisdiction, contrary to common wisdom.

What drives a subsidiarisation question is not the simplicity of insolvency. It is the desire on the part of some regulators to be able to get their hands around things in the event of failure. A solution that is preferred, and it is certainly the one that we prefer, is not to look at it in terms of legal constructs but to look at the businesses and the materiality of those businesses, the substitutability of those services, and then make a judgment about what needs to be done in the event of a hypothetical failure to protect that service and to prevent contagion or systemic risk across a marketplace. That is the way that the recovery and resolution discussion is now progressing.

Q853 Baroness Wheatcroft: The interconnectedness with any bank obviously makes a wind-up difficult. On the other hand, if you are looking at it from the point of view of a national regulator, having a neat, clean operation in your territory has advantages, particularly when you are looking to impose new capital requirements. Why are you not keen on the subsidiarisation structure when others are?

Andrew Procter: I am not sure it is as simple as some are and some aren't. In fact, let's be clear; we have 5,000 subsidiaries within the bank. There is not an aversion to having subsidiaries where it is appropriate, but it is a question of the implications of subsidiarisation for capital, liquidity and risk management. The quarantining of capital and liquidity and the ability to manage risk across the group is impeded, depending upon how far you take the subsidiarisation question and how high the firewalls are. In an extreme example, we are required already to subsidiarise in Japan and Korea, with enormously high firewalls that in fact frustrate our ability to manage risk in the way we would want to. The United States also

has an insistence on subsidiarisation. It is not simply a case of a preference for one. We are already forced down certain paths; so we can already see the advantages and disadvantages of it. The preference is to be able to manage risk on a group-wide basis.

Q854 Baroness Wheatcroft: 5,000 subsidiaries might sound like the sort of complexity that is going to cause problems anyway.

Andrew Procter: In fact, for the important operating subsidiaries there are only a few dozen.

Q855 David Mowat: I have a supplementary question on that. It is perhaps more for Goldman Sachs and JP Morgan. Is your operating structure in any way geographic: i.e. is the UK a P&L node, or do other businesses go up beyond the UK?

Sally Dewar: We operate on a line of business model—so investment banking and asset management, but within the UK we still have legal entities that roughly split that way too. For me, one of the critical factors that the UK authorities have to consider is to do with the critical functions to the UK, not just the legal entity structure. While everybody can get focused on legal entity, there are some aspects where a legal entity might in and of itself not be systemic but some of the support services they provide within their UK infrastructure might be. You have to look at it from both aspects.

Q856 David Mowat: I can see that, but your businesses, therefore, go across legal entitles and in a sense the statutory account is something that comes later. It is not the primary P&L node. It seems to me that it must be awfully difficult for you to be regulated, because a business would potentially straddle dozens of regimes.

Sally Dewar: You can see the main function of a legal entity within a line of business in the UK, even though we operate globally across regions.

Q857 David Mowat: Yes, but it is not how you think about the business, is it?

Sally Dewar: No; that is exactly right.

Robert Charnley: I would add, though, that it is clearly critical to think from both perspectives about how these businesses operate. We are structured fairly similarly, in that we run our businesses along business lines as opposed to necessarily along geographic or regional lines. Having said that, we pay a lot of attention both to individual legal entities in terms of their financial position, their regulatory capital position and so forth, and to regions. We are interested in the performance and risks within regions as well as across regions.

Q858 David Mowat: As risk managers, do you principally report to people that are managing the overall business or to somebody that is managing the statutory bit in the UK?

Robert Charnley: In our sector it is both.

Sally Dewar: We do both too.

Q859 David Mowat: Which one would be primary?

Robert Charnley: I would say they have equal primacy, so the interests of a legal entity have to be considered alongside those of the business.

Q860 David Mowat: I am a little surprised by that. I would have expected you to have said that the thrust of it was by business, and that is where the seniority in your organisation would have lain.

Robert Charnley: As I say, it is clearly important to have a consolidated view of risk and understand how risk builds up across the different entities through which we operate, but it is certainly of no less importance to understand at the individual legal entity level how the risk carried in that entity impacts its financial position.

Q861 David Mowat: I have a final observation. The guy that runs the overall business, then, is potentially subject to dozens of different jurisdictions within his business, isn't he? He must be.

Robert Charnley: Certainly, there is a need to understand across different jurisdictions and individual legal entities how risk is aggregated. In our case—and probably echoing Andrew's comment earlier—the actual number of subsidiaries through which we operate that carry risk and are operating entities is really quite limited. The need for any individual business manager to understand their risk is something that can be achieved relatively straightforwardly in terms of how that aggregates across the operating entities.

Q862 Lord Newby: You have already referred to the need to have a joined-up approach as far as possible. One area that is not joined-up in terms of structures is the UK and EU structure. How worried are you about the difference in structures and whether that means you can have an effective way of exerting influence from the UK within a different structural format?

Robert Charnley: I would say we are not worried by it. We clearly recognise that, with that difference in structure, there is the potential for a mismatch in terms of the specific areas of focus of the UK bodies vis-à-vis their EU counterparts. I don't think we worry about that so much as recognising a need for there to be adequate co-ordination mechanisms within and across the UK authorities to ensure that they are interfacing effectively with their EU equivalents. In this respect, we very much agree with the comments you have heard from AFME and others in previous sessions that this legislation could be improved by perhaps providing more specifically within the legislation a committee or some other process for achieving that level of co-ordination as regards interaction with EU bodies.

Sally Dewar: I would say there is a potential for concern. There are lots of similarities between the proposed UK structure and the European structure. The UK has to speak with one voice, and there is a risk that the UK does not speak with one voice because you have different authorities being represented on these European committees. In order to make

sure we maximise the influence that the UK can play, we need to make sure that that one voice is coherent, well articulated and consistently applied. There are also some interlinkages that we are concerned need to be formally embedded within the process. For example, how the Financial Policy Committee interrelates with the ESRB, we think, is something that is very important and needs to be formally addressed.

Andrew Procter: I have two other observations. First of all, let us not assume that the European statutory authorities have worked out how to divide the world up themselves. There will be overlaps, duplication and potential gaps for them as well. Sally mentioned a systemic risk board, but if you take one of the FCA's powers around the banning of financial products, both the EBA and ESMA have the same power. They have not worked out how they will divvy up responsibility.

I would also take it up a level. The G20 regulatory agenda is being implemented by the Basel Committee, by IOSCO, the insurance association, and by the Financial Stability Board. The UK's consistency of message to those authorities is equally important, because by the time some of these proposals get to the European Union they are already pretty well baked. I agree with Robert's observation about the need for close co-ordination. A committee secretariat might be a way of achieving that, but it is not just about the European authorities. It is about the global position.

Q863 Lord Newby: It is presumably also about the effectiveness of the individuals who are doing it. A number of people before us have been worried about how effective the UK was in terms of the people who were representing us on some of these bodies. Do you share that concern? If you do, have you considered putting forward people from your own organisations to go on secondment to work for them?

Andrew Procter: We should accept that the UK has a tough task in a number of these European committees. Certainly, I have sat as a regulator on European committees and so has Sally. Often, the position is that the UK thinks there is suspicion. I don't think it follows from that that the standard or the quality of UK participation or representation has been poor. On the contrary, almost invariably, the UK has made the strongest or at least a credible and helpful contribution to the debate, but it is a debate which is now extremely diverse. There are very different views, and very often the discussion is about things that most concern the UK, but everyone has an opinion.

On the question of secondment, from our perspective it works both ways. We are happy to take people in and we are happy to send people across. Both Sally and I sit on the stakeholder groups for the two new statutory authorities: Sally for the Securities and Markets Authority and I sit on the Banking Authority. We try to participate in that respect as well.

Q864 Lord Newby: One issue at the moment between the UK and the EU relates to capital requirements and whether the EU should prescribe maximum capital requirements. There is obviously a potential problem there with the proposals in the Independent Commission on Banking. Do you think that there should be a maximum capital requirement required by the EU, or should it be left to national regulators to determine that?

Sally Dewar: Everybody has bought into a global regulatory reform package. We are certainly extremely supportive of the proposals that have come through Basel III. We believe it is absolutely critical that as an international package, in order for it to be successful, it has to be implemented on a global basis. It has to be adopted globally and consistently applied. Any deviation from that risks undermining the whole of that framework, which was done on the premise of a financial stability backdrop. It was done globally to protect countries, economies and firms for the future. That is the package that everybody has adopted and has signed up to, and that is the one we believe we need to focus on and make successful.

Robert Charnley: One of the elements that is often forgotten, which existed in the Basel II framework, is the pillar 2 element, which allows individual regulators to impose additional capital requirements for risks that they do not believe are adequately addressed by the minimum standards. The FSA, in the past, has been a pretty active user of pillar 2. Going forward, I would expect similarly the PRA to be an active user of that. We should not overlook that element of flexibility that the regulators have.

Q865 Chairman: If they are allowed it by European Directives.

Robert Charnley: They will be.

Andrew Procter: I think pretty clearly they will be given that pillar 2 power, but it is a bank-by-bank judgment about the need for additional capital or liquidity or other constraint on a risk-based view of a particular bank. That would survive in CRD IV.

Q866 Chairman: The Governor of the Bank of England was fairly emphatic last week that he thought CRD would limit the extent to which he could pursue, particularly, counter-cyclical measures.

Andrew Procter: I have read his evidence. My understanding of what he said was that he was exactly right in this respect. Basel normally expresses itself as a minimum harmonisation standard. The European Commission has judged that, consistent with a single market and the ability to provide services across that market, in Europe there should be a maximum harmonisation. But there are two further ingredients. One is the one that Robert has touched on: pillar 2, bank by bank, making a risk-based judgment and adding capital requirements. The other is a counter-cyclical buffer. So jurisdiction by jurisdiction the prudential authorities can judge that the credit market is overheated and they can add an additional capital requirement. For example, if the UK were to judge that there was an overheated credit market, they could ask banks in the UK to hold additional capital up to an additional 2.5% against the assumption that doing that will cause a contraction in the credit market. There is that power across the market as well.

Q867 Chairman: Who sets that maximum of 2.5%?

Andrew Procter: It is also part of the Basel package. That is again provided for in CRD IV.

Q868 Baroness Wheatcroft: Turning to the Financial Policy Committee, do you think its objectives need to be spelt out a little more? Do you think the current objective for

achieving financial stability is sufficient, or should there be some stipulation about ensuring that there is an adequate supply of credit, for instance, which some of the banks have suggested? Are you comfortable with what is in the legislation at the moment?

Andrew Procter: I have seen the BBA proposal. I see the symmetry with the MPC objective. I understand the concern that the current objective might be read as a rather negative one, and that there is a need to balance stability and growth. The other proposals that the BBA and others have put forward—that is, a combination of the Treasury putting forward on behalf of the Government guidance as to the factors that might be taken into account, together with the Committee itself stating each year the factors that it would regard as significant and the criteria that it would have for success, together with a requirement that it reports on those and its key decisions, that it is transparent as to its process, minutes are published and there is effective parliamentary scrutiny—ought to be enough to achieve that balance.

Sally Dewar: I definitely believe that the Financial Policy Committee, in making their overall judgment about financial stability, should stand back and think of the broader implications on the economy. That should be embedded within their thought process and not to do that, I think, could have unforeseen consequences. It forces the Financial Policy Committee to stand back and think of the broader implications.

Q869 Baroness Wheatcroft: By leaving it vague, in a way, it focuses the mind.

Sally Dewar: Yes.

Robert Charnley: It would be helpful to provide some elaboration of the objective and the definition of financial stability. I am aware that a number of people, better qualified than me, have struggled to define exactly what financial stability looks like and what it means in practice. A number of indicators have been suggested, for example, that could provide some useful colour on what the overall aim of this stability objective is. I do think it would be useful to require the FPC to do further work there and publish some additional criteria as to how that objective might be targeted in a particular point in the cycle.

Q870 Baroness Wheatcroft: Given the overriding remit of this committee, which is a very powerful new institution, how do you feel about the make-up of this body? Do you think maybe there should be more outsiders from the Bank on it? Should non-economists be represented on it, for instance? Do you have any thoughts on the make-up of the Committee and its accountability?

Robert Charnley: In terms of the make-up, I have no specific suggestion. Given the difficulty, perhaps, of defining financial stability and the need to take account of a broad range of factors, not just domestically but across jurisdictions, given the global nature of financial markets, I do think the breadth of expertise needs to be carefully thought about. I do not have a strong view today on the proposed make-up of the Committee and whether it would have that breadth of expertise, but I do think that is something on which this Committee should very much focus.

In terms of the tools available to the Committee, again, we have seen in some jurisdictions some use of macro-prudential tools. I do not think we have enough experience

yet globally of those tools in practice, how effective they are, what potentially some alternative tools might be and what effect they might have. I do think it is very important, again, for any given tool that may be identified, for there to be some transparency around how it is expected to operate and what its objective is.

Sally Dewar: I agree. I think it is valuable to have a broader expertise and broader insights. When you think about all the discussions that have been had around the construct of a board of a major financial institution and the expertise that brings added value, then I agree with that in this context as well. I also think that you have to stand back and look at the different objectives of the different authorities that are represented on the Committee. If you think about one specific example—liquidity—the PRA will be focused on drawing up the liquidity buffer. The Bank of England will be focused on the definition of liquidity and what comprises liquid assets. We have a broader macro-economic objective of increasing the supply of credit and a squeeze on funding. Somebody needs to stand back and say, "Putting all of that together, does that work?" I see that as the role of the Financial Policy Committee. You need to have the broad expertise that can stand back and think about those issues in the round.

Andrew Procter: To answer the question from the other direction, I do not see any reason to circumscribe the membership by reference to any particular profession. As Sally and Robert have said, if people can contribute, they should be able to contribute. It is a very difficult job spotting systemic risk. It is easier to say it than do it. The history has not been good for those who have attempted it. Analysing the kind of data that will come in and looking for trends is very tough. Deciding on the impact of the macro-economic toolkit and which lever to pull is also very tough, but I do not think that precludes any particular profession.

On the question of oversight and governance, I don't have a strong view about whether it is five/four, one way or the other. It is much more important that the focus be on its transparency; that the minutes are available; that key decisions are reported upon; that that is done against the criteria that we discussed in answer to the earlier question; and that there is an ability on the part of Parliament to ask questions about exactly how they went about their job.

Q871 Lord Skidelsky: Could I ask your views on a macro-economic question, because this underlies a great deal of this proposed legislation? The FPC is to be given the necessary powers to ensure the stability of the financial system. Why is the financial system unstable? Why does it need to be stabilised? Is it more unstable than any other sector of the economy, or is it equally unstable but the consequences of its instability are greater? That is the first question. Why do we need these powers? What makes the financial system or the banking system inherently unstable?

Sally Dewar: In terms of the UK, the financial services sector is a hugely important part of the economy and the contribution to GDP. That is one aspect; it is hugely important. It is very interconnected. As we saw with Northern Rock, when there was a squeeze on wholesale funding and the bank was so dependent on wholesale funding, then that rippled through the whole banking sector. There is a huge amount of interconnectedness in the way the global banking model has grown up. That means we have to make sure that the brakes

and the levers embedded in that system are as robust as the drivers of revenues and business models that underlie it.

Q872 Lord Skidelsky: Are you then saying that the banks concerned were unable to manage their own risks—they didn't know what they were doing?

Sally Dewar: There are many lessons to be learned from the crisis. Alongside regulators who did not understand the business models in sufficient depth and did not understand the risks being built up in the balance sheets, similarly the risk management processes, the escalation of issues, the management information within the institutions—I am talking very generally here—through the reports that have come through the supervision committees since the crisis, would suggest that, yes, that was an issue.

Andrew Procter: You can also look at it slightly differently. An individual bank may be doing fine at managing its own risk, but it cannot exist in isolation in the system. The transmission of shocks from one bank to another and the contagion effect caused by sentiment and loss of confidence is an enormous risk. Even today, as you look at the markets, an individual bank may feel that it has managed and hedged its positions and has adequate collateral, and yet it recognises that the value of that collateral might be very quickly eroded in the event of a failure of some unrelated bank.

Going back to your earlier question, there is, if you like, an inherent instability that comes from that kind of contagion effect, although I cannot answer it as an economist, as I know you are. But, also, the consequences for the real economy are so much greater in the financial sector, as we have seen. If you think of the failure of other large corporates, they can be dramatic, but they tend to be more contained than the failures of the banks and the impact of that on the real economy and on ordinary citizens.

Q873 Lord Skidelsky: Was the inability to manage risk or the deficiency in managing risk due also to the speed of innovation? Innovation was proceeding at a huge pace and people did not understand what the implications of the innovation were.

Andrew Procter: I am not sure that it was speed. I certainly agree that people did not understand some of the risks that they were facing. They may not have understood them six or 12 months later either. I am not sure it was simply a matter of speed. I think there was an underestimate of the potential for some of the tail risks to emerge.

Robert Charnley: On that point, I would add that one of the things that was missing, both within institutions and across the supervisory community, was a perspective on the concentration of risk. It was not necessarily to do with innovation, complexity or the speed of transmission. It was the accumulation of concentrations of risk across the system, which, for any individual institution, was perhaps harder to spot and within the supervisory structure perhaps not adequately catered for in terms of both the information available and the action to be taken, when information was made available, as to potential build-ups of concentrated risks. The work that is under way globally, and reflected here in this legislation, in terms of focus on macro-prudential issues and particularly risk concentration, is critically important as one of the gaps exposed in the crisis that needs to be addressed in the regulatory reform process.

Q874 Lord Skidelsky: Can credit growth be moderated in a boom and boosted in a recession? It seems to be an assumption that we are looking forward to the next boom, which seems to be some way away. We are more confident now that we can cut off the boom by changing the supply and price of credit before it gets out of hand. Is that confidence well based? Looking at it the other way round, can we boost the supply of credit in a recession? We can presumably print a lot more money. Can we boost the supply of credit?

Andrew Procter: As I am sure you are aware, in the context of the Basel reforms there has been a war of models going on and competing views on that point. There seems to be general agreement that raising capital requirements will cause contraction in the credit markets. That is the basis of the counter-cyclical buffer. But by how much and how quickly is the subject of enormous debate. I am not sure I can do any better than to say there is a spectrum. Clearly, that has been recognised by the Independent Commission on Banking here. That is why they talked about the phasing in of requirements. That is why the Basel proposals are now phased in to 2019. Frankly, nobody really knows the extent to which raising capital would cause that contraction. They have to make assumptions about other ways in which the banks would absorb the impact of that.

Q875 Lord Skidelsky: There is no accepted transmission model.

Andrew Procter: There are many competing models. That is the way to think of it. I know that, when the BIS did some modelling work for the Basel Committee, they had of the order of 50 to 60 different models that they looked at to try to get a sense of the potential range of outcomes.

Sally Dewar: I would add to that, again, going back to the importance of Basel III and the regulatory reform programme that it proposes. As Andrew says, nobody can say for sure, but they have done the most work and the most analysis. We need to get behind that programme and implement it so that the intention is that it will iron out those booms and bust scenarios. That is what the framework is predicated on.

Q876 Lord Skidelsky: But the conclusion is that there is no confident expectation that it will do that, because there is no agreed model on how it will do that.

Sally Dewar: There are two things. That is why there is such a long lead-in time, and the transition process tries to address that. There is also a very long monitoring period. Basel is constantly monitoring what is happening as we implement, and making adjustments as necessary. That is really important.

Andrew Procter: I take exception with one premise in your question. I think there is confidence on the part of the Basel Committee that a counter-cyclical buffer imposed over a 12-month period would cause a contraction in the credit market. Whether they could demonstrate it is another matter.

Q877 Lord Maples: In all the unravelling of what went wrong in the run-up to this, we have concentrated very heavily on the failures of regulation, but actually the failures were

within banks. Quite a lot of stories have emerged which lead people like me, and I consider myself a reasonably well-read observer of this scene, to think that what went wrong in quite a lot of banks, perhaps including yours—I don't know—was that the motivation was too much for individuals, or at least in some areas of activity, and not with wealth management, because that is obviously a discrete area where it is quite difficult to do this. The employee was motivated hugely by their own personal reward formula to do things that you would not do in normal businesses. You would not risk the business. You would put the customer or the client first, the business second, and yourself third. Somehow, the reward mechanism distorted that. I don't know whether you would disagree with that, but, if you do disagree with it, please say so. What I am more interested in is what your banks have done since the Lehmans crash, both on the front of trying to introduce a different ethic and in the mechanistic approach to people's compensation arrangements. What have they done to try to address that problem, if you do accept there is a problem?

I note you are all gamekeepers turned poachers, though you have been at Goldman Sachs so long I am not sure how many game-keeping genes are left. I am particularly interested in the fact that you have both made that transition and therefore can both perhaps view it slightly more objectively. I would be interested in whether you recognise that is a problem, and if you do, what your individual banks have done to address it.

Robert Charnley: Yes, I would say we recognise the problem you refer to. One of the things that became apparent as the crisis unfolded and in the analysis that has been undertaken in the aftermath was, in some cases, certainly, failings in risk management and misaligned incentives. The risk management dimension is especially important here. With appropriate culture and risk management structures, some of the incentive issues can perhaps be mitigated and controlled. That is not enough in its own right, but to the extent that the incentives were misaligned and there were failings in the culture and structure of risk management, then you saw problems as a result.

To answer your question of what we have done, in our case you may be familiar with the work that we undertook over the past year, culminating in a report from our Business Standards Committee, which aimed to look at some of the lessons learned through the crisis, particularly as it relates to our interactions with clients and both our own understanding and our clients' understanding of how we interact within the roles that we play with respect to clients. The work of the Business Standards Committee resulted in a number of recommendations on how the obligations we have to clients need to be clarified and made clear and transparent, both to our own people and to the clients that we serve.

Q878 Lord Maples: Do you see that as a set of ethical issues?

Robert Charnley: It certainly touches on ethics. The question of ethics is perhaps deeper and more embedded than simply a question of how we interact with clients. Clarity on the specific obligations we owe to clients is a more precise question perhaps than just an ethical one. But, yes, I think ethics are absolutely important to the culture and the spirit of how you interact with clients as well.

Sally Dewar: The thing that I would observe, looking at the way J.P. Morgan does it this year and not being part of it last year, is how embedded risk management is in the remuneration process. That was one of the aspects that came out of Sir David Walker's report, and it is embedded within the remuneration code that the FSA has put in place. I

observe compliance with that code and I also observe, as I say, very strong engagement from risk management in terms of looking at individuals' compensation and the risk-reward balance.

Q879 Lord Maples: As a result of that, have actual changes been made in people's individual compensation arrangements? There must be some sort of company ethics, and most businesses do try to inculcate into their employees a strong sense of what the business is about. Do you think those things have both changed for the better? This sort of thing would have shocked you when you were a regulator, I imagine. I am not asking you to say—except JP Morgan, of course.

Sally Dewar: I am limited in what I can observe. Obviously, in the broader sense, in my previous role, I saw a much bigger spectrum. In my current role today, I just see the compliance with the code and I see risk engaged. I don't know if that is a change from last year. I cannot comment on that.

Andrew Procter: The code reflects, initially, the Financial Stability Board recommendations and then a couple of requirements, with Directive 3 provisions on remuneration. There have been four essential changes in the mechanics of how remuneration works. First of all, the balance between cash and stock for bonuses has significantly changed in favour of stock.

Q880 Lord Maples: What are the exercise periods of that?

Andrew Procter: That is the next change. The deferral periods are now extended out to about five years, typically. The claw-back provisions are much tougher than they have ever been before, either for malice or misconduct or because the profits upon which the bonus decision was made turn out to be illusory. Finally, there is a far greater emphasis on indicators of good and bad behaviour being reflected directly in the bonus decision. The regulators here, and all of our key regulators around the world, expect us to be able to document a process by which we capture information about the behaviour of individuals and directly reflect that in bonus decisions. If you compare today to, let us say, 10 years ago, just to neutralise the discussion, it is more about their behaviour and less about whether you think that next year they are going to do a wonderful job for the bank and make lots of money. The banks are really held to account for that in great detail by the regulators. You are now expected to be able to demonstrate the connection between the information you have gathered and the decisions you have made.

We have a group Compensation Oversight Committee of which I am a member. I am sure the other banks do as well. Our job on that committee is to make sure we can demonstrate that there is real accountability and that people who take the bonus decisions take them according to that set of standards. That is, of course, against the mechanical background of the change in the balance between cash and stock, the greater deferral and the much greater ability to claw back.

Q881 Lord Maples: To a large extent, you all seem to see this as a mechanics of compensation as related to risk issue, which I agree with—it is a hugely important part of it—but it seems to me that it also raises what I would call ethical issues. You have all

touched on it, but I wonder if I could push that a bit further with you. If I am a graduate recruitee, or whatever the word is, to one of your banks, to what extent, in my induction training and my continuing education at the bank as I progress through it, are ethics an issue on which you would expect to engage with me and teach me what they are within the company? Have those changed since 2007, or has the importance of them changed?

Andrew Procter: The articulation of them has become clearer. I would think that at bottom they have not changed, but there is a much clearer articulation and expression of them. On your key point—to what extent we seek to inculcate those ethics into new joiners—every new joiner at our bank, and I am sure at Sally's and Robert's bank, goes through an induction programme in which culture and ethics are the most important things. They are much more important than your e-mail address or how to find your way around the bank. That is the most important thing. It is the expectation that the bank has of you as an employee and your responsibility for protecting the reputation of the bank. That is not just a selfish, inward-looking thing; it is a consequence of the damage that you can cause by inappropriate behaviour. That is really what the induction programmes are about these days.

Sally Dewar: I experienced that first hand, having had the induction programme when I joined JP Morgan. It was exactly as Andrew says. There is a huge focus from Jamie Dimon on the reputation of the firm, the way we do business and the risk management processes. That sets the culture. As a regulator, it was something that was considered a lot in relation to whether you can formally embed a regulatory process on culture and ethics. There were a lot of discussions in my final year at the FSA about that. The view was that it is a tone that is set at the top. It is set primarily by the board and then that filters through the risk management processes, the governance structure and the way business is done. Everybody has to adopt that, going right through the firm.

Andrew Procter: Just to pick up on that before Robert answers, I also run the bank's reputational risk programme. One of the toughest things is how you get the message across, because the same words can mean totally different things to different people. Effectively, you do it by telling stories. You tell stories about the bank on what is acceptable and what is not acceptable rather than use trite formula. We do have codes of ethics. We do succinctly state our expectations, but that is not enough. It is absolutely about telling stories and demonstrating a commitment to those values at the top. In the event that someone fails to exhibit those standards, going back to your earlier question, that will be reflected in a reduced bonus. Frankly, that is a very powerful way of dealing with it.

Q882 Lord Maples: Even if they made less money than the guy next door.

Andrew Procter: Especially, I suppose—but certainly, yes.

Q883 Lord Skidelsky: Even if they made more money.

Andrew Procter: That is the better question. That is exactly the point.

Robert Charnley: Certainly, these topics are embedded in our induction process, but I would also stress the importance of an ongoing focus on these. That is exhibited in many ways but certainly through the risk management and decision-making processes across our bank. We establish the relevant committees that are charged with decision making around

transactions and risk decisions, interaction with clients, the handling of conflicts and so forth, with the most senior people across the firm. Many of our senior people sit on more than one of these committees and it is absolutely the mandate of all of those committees to focus on reputational and business standards issues.

Q884 Lord Maples: If any of this is in writing in a form which is available to share with us, we would be very interested to see it, because it does seem to me to go to the heart of a lot of what went wrong. I want to ask one very specific thing. Would your proprietary trading desk be allowed to knowingly bet against a client's position?

Andrew Procter: I was going to say in answer to your first question about remuneration that pure prop trading in that sense just does not exist in our bank. We do not remunerate anyone in that way. I don't think we want to be distracted by the complexities of the Volcker Rule, but there is a very difficult issue related to holding stock against anticipated client flow which might still be counted as prop trading.

Q885 Lord Maples: That could be just a market maker's activity.

Andrew Procter: Anyway, the answer to your question is no—in our case.

Sally Dewar: No.

Robert Charnley: Equally no.

Lord Maples: In which case, for at least one of you, that has changed in the last four years, but for the better. Thank you very much.

Q886 Chairman: On a general point, because time is racing on, it was important to hear from all three of you on those last issues, but when one person's answer suffices for the other two, please just nod and we will go on.

On the issues which Lord Maples has been raising, you specifically mentioned discussions and negotiation or supervision by the regulator on payment structures. In the existing legislation, before this Bill comes into force, does the regulator have the power and the discretion to exercise power to change the remuneration system at banks? Perhaps, Sally, you would like to answer that.

Sally Dewar: Certainly the regulator has the authority to rip up a contract. That was part of the debate that was held last time on the whole issue of contracts and the interaction between regulation, and whether they should be involved directly in the remuneration of individuals. It is a very intrusive process that the regulator goes through, looking at those individuals who fall within the code and the terms on which they will be remunerated. They have a very powerful role.

Q887 Chairman: There is no particular reason to enhance the powers or bring in new powers?

Sally Dewar: Not in my view, no.

Andrew Procter: Those powers are the domestic implementation of particular provisions of Capital Requirements Directive III. They exist at European level and, provided they are effectively implemented in each country, the powers are there.

Q888 Lord Maples: Did I understand you to say—and I am sorry to interrupt—that the regulator can, to use your words, "rip up an individual contract"?

Sally Dewar: That was the terminology that was used, yes.

Q889 Lord Maples: And that is exactly what you said?

Sally Dewar: Yes.

Lord Maples: It sounds a pretty strong power.

Q890 Baroness Drake: Judgment-led approach to regulation requires, among other things, knowledge and insight and highly competent staff. Do you think the regulatory authorities in the UK would be able to achieve the requisite level of market intelligence, given the increasingly complex financial service markets that they will face? What will it take to get that requisite level of market intelligence to inform judgment-led regulation? What is the challenge?

Sally Dewar: There are two aspects that are absolutely key to judgment-led regulation, and I fully support it, in terms of identifying risks and managing the risk where the supervisor focuses on what should be important. It requires very good data and quality, highly-experienced supervisors. It is a riskier proposition because a judgment can be right or wrong and you have to stand by the consequences of making that judgment. I definitely think it is a model that the FSA has already moved towards. It is a very much more intrusive form of supervision but one that should identify issues before they get too crystallised.

Andrew Procter: There are two other things from my perspective. One is that it might be thought to involve an element of subjectivity which does not therefore require up-front clarity around expectations. Clearly, that is not acceptable. Going forward, the regulators will have an even greater responsibility to be clear about expectations. That is necessary so that banks can understand what is expected of them. It is necessary so that banks can effectively plan.

The second thing I would say is that it is incredibly tough to expect a regulator to exercise this kind of judgment, particularly given the level of resources they have. I illustrated this in a discussion I had with the FSA recently where I estimated the number of regulators that we have assigned to us around the world on a full-time basis. There are perhaps 125 to 150. Contrast that with the number of compliance, legal, audit, credit, market risk, operational risk and other risk managers within Deutsche Bank of perhaps 7,000 or 8,000. The FCA will have 27,000 firms and the PRA 2,500. It is an enormously high expectation to expect them to be able to get on top of the information about a firm to an extent where they can exercise that level of judgment. That has real implications for resourcing. We will get the

regulators we are prepared to pay for, but there needs to be an awareness that this is a very tough ask for regulators.

Q891 Baroness Drake: The Bank of England's view was that they needed more powers than the Bill afforded them to require information to be provided, particularly in the shadow banking system. Do you disagree with that?

Andrew Procter: My understanding of what they had said was that they thought it was important for the FPC to be able to get the information directly without having to go through the PRA and the FCA.

Baroness Drake: And the Treasury.

Andrew Procter: I am not sure it matters a great deal. Provided that the information is available, I am sure they can work it out. In fact, there will be competition for that because the Systemic Risk Board will be looking for exactly the same kind of information. The important thing is that, within the legislative framework, there is clearly ability to get the information that is needed to make a judgment about whether it is necessary to shift the perimeter in the context that you describe. What is important, though, is that there is also power to shift the perimeter, and that is not absolutely clear, particularly if you contrast it with the US legislation, where the ability of the Federal Reserve to designate an entity as a non-financial institution that is none the less systemically important is absolutely clear.

Q892 Baroness Drake: When you say it is unclear about the power to extend the regulatory perimeter, do you mean that the Bill simply does not make it sufficiently clear how that regulatory perimeter could be extended or do you mean that too much of the power to extend that perimeter rests with the Treasury?

Andrew Procter: I think it is the former rather than the latter.

Q893 Baroness Drake: Do you think there will be a material change, going forward, about international co-operation between regulatory bodies on sharing market intelligence?

Andrew Procter: Inevitably. Actually, that is a process that is already well under way. These three banks will all have regulatory colleges at two levels. The key regulators have become information exchanges. In our case there are three, and in Sally and Robert's case certainly there are the US and UK regulators, if not others, but then there are other colleges below that for the other global regulators. That needs to be improved; it needs to be made more efficient and effective; and it needs to reflect the wider interest in information that goes to systemic risk. But I think we are basically on that track already.

Q894 Baroness Drake: In terms of the highly competent staff to exercise this judgment and interpret the intelligence, do you have any views as to how the regulatory authorities should go about securing such staff and any conflicts of interests in your views on how such staff could be secured by the regulatory authorities?

Robert Charnley: I would say that the FSA has been able to attract and retain very competent staff in the past. Some of the people we interact with are hugely impressive in terms of their understanding of risk and so on. I agree that retention, more broadly, is an issue. There are things that can be done. Regulators need to think about regulation as a career for some of these individuals and offer some of the training and development opportunities that would make that an attractive career proposition. That could include assignments working for some of the global and EU-level authorities that have been mentioned here. It could include secondments to and from the industry. We have seen some of that in the past and we are very supportive of that. That can be an effective way to both train and retain people at a regulatory body, where, frankly, the perspective that one gets working as a regulator across the financial system is unrivalled.

Q895 Mr Brown: From the point of view of the organisations that you represent, what are the attractions of the shadow banking market in the United States?

Sally Dewar: By shadow banking, I am taking that to mean the carrying out of traditional banking activities outside the regulatory purview.

Mr Brown: Yes; about $16 trillion worth, which is quite a lot of money.

Sally Dewar: Obviously, from our perspective, we sit firmly within the regulatory purview. For us, the issues to do with regulatory arbitrage or the ability to act in a non-transparent way to avoid that oversight are issues that the shadow banking sector would present and we are very keen to ensure that, through the regulatory reform programme, the way regulators capture that is enhanced. Certainly, through the crisis, issues on getting to key data that would help the regulator determine whether a particular unregulated sector was systemically important were critical. Those issues do need to be resolved.

Andrew Procter: It is a little bit of a misnomer, picked up in your question. You cannot be a shadow bank except if you are breaking the law. If you are doing banking, you have to be regulated. The way that the FSB has defined it is credit intermediation outside the banking system. In the US, that is a hugely important part of credit intermediation; it is far more important than it is in Europe and in the UK. In the US, it has given rise to a whole spare tyre theory that it can be an engine for growth.

Clearly, as Sally says, the concern has to be that you make sure you understand what is happening there and then you understand whether it might be a source of systemic risk. That is why in the US the Financial Stability Oversight Council, as the prudential oversight body equivalent, has been given authority to gain information about the activities in that sector to make sure that it sees emerging risk. In fact, in a number of areas it has brought activity within the regulated sector.

If you look at the Financial Stability Board paper on this, they came up with a series of 10 recommendations on things to be done. There is a lot of work to be done yet. But they did single out the UK, for example, for its bringing of certain hedge fund activities within a clearer understanding. That is an example of the sort of thing that needs to be done. Not all credit intermediation outside the banking sector is bad. In fact, in the US, it has been proved to be positive in many respects.

Q896 Mr Brown: Mr Charnley, is there anything you want to add?

Robert Charnley: I have nothing to add, no.

Q897 Mr Brown: I have not quite caught what the advantages are, apart from evading the regulator. What other advantages are there? Is there a public interest argument for allowing this to continue or should it be regulated?

Andrew Procter: The US experience is that there are a whole range of credit intermediation vehicles that are acceptable, but in recent times the problem has been making sure you understand exactly what is happening there. It may well be—and I think this is implicit in some of what the Financial Stability Board has recommended—that more and more of it will be brought within the regulated sector, not necessarily for licensing or registration, but at least for reporting and at least so there is an understanding of what is happening there. It does not necessarily follow with some of the structures that you need a full panoply of capital and liquidity requirements. We would need to look at that. I am sure anyone can make available the Financial Stability Board work on it, which is very illuminating on that.

Q898 Mr Brown: Baroness Drake touched on the point earlier. In his evidence to us, the Governor, who is going to be in charge of the regulatory structure directly, said he really wanted to know more about what was going on. Do you think that is reasonable?

Andrew Procter: Yes.

Q899 Mr Brown: Is that true of all of you?

Robert Charnley: Yes.

Q900 Mr Brown: So there is not going to be a problem with this when we try and amend the Bill.

Sally Dewar: Any tools that are being thought of to develop the capture of shadow banking activities have to be flexible because it evolves all the time. What we are all interested in is having a regulatory reform programme that produces a robust, sustainable and buoyant market for the future. That includes addressing issues about transparency and regulatory arbitrage.

Q901 Mr Brown: Yes; I was much taken by what Mr Procter said earlier about transparency. As I understood it, the Governor's point was that, if we are signing up to judgment-led regulation, he has to have the facts on which to base the judgments. That seems reasonable.

Andrew Procter: It is perfectly reasonable.

Chairman: Mr Mowat, we are in injury time.

Q902 David Mowat: I am reflecting on the answer that you gave me earlier about your global structures and the way that that must create a regulatory issue. You have these guys running a global business, and maybe 20% of that business is in the UK. They are responsible to the top of the bank for the P&L of that business, in whichever geography they obtain those results. Then somebody comes along to him and says, "Right, we have an issue in the UK with the PRA", which might be 20% of its business. How is that going to work in practice? How do you make him pay attention to an issue of that type when he may say, "It's fine in Singapore. We have done just the same as that in Singapore and the US. Just go and tell the UK guys that that is the case"? Isn't there a fundamental problem in trying to do national regulation of any kind against global businesses like yours?

Robert Charnley: I don't personally see that to be an inherent conflict as such. In our experience, we have this situation today where we have global businesses that are regulated along national and individual subsidiary lines and we have not found that to be a problem in practice. The reason for that is that, first of all, many of the regulatory requirements are well aligned today. There are areas where they could be better aligned, but the thrust of many of the requirements, whether they relate to prudential issues, capital adequacy and liquidity or conduct issues, are well aligned. I just cannot imagine a situation for one of our global businesses where a matter that was felt to be important by a national regulator in one of the jurisdictions where that business operated was not seen to be important or relevant to the business globally.

Q903 David Mowat: As risk managers to a global business, are you responsible for somehow keeping the leader of that business globally apprised of the risk profile of his entire business, because that must be what matters?

Robert Charnley: Yes.

Q904 David Mowat: Is that how it works?

Robert Charnley: Yes.

Q905 David Mowat: So you don't care which geography those risks are being incurred in; you are just telling them that it's a problem, potentially, from your perspective.

Robert Charnley: There are two issues that are important there. One is having a good view on a consolidated level of the risk in that business, and secondly, having a view on how that risk is applied or accumulated across the different components—the geographies, the legal entities—where it resides. They are equally important for any risk manager or head of a business. Both of those perspectives are critical to understanding and managing the business risk.

David Mowat: I should say, when I said "him", I meant him or her, as the leader of the business.

Sally Dewar: I would just emphasise that the importance the FSA has to the legal entity is very significant in terms of the oversight that they have and the governance structure and

framework they have in terms of both EMEA and leading up to global escalation processes. They look at governance structure, escalation processes, who has accountability, and who has responsibility locally and globally. They consider all of that in their oversight.

Q906 David Mowat: I want to ask a couple of questions on the ICB report. Do you have any observations on it from the perspective of your bank—in particular, the ring-fencing and the loss absorbency requirements?

Robert Charnley: There are a couple of things that come through in the ICB report which we think are very relevant in the context of the global reform process. One is the resolution topic. Ring-fencing is one of the ingredients that is designed to facilitate resolution or the ability to protect systemically important parts of an institution that gets into difficulties. That is clearly a topic that is globally relevant and, for all of our organisations, one in which we are very engaged, as we alluded to earlier. The other, of course, is capital and increased capital requirements. Again, we have touched on those. The proposals to require additional loss-absorbing capital contained in the ICB report largely reflect the work that we have seen most recently reinforced by the G20 on systemically important banks. That theme of additional loss absorbency for more systemically important institutions is a very relevant one for all of our organisations.

Sally Dewar: I would just add on the issue of loss absorbency that, again, it is important as part of the global regulatory reform package. When thinking about these issues, we have to go back to trying to execute this on a globally consistent basis. It is a relevant consideration.

Q907 Chairman: But that is not what Vickers says. Vickers says that we should go further than what is done elsewhere. If that happened, would that seriously hamper your businesses based in London?

Sally Dewar: For us, I think it is a very important issue. A lot of what they allude to already mirrors what Basel III does or supports the Basel process.

Q908 Chairman: That sounds as if you are trying to avoid answering my question.

Sally Dewar: From our perspective it probably would not have a significant implication, but we are concerned about having a regulatory reform programme that is globally consistent. We are also concerned about the cost-benefit analysis that has been done and making sure that the cost-benefit analysis stacks up in terms of the additional reform that has been proposed.

Q909 David Mowat: Going back to the fact that you have these global business streams, the question that occurs to me is that, if you do have a different regulatory impediment in different geographies, almost automatically the guy leading that business stream will say, "If we can't do that there, let's do it there." It is not even a deliberate thing; it is just almost like a management operating decision. He is not thinking geography. That is a natural consequence of your organisation, isn't it?

Sally Dewar: You are absolutely right. Constantly, when we are looking at business model and where to do business, the impact of regulatory reform has to be considered.

Q910 David Mowat: Therefore, given that you have that structure, in a sense, whatever Vickers or anybody says, you get regulatory arbitrage almost by accident because that is what you need to do to meet the P&L commitment to the top of the bank. That is just the way it is going to have to be. I am just thinking that, if I was running a bank and that business stream, that is what I would think.

Andrew Procter: To a point. What is clear, though, is that, as Sally says, you make decisions based on tax, cost and other factors relevant to a market, but you won't go to a market which might be described as the 21st century equivalent of a tax haven. You will be careful about not arbitraging to that extent.

Q911 David Mowat: Yes, but that is for reputational reasons, I guess.

Andrew Procter: Quite.

Q912 Chairman: Are you happy to go along with the idea of ring-fencing as in Vickers?

Andrew Procter: For us, no.

Q913 Chairman: You are not happy.

Andrew Procter: It would not apply to us; so it is easy.

Robert Charnley: Likewise, it would not apply to us.

Q914 Chairman: Does it leave banks that are doing both ordinary banking and investment banking at an advantage or at less of an advantage, or does it not make any difference as far as you are concerned that they are still allowed to, or would you prefer it if everybody was Glass-Steagallised?

Andrew Procter: There are two questions there, which are different: Glass-Steagall and ring-fencing. When we have thought about the ring-fencing issue and how we would react in a fanciful "what if" situation if Germany, for example, introduced something similar, it does clearly have an impact on your ability to fund your operations if you split the two businesses in half. That is clearly an issue for us and would clearly be an issue for banks that are subject to it. Glass-Steagall is a different matter. If you look at the work that the European Central Bank published last week on the significance of business models, they try to identify the factors that heightened the risk of failure and those that improved the chances of success. It is absolutely clear from that that the solution or the response to those risk characteristics is not Glass-Steagall. There is plenty of evidence of narrow banks failing and of more broadly based banks—indeed, one of the criteria that they identify as helping for success—surviving well in a crisis.

Sally Dewar: I would support that. Glass-Steagall type separation would not have prevented some of the problems we encountered in the crisis and the premise of some of this reform that is taking place. In terms of ring-fencing, it is quite difficult to assess, because we do not have that cost-benefit analysis that then shows the marginal benefits or otherwise of going as far as ring-fencing.

Robert Charnley: The only thing I would add perhaps, and again it is a resolution point, is that ring-fencing is one possible answer to making an institution more resolvable. I do think that any measures taken with respect to the resolution objective also need to be balanced against the objectives of operating and managing the risk of a business on an ongoing basis in normal day-to-day operations. Measures taken to facilitate resolution can in some cases—and ring-fencing may be an example of this—damage the ability to operate the business on an ongoing basis. Andrew has referred to funding costs, for example. A perspective needs to be kept on the importance of the ability of some of these organisations to manage their risk in the most effective way in life as well as in death.

Chairman: Thank you very much indeed, to all three of you for all your answers. They will be very helpful to the Committee in its further deliberations. We are very grateful.

Goldman Sachs International – supplementary written evidence

At the Joint Committee oral evidence session this week on the Draft Financial Services Bill, Lord Maples asked witnesses to provide information on the changes that financial institutions have made since the onset of the financial crisis.

As Lord Maples rightly acknowledged, the financial services industry has been the subject of considerable scrutiny. We recognise this challenging period as an opportunity to engage in a thorough self assessment and to consider how we can and should improve for the future.

During the hearing I referenced the work of Goldman Sachs' Business Standards Committee. The firm established this Committee last year to conduct an intensive review of our business standards and practices across every major business, region and activity of the firm. In January, the Committee published its report making specific recommendations in a number of different areas of our business, which the firm is implementing. Moreover, the overall effort, at its core, is a recommitment of Goldman Sachs to our clients, to the importance of individual accountability and to our culture of teamwork, excellence and integrity.

11 November 2011

Professor Charles Goodhart CBE, Professor Emeritus of Banking and Finance, London School of Economics; Rt Hon Alistair Darling MP; Professor Eilis Ferran, Professor of Companies and Securities Law, Cambridge University and Professor John Kay, Economist - oral evidence (QQ 207-287)

Transcript to be found under Professor Eilis Ferran

Professor Maximilian J. B. Hall, Loughborough University – written evidence

As outlined in my covering letter, I wish to split my comments between those relating to proposed *structural reform* of the financial regulatory and supervisory framework and those concerned with the proposed *policy reforms* and to focus on the issue of whether enough has been done to reduce fragility in the UK financial system.

With respect to the former, my views are already in the public domain[168]. Excluding agencies associated with competition and consumer credit regulation, my preference is for a four agency structure comprising the FSA, the Bank of England (henceforth, the 'Bank'), HM Treasury and a new, independent, Deposit Protection Agency (DPA). As now, the FSA would be responsible for the micro-prudential regulation and supervision (including conduct of business) of financial intermediaries and the triggering of the 'Special Resolution Regime' (SRR) introduced under the Banking Act of 2009. The Bank, in turn, would be granted the new macro-prudential powers necessary to allow it to discharge its statutory responsibility for financial stability. As now, the Treasury would be responsible for the drafting of financial regulations, the discharging of international commitments and final arbiter, as the keeper of the nation's purse, of decisions taken to mount support operations. Finally, the fourth agency, the DPA, would be responsible for deposit protection - the sub-scheme of the Financial Services Compensation Scheme should be replaced by a stand-alone deposit insurance fund (see below) - and failure resolution, under a Prompt Corrective Action (PCA) -type mandate, with the SRR tools currently available to the Bank at its disposal. Accordingly, the 'work out' specialists would reside at the DPA, not the Bank, and the deposit insurance function would be removed from the FSA's jurisdiction, long-standing features of the systems operated in the USA and Japan.

I appreciate my preference for the retention of the FSA in its current form is controversial and would preclude the introduction of the "twin peaks" model, but, nevertheless, would justify such a position on the following grounds. Firstly, although the FSA clearly had a bad crisis, as it readily acknowledged in an excruciatingly-painful but very honest internal *post mortem* on its supervisory failings with respect to Northern Rock, the subsequent introduction of its 'Supervisory Enhancement Plan' and policy development since then (under the guidance of Lord Turner) strongly suggest to me that it should be given another chance to prove itself. I strongly agreed[169] with the Labour Government's decision of 1997 to create the unified agency but, like everyone else, was horrified at its effective "capture" by both the finance industry and government in the mistaken quest for 'light touch regulation' during the 1998-2007 period. I do not subscribe to the view, however, that it took its "eye off the ball" because of its over-riding concern with conduct of business issues (as opposed to prudential issues - although the prime focus on capital adequacy undoubtedly was responsible for a neglect of other prudential concerns), which questions the case for the introduction of a twin peaks approach. Moreover, the Bank also had a bad crisis[170], yet has

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[168] Hall, M.J.B. (2009), 'The reform of UK Financial regulation', *Journal of Banking Regulation*, 11(1), 31-75, December. [Appendix F compares my preferred regulatory/supervisory structure with that of the main protagonists.]

[169] Hall, M.J.B. (2001), 'The evolution of financial regulation and supervision in the UK: Why we ended up with the Financial Services Authority', *Banca Impresa Societa*, XX(3), 377-412, December. [Published by Il Mulino, Bologna.]

[170] See Hall, M.J.B. (2008), 'The Sub-Prime Crisis, The Credit Squeeze and Northern Rock: The Lessons To Be Learnt', *Journal of Financial Regulation and Compliance*, 16(1), 19-34, March; and Hall, M.J.B. (2009), 'The Sub-Prime Crisis, The Credit Crunch and Bank "Failure": An Assessment of the UK Authorities' Response', *Journal of Financial Regulation and Compliance*, 17(4), 427-452, November.

not seen fit to conduct an internal *post mortem* on its crisis-related failings, challenging the notion that the proposed switch of micro-prudential regulation and supervision to a new agency is of undeniable benefit to the UK economy. In my mind, the decision is highly politicised and reflects the Coalition Government's determination to implement the Conservative Party's White Paper proposals produced when in opposition (July 2009 - see Appendix E of the Hall reference cited in note 1). Accordingly, I believe the move is a 'leap of faith', with not-so-distant banking history - i.e. the BCCI and Barings affairs[171] - cautioning against blind acceptance of the alleged logic behind the structural changes.

Secondly, with respect to the operation of the 'Tripartite System' during the recent crisis, I do not accept that it is beyond repair. Developments at the time suggest to me that each of the three agencies possessed an effective power of veto, a recipe for inaction. Reclarification of respective roles, reaffirming the supremacy of the Treasury in decisions relating to bail-outs, could surely be undertaken. Moreover, the crisis management arrangements proposed under the new structure have yet to be tested, their success, as before, being dependent on effective co-ordination and co-operation between the relevant bodies.

Finally, when assessing the merits of burdening the Bank with both macro and micro prudential powers, the old debates about potential conflicts of interest and threats to independence automatically arise. Aside from issues of competence, one of the main arguments against giving the central bank responsibility for regulation and supervision has always been the fear that inevitable bank failure will damage the moral standing of the Bank, to the detriment of the wider economy. In this respect, many central banks - but, notably, not the US Fed - see the regulatory and supervisory function as a 'poisoned chalice' which, when considered alongside the potential for heightened conflicts of interest, lead some to conclude it is an area of responsibility they can well do without. Of course, the arguments for and against the joint discharge of monetary and prudential policy by a central bank are finely balanced, a position not fundamentally changed by crisis-related evidence given the failings of both central bankers and regulators/supervisors alike, but, within a UK context, at a time when the Bank's credibility is being undermined by persistent overshooting of inflation targets, the risk of further reputational damage arising from future bank failure should not be underestimated. Moreover, additional responsibilities will undoubtedly lead to demands for more external oversight of the Bank, thereby undermining its independence.

Moving on to a consideration of the policy reforms proposed, the initiatives of Lord Turner, the G20, the Basel Committee on Banking Supervision (BCBS), the Financial Stability Board/Forum and others would appear to have advanced the debate in the right direction. Accordingly, although some of the detail has yet to be fleshed out, policies such as higher capital and liquidity requirements (including counter-cyclical capital charges and provisioning, and capital surcharges for 'Systemically-Important Financial institutions' (SIFIs)), restrictions on leverage, debt bail-in arrangements, the use of contingent-convertible debt and the requirement for large institutions to provide 'living wills' all have something positive to offer. Clarification of the potential benefits for the UK economy to be derived from implementation of Basel III is, however, available following recent research within our School of Business and Economics[172]. Moreover, our empirical research also suggests that market

[171] Hall, M.J.B. (1999), *Handbook of Banking Regulation and Supervision in the United Kingdom* (3rd Edition), Edward Elgar Publishing, Cheltenham, Chapters 11 and 12.
[172] See Yan, M., Hall, M.J.B. and Turner, P. (2011), 'A Cost-Benefit Analysis of Basel III: Some Evidence from the UK', *Working Paper*, School of Business and Economics, Loughborough University, July. The key findings of this stand-alone, country analysis of the long-term net benefits deriving from the adoption of Basel III's capital and liquidity requirements are:

discipline in the UK might feasibly be enhanced through the introduction of a mandatory subordinated debt policy[173], and that supervisors should make greater use of market information, in addition to accounting and supervisory information, in their monitoring of bank risk[174]. In this way, policymakers can usefully expand their reliance on market discipline and market forces, thereby extending the Pillar 3 requirements of Basel II/III which relate solely to information disclosure, a necessary but not sufficient condition for effective market discipline[175]. Market discipline, about which Mervyn King rightly agonised before eventually extending emergency liquidity support to Northern Rock and the wider banking system, is sorely lacking in the aftermath of the global banking crisis and measures, such as those recommended above, are urgently required to restore a semblance of normality to financial markets.

The penultimate area I wish to touch upon is that of deposit protection. As mentioned above, I would prefer it if deposit protection was formally separated from other forms of investor protection in recognition of its unique potential stabilisation features; that is, unlike the other forms of protection, an appropriately- designed deposit protection scheme can reduce the chances of the insured event - a bank failure - occurring by reducing depositors' incentives to initiate or otherwise participate in bank runs. In this way, financial fragility and the threat of contagion is reduced. This benefit, long recognised as the major benefit in the US since the introduction of Federal deposit insurance in 1933, is additional to the compensation accruing to depositors of failed banks. Having established a free-standing scheme, ideally run by a separate agency, the features of the scheme then have to be assessed from an "incentive-compatible" perspective to minimise the costs associated with the induced moral hazard, adverse selection and principal/agency conflict[176]. Although, post crisis, UK arrangements have been improved via attempts to increase awareness of the scheme and a reduction in the normal period before compensation becomes available - to 7 days from a bank's closure - more could be done to improve incentive compatibility[177].

(i) that the permanent net benefits for the UK economy would be substantially higher than the average estimates of the BCBS; and (ii) that the optimal tangible common equity ratio, when the Basel Committee's long-term liquidity requirements are also being met, is 10% of risk weighted assets. This is higher than the 7% threshold recommended by the BCBS for normal banks and, indeed, higher than the upper threshold - of 9½% - recommended by the BCBS for SIFIs. It is, however, consistent with the Independent Commission on Banking's interim report suggestion that ring-fenced, UK retail banks operate with a minimum core tier one ratio of 10%; and is supportive of the UK government's attempts to retain the discretion, within the EU, to raise the minimum capital threshold above any agreed minimum capital requirement for EU-authorised banks.

[173] See Hamalainen, P., Howcroft, B. and Hall, M. (2010), 'Should a Mandatory Subordinated Debt Policy be Introduced in the United Kingdom? Evidence from the Issuance Activity of Banks and Building Societies', *Contemporary Economic Policy*, 28(2), 240-263. The key finding of this paper is that implementation of a mandatory subordinated debt policy - a long-standing favourite of both the US and EU Shadow Regulatory Committees - in the UK is feasible if confined to the six largest banks, with the banks being required to make at least three issues of subordinated debt a year and their outstanding amount of subordinated debt being constrained within 2½% and 3½% of risk-weighted assets. The main policy implication is that such a policy should be considered as a complement to Basel III, thereby further enhancing market discipline.

[174] See Hamalainen, P., Pop, A., Hall, M. and Howcroft, B. (2011), 'Did the Market Signal Impending Problems at Northern Rock? An Analysis of Four Financial Instruments', *European Financial Management*, forthcoming. The main finding of the research is that, of the four instruments considered - credit default swap spreads, subordinated debt spreads, implied volatility from options prices and equity measures of bank risk - equities provided the earliest and clearest signs of potential concerns about Northern Rock prior to the emergency funding announcement of September 2007, suggesting that supervisors look more closely at equity measures of bank risk in their monitoring of bank condition.

[175] Suggestions about how market discipline policies might be incorporated within bank regulatory frameworks are provided in Hamalainen, P., Hall, M. and Howcroft, B. (2005), 'A Framework for Market Discipline in Bank Regulatory Design', *Journal of Business Finance and Accounting*, 32(1 and 2), 183-210; and in Hamalainen, P. Hall, M. and Howcroft, B. (2003), 'Market Discipline: A Theoretical Framework for Regulatory Policy Development', in 'Market Discipline in Banking: Theory and Evidence' (Ed. E.G. Kaufman), Part I, 57-98, *Research in Financial Services: Private and Public Policy*, Vol.15, [Elsevier].

[176] Hall, M.J.B. (2001), 'How Good are EU Deposit Insurance Schemes in a Bubble Environment?', *Research in Financial Services: Private and Public Policy, 13, 145-193, December.*

[177] Hall, M.J.B. (2002), 'Incentive Compatibility and the Optimal Design of Deposit Protection Schemes: an Assessment of UK Arrangements', *Journal of Financial Regulation and Compliance*, 10(2), 115-134, May.

Accordingly, a pre-funded scheme should replace the current hybrid system which relies heavily on ex-post top ups as circumstances dictate; and, notwithstanding the practical problems involved, a risk-related premium structure should replace the current flat rate structure, both to offset the increased moral hazard resulting from the increase in the level of protection to £85,000 per customer per bank and from the abolition of co-insurance, and to minimise the inequitable cross-subsidies existing under current arrangements whereby the strong/well-managed subsidise the weak/poorly-managed. It is to be hoped that the FSA's current review of the FSCS's funding model results in these outcomes.

Finally, I believe it worth exploring how directors' personal exposure to litigation following bank failure can be increased with a view to deterring the type of reckless behaviour prevalent in the run-up to the crisis. Such a system was, I believe, successfully introduced in New Zealand in the early nineteen nineties as the regulatory authorities there sought to roll back the panoply of controls imposed on the financial sector (although, as pointed out by their critics, this was only possible because they could 'piggy back' on the regulation and supervision exercised by the Australian authorities on their largest banks).

In summary, I am not convinced by the structural changes to the regulatory and supervisory framework proposed by the Coalition government. There can be no presumption that the abolition of the FSA, the switch to a 'twin peaks' approach and the return of micro-prudential regulation and supervision to the Bank will necessarily improve 'performance', and cost-effectiveness is hardly likely to rise. Moreover, tougher capital requirements than those recommended by the BCBS should be introduced, along with additional measures to increase market discipline (such as the recommended introduction of a mandatory, subordinated debt requirement). Supervisors should also explore further the benefits of using market information, alongside accounting and supervisory information, to assist in the monitoring of bank risk while deposit protection arrangements should be further amended, along the lines suggested, to increase incentive compatibility. Finally, possible measures to increase directors' personal financial exposure to bank failure should also be examined to try to deter reckless behaviour. All of these measures, I believe, would serve to further reduce fragility in the UK financial sector.

September 2011

Herbert Smith LLP – written evidence

Please find below Herbert Smith LLP's written submissions in response to the Joint Committee's call for evidence on the draft Financial Services Bill. As a leading international law firm, Herbert Smith advises a wide range of financial institutions, including retail and investment banks, insurers, building societies and investment firms, and has been involved with the work of several leading trade associations in this context. We are pleased to have the opportunity to comment on those questions raised in the call for evidence on which we have evidence to contribute. We have not sought to address all of the questions raised.

Executive summary

- We are doubtful that a significant change in the regulatory architecture will, of itself, have any significant impact in reducing or managing the risk of a future banking crisis. In our view, the focus should be on improving the quality of banking supervision to address the failures that contributed to or exacerbated the crisis.
- The effectiveness and efficiency of regulation following the proposed reforms will very much depend on how well the various regulators (the Bank, the FPC, the PRA and the FCA) coordinate their activities - and on effective engagement with the European Supervisory Authorities ("ESAs") and other international regulators and standard setters – the mismatch between the functional separation of regulatory responsibilities in the UK and the sectoral separation of responsibilities of the ESA's will present some significant challenges.
- In all the circumstances, amending legislation is the better approach in these circumstances, and should enable those aspects of the current regime that work well to be retained, but proper account must be taken of the very different objectives that the new regulatory bodies will have.
- The accountability and governance arrangements for the Bank of England, FPC, PRA and FCA could be improved in some respects.
- Formulating the PRA's insurance objective to include future policy holders creates some potential problems and will result in two groups of consumers, policyholders and deposit holders, receiving different levels of protection.
- The success of the proposed judgment-based approach to regulation will depend on the success of the regulators in developing deeper understandings of commercial and behavioural drivers, of markets and of consumer behaviour, needs and experiences. Ensuring that the regulators have the appropriate level of skill and experience to superimpose their judgments on firms and their Boards will be a significant challenge. There should be meaningful safeguards in respect of a judgment-led approach, which should involve the objective exercise of discretion, having regard to the statutory and operational objectives, and the regulatory principles.
- We are not persuaded that it is necessary or appropriate to bring the listing regime into the general legislative framework of the FCA, nor that responsibilities for the financial soundness of critical market infrastructure are to be apportioned in the most optimal fashion.

- The adverse impacts of so-called "early" publication of Warning Notices cannot be justified by the perceived benefits, and the stated aim of the proposal could be achieved more effectively without adverse impacts. If the proposal to empower the FCA and PRA to publicise information about Warning Notices is to proceed then other aspects of the enforcement process need to be re-examined.
- Consistency in rule-making will be critical to the success of the new regime, particularly for firms falling with the "capable of PRA designation" category, consistency of prudential rule-making will be critical.
- Current proposals for coordination are less than optimal as they focus on institutional rather than functional approaches.
- We consider that the proposed power to allow regulators to direct directors (present and past) of listed companies, sponsors and primary information providers to commission reports from skilled persons to be an inappropriate and disproportionate power to deploy against individuals.
- A full Tribunal rehearing should be retained in respect of the withdrawal of authorisations and approvals, and in respect of the imposition of restitution and prohibition orders.

Proposed changes to regulatory architecture

It is difficult to establish any objective empirical evidence to support the effectiveness of differing approaches to regulatory structure. While it could be observed that some jurisdictions that have operated the "twin peaks" system were less affected by the recent crisis than the UK (such as, for example, Australia), it is difficult to establish whether or not there is any causal link. Indeed, it could equally be noted that prudential supervision and conduct of business regulation of banks is split in the US. We are therefore doubtful that a significant change in the regulatory architecture will, of itself, have any significant impact in reducing or managing the risk of a future banking crisis. In our view, the focus should be on improving the quality of banking supervision to address the failures that contributed to or exacerbated the crisis.

In particular, it appears that insufficient attention was paid to the build-up of systemic risks within the financial system. Much has been made of the need to enhance "macro-prudential" supervision. The proposed establishment of a Financial Policy Committee (FPC) to focus on the identification and monitoring of such risks, and to recommend regulatory action to remove or reduce the build-up of systemic risks is intended to address this. However, it is not clear that the problem with the existing regulatory arrangements was primarily one of organisational structure: The FSA has clear responsibility for the prudential supervision of banks and a statutory objective of maintaining confidence in the financial system. The FSA has also long recognised the need to assess the build-up of risks presented by wider industry and economic developments (as evidenced through the annual publication of the FSA's "Risk Outlook"). The FSA's own assessment of the causes of the crisis indicates that the primary problems with regulatory supervision of the banking industry arose from the quality of supervision and a failure adequately to identify, assess and analyse risk - not from the institutional architecture.

There may be some force in the view an integrated regulator such as the FSA is subject to pressure to address the conduct issues (particularly those affecting retail consumers) that give rise to the greatest public concern on a day to day basis and that there is therefore a risk that prudential supervision receives less attention and resource than it should. However,

the assumption that a body operating under the auspices of the Bank of England is in some way inherently better equipped to provide more authoritative prudential oversight of banks needs to be tested rigorously.

It also appears that coordination within the tripartite system did not function optimally during the crisis. However, in creating the new regulatory structure, there is a risk of substituting one coordination problem with a whole new set of coordination issues, and in day to day issues not just at times of crisis. The effectiveness and efficiency of regulation following the proposed reforms will therefore very much depend on how well the various regulators (the Bank, the FPC, the PRA and the FCA) coordinate their activities - and on effective engagement with the European Supervisory Authorities ("ESAs") and other international regulators and standard setters. There is a mismatch between the functional separation of regulatory responsibilities in the UK and the sectoral separation of responsibilities of the ESA's: this will present some significant challenges for the regulators in ensuring that they are appropriately represented in discussions where issues affecting their respective remits are raised, and in ensuring that overseas regulators are clear about the remit and responsibilities of each authority and have effective and direct lines of communication to the relevant people.

The proposed reforms of the UK's regulatory architecture will not create a true "twin peaks" system, but take a pragmatic approach, aiming to ensure proactive judgment-led micro-prudential regulation of the most systemically important firms, and seeking to avoid what has since been described as a "tick box" approach to regulation. The more systemically important financial services firms (some 1,700 banks, insurers and complex investment firms) will be regulated separately in terms of prudential regulation and conduct regulation. However, prudential regulation of the remainder of the regulated community (over 18,000 financial services firms) will remain in the hands of the conduct regulator, which will (in the main) carry out desk-based prudential assessments on a thematic and sector specific basis, pursuant to its own statutory objectives, and will undertake its prudential interventions on a gone-concern basis.

Care needs to be taken over the theme that has emerged from consultations on the new framework to the effect that prudential regulation will in some sense be more "judgment led". It is not clear precisely what is meant by this phrase but a number of points should be kept in mind: First, the suggestion that prudential regulation involves considerable exercise of judgment by supervisors while conduct regulation does not is unhelpful and inaccurate. Second, the implication that there is a lack of scope for judgment and exercise of supervisory discretion under the current regime is wrong – the FSA has spent the whole of its existence eschewing "tick box" approaches to regulation and compliance in favour of the use of broad principles and the exercise of the very considerable supervisory discretion afforded to is under the existing legislation. The shortcomings of financial regulation exposed by the crisis did not arise from a lack of scope for exercise of judgment and discretion by supervisors – they arose from bad judgments. Third, further increasing the breadth of supervisory discretion raises additional concerns as to how regulators are held accountable for the judgments they make and how arbitrariness, inconsistency and unfairness are to be protected against. Finally, it must be recognised that the scope conferring supervisory discretion will be limited by the requirement on the UK to implement and apply EU directives and regulation which increasingly set the standards by which firms are to be regulated.

Is it appropriate to make such major changes to the regulatory system by way of amending legislation, rather than starting afresh?

Starting afresh would exponentially increase the length of the process, with concomitant uncertainty for firms and markets. The process of drafting, enactment and implementation of the Financial Services and Markets Bill took far longer than the current (perhaps ambitious) timetable envisages. There is also a risk that in legislating from scratch, a number of areas of contention that have been settled through a combination of legislation, rule-making and guidance, may be reopened, which could create further uncertainty. In addition, since the European legislators and supervisory authorities are increasingly using directly applicable regulations rather than directives and are moving towards maximum harmonisation of regulations and technical standards, the merits of entirely recasting the existing UK legislation at this stage would seem to be significantly outweighed by the disadvantages. In our view amending legislation is the better approach in these circumstances and will enable those aspects of the current regime that work well to be retained.

That said, care will need to be taken to ensure that in amending the legislation proper account is to be taken of the very different objectives that the new regulatory bodies will have. Given their different objectives it should not be assumed that all of the statutory powers and functions currently conferred on the FSA will be required in the same legislative form for both the PRA and the FCA.

Are the accountability and governance arrangements for the Bank of England, FPC, PRA and FCA satisfactory?

The draft legislation is virtually silent about the basis on which the FPC is to exercise its functions. There is no requirement in the Bill for the FPC to issue a policy statement setting out how these powers might be used. This is in contrast to the requirements for policy statements in the use of various powers, for example enforcement powers, by the other regulators. Such statements are not binding, and it could be beneficial for the markets to know how the FPC might use these powers and add to the transparency of the process. We believe that the FPC should have regard to the likely impact of any direction, and in order to enable it to do so, should be expected (in the ordinary course) to consult with the regulatory authority to whom a particular direction is to be issued before that direction is issued.

The statutory mechanisms to support close cooperation between the Treasury and the Bank group, including the MoU on crisis management, are important, and must address the potential for conflict of interest between the PRA in its role as prudential supervisor of regulated firms, and the Bank in the operation of the Special Resolution Regime. The Governor's role, in particular, will pose particular issues, as he will be required to manage his responsibilities for the Special Resolution Unit, and at the same time the chairmanship of the FPC and the PRA (and the MPC). The EU paper on crisis management notes that supervisors and resolution authorities are, in many jurisdictions, kept separate, in part, to reduce the incentives for regulatory forbearance.

Under these new proposals, very significant power will be concentrated in the Bank. The PRA is closely connected to the Bank's governance. Since the Bank's governor is the chair of the governing body, one of its deputy governors is its chief executive and another is a member, we do not believe it is appropriate for the Bank to control the key elements of investigation of complaints against its own subsidiary. Because a failure by the PRA will inevitably reflect on the Bank, there is an apparent conflict of interest here. We believe it would be better for the Treasury, not the Bank, to approve the complaints scheme, and the Treasury, not the Bank, to appoint the independent investigator. This would also align the position with that of the PRA, although the PRA would have to report to the Bank as well as the Treasury on its response to the complaints.

Has the right balance been struck between the powers of the FPC and the powers of the Treasury?

Overall, the draft Bill provides a good balance between independence and accountability of the FPC to the Treasury. However, the basis on which the Treasury is to determine whether it is appropriate to prescribe a macro-prudential measure pursuant to section 9K(2) is not clear. The Treasury's February consultation suggested that the FPC might seek the creation of such a tool in circumstances where the PRA or the FCA was refusing to comply with a recommendation on the grounds that the authority believed that the action would have significant unintended consequences. The FPC should at a minimum be required to take full account of the potential unintended consequences outlined by the authority in coming to any decision to request the Treasury to amend the FPC's toolkit, and the Treasury must have full discretion to determine whether, in its view, the authority's reasons for not complying are sufficient, and whether it is appropriate to create the tool in question.

Are the PRA's objectives clear and appropriate?

The PRA is to be given two objectives: the general objective, which is PRA's responsibility for the safety and soundness of PRA-authorised persons, and the insurance objective, which is to secure the appropriate degree of protection for those who are or may become policyholders.

The Government rightly recognises that it would be unrealistic for regulation to seek to remove all risks from the regime, but rather to ensure that such risks are properly managed and priced, and that where failures of systemically important firms occur, these are managed in an orderly fashion. A zero-failure approach to the regulation of dual-regulated firms would be impracticable, and the costs of such a regime would likely destroy the markets and businesses being regulated. As currently drafted, the use of the word "avoid" in the description of the way in which the PRA is to meet its general objective (as set out in paragraph 2B(3)(a)) might be read as suggesting that the PRA should ensure that the firms it regulates take no risks. This is clearly not the intention and should be remedied in drafting.

The insurance objective was added to address criticism that the previous iteration of the PRA's objectives did not fit well with its responsibilities for the prudential regulation of insurance companies. Formulating that objective to include future policy holders, however, extends the duty beyond that of other insurance regulators, whose objectives focus on protection of current policy holders, and beyond the objectives of Solvency II. The inclusion of a reference to the protection of future policy holders also creates some potential problems, not least in determining how far into the future the objective should extend, and there is some risk of overlap with the FCA's objectives and remit for regulating conduct of firms, for example with respect to mis-selling of products.

The PRA is not under any express requirement to protect current and future deposit holders, whose interests are not specifically covered by the general financial stability objective. It therefore appears that these two groups of consumers, namely policyholders and deposit holders, will receive different levels of protection.

The draft Bill also provides for the PRA to be responsible for 'contributing to the securing of an appropriate degree of protection for the reasonable expectations of policyholders as to the distribution of surplus under with-profits policies.' However, there are reasons other than lack of financial soundness that may cause policyholders' reasonable expectations not to be met for, some of which may more properly be seen as conduct issues and therefore the responsibility of the FCA. Arguably the general and specific objectives of the PRA cover the issue of ensuring that an insurance firm has sufficient funds to meet its requirements to

policy holders without separately specifying that all matters to do with with-profits fall to the PRA. Any coordination issues that might arise would be addressed by the FCA and the PRA's overarching duty to coordinate. The ability to extend the PRA's remit (by order made by the Treasury) would give the system an element of dynamism, but in practice EU regulation may constrain the usefulness of this power.

'Judgment-based' regulation and a more proactive approach to regulation

The success of the proposed judgment-based approach to regulation will depend on the success of the regulators in developing deeper understandings of commercial and behavioural drivers, of markets and of consumer behaviour, needs and experiences.

A judgment-led approach should involve the objective exercise of discretion, having regard to the statutory and operational objectives, and the regulatory principles. It is important that there should be meaningful safeguards in respect of this approach. This is all the more critical since the regulators will benefit from statutory immunity from actions for damages (save in cases of bad faith, or where human rights are breached), so that there is a real risk of moral hazard. It is not impossible to conceive of a situation where a regulator, in imposing its judgments on the Board of an institution, is effectively acting as its shadow director, but without necessarily being subject to the same duties and liability to which others acting in such a capacity would be subject.

We believe that the Practitioner Panel has performed a valuable role in enhancing the quality of regulation. A more 'judgment-based' regulatory approach makes it even more important that there should be a mechanism to facilitate industry consideration and understanding of how far the PRA is giving due regard to the considerations set out in the legislation, meeting its statutory objectives and balancing its 'have regards' from an industry standpoint.

We do not believe that a new regulatory culture and a more proactive approach can be achieved through legislative provision, although clearly the legislation provides the framework within which the authorities must work and will establish the parameters within which the regulators will work. However, the culture and approach of any institution must be set from the top. The approach documents published to date by the FSA and the Bank are significant building blocks towards the establishment of a more proactive culture and approach, and our perception is that the FSA is making considerable efforts to improve the quality of its staff and its training, to recruit experienced practitioners from industry as advisors, and is seeking to develop a senior level, high quality, business and market analysis team. Nevertheless, ensuring that the regulators have the appropriate level of skill and experience to superimpose their judgments on firms and their Boards will be a significant challenge.

Rights to challenge regulatory decisions

We have some sympathy with the view that a full de novo hearing before the Upper Tribunal may not be the most appropriate means of reviewing some of the most technical judgment-based supervisory decisions taken by the PRA, specifically in relation to the maintenance and adjustment of appropriate levels of capital and liquidity to be held by systemically significant firms. It may be that a committee of experts, or possibly senior level PRA staff with appropriate expertise but not involved in the initial decision-making, might provide a more appropriate forum for review of the proposed action in such cases, with a right to appeal to the Tribunal on limited grounds.

We strongly believe, however, that in all cases involving the right of an individual to work in a regulated industry or in certain roles in advisers to regulated bodies or as advisers to or as

directors of issuers and in all cases where financial penalties in the nature of a fine are imposed, the affected party should be entitled to a full hearing by an independent tribunal on the merits so as to be compliant with EU duties and the ECHR. This is all the more essential if there is to be no proper separation of enforcement and decision-taking: a proposed amendment to section 395(2) would erode the principle that the decision-maker should be separate from, and not directly involved in, the investigation and enforcement team.

The FSA recognises that where a regulator is committed to taking forward difficult and challenging cases, it is inevitable that, in some of those, the Tribunal will reach a different conclusion as to the facts and the resulting sanction[178]. Recently, the Upper Tribunal disagreed with the FSA's decision to fine and prohibit Mr Geddis, finding that his actions had demonstrated a lack of care resulting in a disorderly market on a single occasion, in a manner which he would never repeat and that he remained fit and proper. Under the proposals mooted in the draft Bill, the Upper Tribunal would have been entitled to make those factual findings, and could have directed a censure rather than the fine proposed by the FSA. However, it would not have been able to make any direction in relation to the ban, and would simply have had to remit the matter to the FCA to reconsider and reach a decision in accordance with those findings.

In relation to EU Commission decisions addressed to private parties, there is a full power to review on the merits (at General Court level) with the ability to quash or uphold in whole or in part and to reduce fines where the decision is upheld, but not substitute their own decision on liability where they quash. The General Court can quash on grounds wider than those available under judicial review in the UK – e.g. for an error of fact, although review of fair process is an important part of the exercise. However, some EU Commission decisions have been taken and quashed 2 or even 3 times on different grounds (e.g. in one case first because the fact that the English and German texts diverged materially led to a factual inquiry that showed the decision had not been taken correctly within the Commission, secondly on grounds of some unfairness in disclosure of evidence and thirdly (against only some of the defendants) on the grounds of insufficient evidence of participation in the offending conduct (a ground not easy to use in judicial review, but clearly an important part of the rights of defence)). This process is inefficient and can take many years.

We believe the present approach, whereby the Tribunal conducts a hearing de novo on the merits and can substitute its own decision on liability based on evidence before it, is more efficient and satisfies ECHR requirements.

The regulation of markets

We are not persuaded that it is necessary or appropriate to bring the listing regime set out in Part VI of FSMA into the general legislative framework of the FCA, given that listed companies are not authorised persons. At present, the FSA's general regulatory objectives do not apply to its discreet role as competent authority for official listing under Part VI because they are not treated as part of its general functions. The competent authority role has always been regarded as a discreet role based on the EU financial services directives' requirements for a competent authority for listing.

The Bank will have additional regulatory responsibilities for critical market infrastructure (clearing, settlement and payment systems) which it will perform directly. The proposal is that the FCA will regulate investment exchanges, and the Bank will regulate clearing houses, along with payment systems and settlement systems. Regulatory responsibilities have been

[178] http://www.fsa.gov.uk/pages/Library/Communication/PR/2011/078.shtml

allocated to the Bank in a piecemeal fashion and there is some asymmetry in the powers and accountability obligations of the Bank in comparison with the PRA and FCA, and in the Bank's own powers with respect to different bodies:

- The Bank already has responsibility for regulating payment systems under the 2009 Banking Act which gave the Bank powers such as the power to issue principles (subject to Treasury approval), to issue a code of practice, to issue directions, to appoint an external expert's report, and to impose sanctions: fine, closure of the payment system, and management disqualification. There are no duties on the Bank to consult before issuing principles or a code of practice, or to conduct cost benefit analysis.
- The draft Bill reallocates responsibilities under the existing FSMA provisions on recognised investment exchanges (RIEs) and recognised clearing houses (RCHs) between the Bank and the FCA. As currently drafted, the FCA's powers with respect to RIEs and the Bank's powers with respect to RCHs and the Bank's powers and responsibilities in regulating payment systems and in regulating clearing house are not fully aligned. The Bank will not have the same powers to control an RCH as the FCA has to control an RIE.
- The Bank's rule-making procedures and disciplinary powers in respect of payment systems and clearing houses will be quite separate - the Bank should have the same set of powers and consultation responsibilities with respect to each. The accountability arrangements are also different. The Bank is under no obligation to conduct an inquiry into its regulatory activities with respect to clearing, payment or settlement, in contrast to the obligations on the FCA and PRA (introduced as a consequence of the recent experience of the FSA's report on RBS).

A better approach might be to give responsibilities for the financial soundness of critical market infrastructure to the PRA or to a separate body, or at least a separate unit within the Bank which has clear and transparent lines of reporting and accountability.

In view of the FCA's remit in relation to client assets and as regulator of markets, it will be important that the Bank should maintain close and meaningful involvement in any decision-making concerning the resolution of a failed central clearing counterparty. The FCA and the Bank will also need to have regard to the output of the European institutions, in terms of rules and interventions, in its regulation of markets.

The FCA's new powers

The importance of a proportionate and tailored approach to regulation cannot be understated, and we strongly believe that a less interventionist approach will be warranted in respect of professional and sophisticated market participants. There have, of course, been several issues in respect of wholesale products which have been sold, some way along the distribution chain, to persons, such as local authorities, to whose profile the products may not have had the optimal alignment, with consequent retail impacts, and we note that the MiFID review is considering a revised classification for such authorities. We would welcome, in due course, a fuller iteration of the kind of retail impacts that it is envisaged would warrant a more intrusive approach to the conduct of wholesale activities.

Product intervention and financial promotions: We are not persuaded that it is necessary to create a specific product intervention power of the kind proposed. The FSA is able to take action under its existing powers to impose requirements in respect of products, mandate minimum standards or restrict sales to certain classes of consumers, and could, we believe, intervene to block an imminent product launch or stop an existing product from

volume sales. We are not convinced that the FCA requires additional powers to direct a firm to withdraw or amend misleading financial promotions with immediate effect. It seems to us that this is readily achievable under (the threat of) the existing own initiative power, and that such matters would often be resolved informally through voluntary compliance. The proposed changes seem essentially to comprise an abbreviation of the period for the making of representations, at the discretion of the regulator, and the publication of the decision.

We agree in principle that, in certain circumstances, it may be appropriate that the FCA should be able to publish the fact that it has issued a written notice of a direction to withdraw or amend a particular promotion. However, given that it is envisaged that the financial promotion will remain out of circulation during the period for the process of making representations, we are not persuaded that (save in exceptional cases) it will be necessary to reduce the time for making representations.

Publication of Warning Notices: We believe that the adverse impacts of so-called "early" publication of Warning Notices cannot be justified by the perceived benefits, and that the stated aim can be achieved through the disclosure of information that identifies key matters which form the subject of FCA concern but which does not identify the firm or individual under investigation. Such an approach would provide, in a far more timely fashion, sufficient information to the regulated sector and the public at large about the issues of concern without the same adverse impacts, and would maintain appropriate due process safeguards for the disciplinary process.

Publication at the Warning Notice stage will in fact achieve the stated aim of highlighting potential issues to consumers or giving firms signals about behaviours the FCA considers unacceptable at a particularly early stage. The time within which the regulator may take action – the beginning of proceedings by the giving of a Warning Notice - against individuals was recently extended from two to three years by the Financial Services Act 2010. We are aware of many instances where the FSA has issued Warning Notices against individuals after lengthy investigations, very close to the expiry of the period for commencing proceedings. The FSA's annual report for 2009/2010 noted that "even in enforcement, timescales are extended; case investigation and preparation takes time, and is only possible if we have first invested in supervisory and enforcement resources; the demonstrable successes of the last year build on two previous years of investment and preparation". The Enforcement Performance Report alludes to the "strong message about the length of time it had taken to progress some enforcement investigations" received in its feedback from firms. It is therefore plain that publication at the Warning Notice stage is most unlikely to deliver warnings to consumers or updates to firms in any timely fashion.

The objectives of deterring other firms from similar behaviour or alerting consumers to potential issues can be achieved equally effectively, and much more quickly - without naming the individual or firm involved. Firms can be made aware of behaviour deemed to be unacceptable through the publication of 'soft guidance' or anonymised public statements, speeches, Dear CEO letters and examples of good and bad practices. One example of an early warning to the market was the FSA's warning on market abuse on 19 March 2008. Speeches and consumer alerts can be, and are already, used to warn consumers of specific issues.

To the extent that the Warning Notice publishes the FCA's view that the firm or individual has contravened a requirement imposed by or under the legislation, the publication of the summary of a Warning Notice will amount to a de facto public censure. Such censure is a disciplinary tool and should be used only in accordance with due process, including the right

of the firm concerned to make representations and, if the FSA should decide to proceed with the public censure, a decision, which the person under investigation is entitled to refer to the Tribunal for review.

Warning Notices are qualitatively different from decision notices, and the latter are often very different from the initial Warning Notice. Whereas the decision notice represents the FSA's concluded view of the evidence, the person under investigation having had an opportunity to present their case through an exchange of written and oral representations, the threshold for issuing a Warning Notice is low, and does not require the FCA to assess the likely success of the enforcement action, which criminal prosecutors are required to do, but merely whether (in criminal terms) there is a prima facie case – whether the material is adequate to support this first step initiating the enforcement process. The firm or individual may not have had any opportunity to make representations in respect of the FSA's factual account, let alone its conclusions.

Publishing details of the fact of issue of a Warning Notice, together with a summary of the notice, as a mechanism for communicating more widely the nature of the FCA's concerns about the firm or the particular conduct will result in reputational damage to the firm. The intention is plainly to include the grounds on which action has been taken, which will clearly indicate that the FCA is critical of the firm's conduct. Such publication therefore amounts to a public censure in all but name, but without proper judicial process, and at a stage where the enforcement team's case may be wholly untested.

The FSA's Enforcement Performance Account suggests that under the scheme now proposed, 30% of individuals/firms would be at risk of suffering reputational damage as a result of the publication of Warning Notices, even though they were not, in the event, ultimately the subject of an adverse public disciplinary sanction. US research suggests that the announcement of legal enforcement actions have a negative effect on share price, and more importantly, that pending cases have larger short-term negative impacts than cases of a similar nature with known outcomes, possibly due to high levels of uncertainty[179]. The initial detriment caused will not in any way be compensated for by the publication of a notice of discontinuance long after the initial Warning Notice.

The filing and publication of contested complaints by regulators before they have been adjudicated upon is a feature of a number of other regimes (both here in the UK and in other jurisdictions, notably the US). It is easy to point to transparency as a self-evident good. However, there is no evidence that regimes with more aggressive enforcement regimes have fared any better in managing risks to consumers or markets. Moreover, in many of the other regulatory and law enforcement regimes in which publicity is given to the filing of a complaint the regulator or enforcement agency does not have the power to make determinations or impose punitive sanctions itself – only to make a complaint which must then be decided upon in an independent court or tribunal at which the defendant has the right to a full, public trial. In contrast, the disciplinary process under the FSMA is an administrative process of adjudication before a regulatory body. It is inappropriate, in our view, to give early publicity to allegations that are not being made before a court or tribunal but by one arm of a regulator that has yet to determine for itself whether the allegations are substantiated or not. Only once the regulator has reached a concluded view should the matter become public when it may be contested before a public tribunal.

[179] Muradoglu, Yaz Gulnur , and Clark Huskey, Jennifer: The Impact of SEC Litigation on Firm Value. Available at SSRN: http://ssrn.com/abstract=1094948

Careful consideration is needed as to the impact that the proposed publication of Warning Notices will have on the relationship between regulators and regulated firms. It is likely to lead to a much more adversarial and litigious regulatory system. This may be the policy objective, but it sits uneasily with notions of more "judgment-led" regulation or with regulation on the basis of broadly stated high level principles which leave considerable discretion as to how they are applied. Such approaches to regulation call for a high degree of openness in the communications that take place between regulated firms and their regulators. If allegations of breach can be published before any fair process of representation or dialogue has taken place then this is liable to have a chilling effect on the supervisory process and the rules on which such allegations may be based will need to be capable of much more certain interpretation.

More importantly, in our view there is a real risk that the industry and ultimately the public will lose trust and confidence in the fairness and integrity of the regulators' investigations and enforcement processes. The proposed new legislative framework provides no mechanism to give assurance or accountability for the quality and accuracy of regulators' investigation findings prior to their publication in a Warning Notice. It is not uncommon in our experience for FSA Warning Notices to contain allegations the substance of which has not been put to the individual or firm concerned during the course of the investigation. The opportunity that exists under the current regime for a firm or individual to obtain a fair hearing of their representations before damaging findings of misconduct are published is a key protection against poor investigative work. Moreover, if (as currently happens in a significant number of cases) the FCA or PRA subsequently decide not to proceed with their action there is no requirement on them to publish any reasoned explanation as to why the original findings have not been upheld.

Having findings subject to challenge by the person who is under investigation is not only required as a matter of fairness, it helps the decision maker reach better quality findings and make better decisions. No system of professional regulation can work effectively in the long run without the confidence and active cooperation of the profession that is being regulated.

In our view, if the proposal to empower the FCA and PRA to publicise Warning Notices is to proceed then other aspects of the process need to re-examined in order to ensure that it does not provide licence for the publication of highly damaging but ultimately unsubstantiated allegations against firms and individuals. Consideration should, in our view, be given to incorporating the following measures into primary legislation:

- The current policy and practice of the FSA is normally to send a "preliminary investigation report" to a person under investigation and invite them to comment on the draft findings of the investigation team before the investigation report is finalized and consideration given to whether disciplinary proceedings should be commenced. Such a process should be required in all cases by the statutory procedure to be followed at the conclusion of an investigation and before a Warning Notice may be issued.
- The legislation should prevent the inclusion in a Warning Notice of any material adverse finding or allegation the substance of which the individual or firm concerned has not been given a reasonable opportunity to answer during the investigation
- The statutory requirements in respect of the independence of the decision maker responsible for issuing Warning and Decision Notices in disciplinary cases should

- The statutory decision making process should include a requirement that the firm or individual concerned have an opportunity to make oral as well as written representations to the decision maker on the Warning Notice (as is the current practice before the FSA)
- The regulator should be required by statute to prepare and publish a fully reasoned Notice of Discontinuance in those cases where publication of a Warning Notice is followed by a decision to discontinue the case.

The prudential regulatory responsibilities of the FCA

Clearly, it will be necessary for the FCA to maintain its own prudential expertise, and to develop appropriate prudential mechanisms for a broad range of firms. The assurance that 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, is welcome, but as yet relatively little detail has been produced in respect of the FCA's proposed approach to prudential regulation.

Whilst the designation of significant investment firms that could pose significant risks to financial stability will be a matter for the PRA, clearly a number of FCA regulated firms will fall within the category of firms that could be PRA-designated. At present, it is not clear precisely what procedural safeguards will surround the designation criteria, nor how PRA-designable firms might move between FCA regulation and dual regulation. We strongly believe that consistency in rule-making will be critical to the success of the new regime, particularly for firms falling with the "capable of PRA designation" category, consistency of prudential rule-making will be critical.

Will the new regulatory arrangements reduce the risk and cost of dealing with miss-selling of financial products?

The FCA's more proactive and intrusive approach is not intended to constitute any form of widespread pre-approval of products. There remains some risk that as use of the product intervention power becomes more widespread, consumers may interpret the fact that the regulator does not intervene in respect of other products as a form of tacit approval or endorsement of those products. This is a moral hazard that the FCA will need to manage on an ongoing basis through its communications.

The success of the regulatory arrangements will very much depend on whether the FCA is able to develop the requisite skills It is not clear that the FSA believes it has yet fully developed the deeper understandings of commercial and behavioural drivers, and of consumer behaviour, needs and experiences, which will enable it to identify potential causes of consumer detriment, or the expertise to set product features.

Coordination between the PRA and FCA

Legislation can put in place mechanisms to facilitate strategic coordination, but coordination on day to day operational matters has to be a matter for the authorities themselves to work out. The general duty to consult is subject to proviso that compliance does not impose a 'disproportionate burden' on the regulators. We do not believe that consulting the other regulator would be likely to be a 'disproportionate burden' if the threshold conditions for coordination are met, although we accept that a requirement for consultation may need to be waived in an emergency.

The current proposal is somewhat less than optimal as it focuses on institutional rather than functional approaches. The focus should be less on where this process is carried out, and rather on the standard to be applied, how best to ensure that all stakeholders can contribute or participate, and whether the technology can be used to achieve the optimal outcomes. In functional terms, this would comprise the development of common admission criteria, the common collection of information, and ideally a common technical platform access to which could be limited on a need to know basis. It seems to us that considerable synergies and efficiencies could be achieved through a shared services function, and that this would also help to ensure operational coherence.

We had proposed a joint rule-book for dual-regulated firms in earlier consultation with the Treasury. We note that, in particular, certain individuals performing significant influence functions within dual-regulated firms currently face the unenviable prospect of being answerable to two separate regulators in respect of two different sets of standards, which may conceivably begin to diverge as the new regulators develop their own different approaches and culture.

Although the Government consultations refer in various places to the need for the regulators to have regard to the congruency of regulation and to be mindful of not placing undue burdens on firms, this is not presently reflected in the draft legislation. It would be relatively simple to amend the draft regulatory principles to make appropriate provision for the regulators to consider these issues.

How do the proposals in the draft Bill fit within the new European regulatory regime? What freedoms and constraints will the UK have to operate within that regime?

The EU will act as a potential constraint on the FPC's ability to act – there have already been disputes as to whether the UK would be able to impose higher capital requirements on UK authorised financial institutions than those stipulated in EU Directives. The extent to which the FPC, or indeed the Treasury, will be able to fashion or use particular tools will depend on the parameters set at the EU level. The rule-making powers of the Bank, the FCA and the PRA will also be constrained by European legislation, increasingly so as the European legislators continue to use directly applicable Regulations (rather than Directives which require implementation), and as the ESAs begin to set binding technical standards and exercise their new powers.

Does the draft Bill contain any proposals or omissions, not covered by the questions above, which cause concern?

The proposed power to enable the PRA and the FCA to impose requirements on the unregulated UK holding companies of certain UK authorised firms which are financial institutions is very broad, and the Treasury is to be given significant discretion to extend its application. Jurisdictional limits will mean that this will create an unlevel playing field. There is a significant risk of unintended consequences: requirements to provide additional capital or liquidity to a regulated subsidiary could significantly impact on funding arrangements for the wider group, or could require the directors to act in breach of the fiduciary duties to the parent company, or to the detriment of its existing creditors. Given the potentially significant impact of this power on an unregulated entity, and the potential for unintended consequences, we consider that there should be significant safeguards surrounding its use.

There are a number of common or recurrent themes emerging from our response to HM Treasury's recent consultation which can be summarised as follows

- the need for the authorities to consult on measures unless urgency makes this impossible;
- the need to ensure where powers of different authorities to regulate overlap that either the overlap is removed, or their processes and remedies are aligned and that there is clarity for the regulated body as to which will prevail in the case of inconsistent or incompatible rulings, coupled with a duty of coordination on the authorities
- in all cases involving the right of an individual to work in a regulated industry or in certain roles in advisers to regulated bodies or as advisers to or as directors of issuers and in all cases where financial penalties in the nature of a fine are imposed, the affected party should be entitled to challenge the regulatory decision through a full independent hearing on the merits:
    - no case is made for the proposal that the regulators should be able to direct directors (present and past) of listed companies, sponsors and primary information providers to commission reports from skilled persons in respect of issues identified by the regulator. We consider this to be an inappropriate and disproportionate power to deploy against individuals, all the more so since these are individuals who are not necessarily employed within authorised firms.
    - a full Tribunal rehearing should be retained in respect of the withdrawal of authorisations and approvals, and in respect of the imposition of restitution and prohibition orders.
- the need to review EU legislation and be certain that the proposals will work harmoniously with existing and advanced draft legislation and take proper account of the role of EU regulatory bodies. The scope conferring supervisory discretion will be limited by the requirement on the UK to implement and apply EU directives and regulation which increasingly set the standards by which firms are to be regulated.

14 September 2011

HM Treasury – written evidence

Thank you for your letter following the Joint Committee's oral evidence session with consumer representatives. Your letter raised a number of points which consumer representatives made during the session; I address each of these in turn.

The Prudential Regulation Authority's insurance objective

Your letter asked why the Prudential Regulation Authority (PRA) is not required to have regard to consumer interests other than in the area of insurance regulation.

As you will be aware, in designing the new regulatory system and preparing the draft Bill, one of the Government's driving objectives has been to create two new authorities, each of which is focused and responsible for its area of expertise. In the case of the PRA, this means overseeing the safety and soundness of the firms it regulates, in a way that will allow it to minimise the impact of their failure, should that occur. For the Financial Conduct Authority (FCA), this means protecting the interests of consumers – I describe in detail below how the FCA's objectives are designed to deliver this outcome.

The crucial point here is that the Government wants each authority to be responsible (and accountable) for delivering the right outcomes within its remit, using its expertise and market knowledge to exercise its judgement about the best way to achieve this. This can only be achieved if each regulator operates with exclusive responsibility for its remit – otherwise, we end up with the potential for one authority to second-guess the other. That is why the Government has chosen not to provide the PRA with a "have regard" to consumer interests in its statutory remit (nor, for that matter, a prudential "have regard" with respect to the FCA).

This is not to say, of course, that the regulators will operate in a vacuum, completely independently of each other. The Government recognises the importance of coordination and cooperation between the regulators, which is why we have included mechanisms in the Bill to ensure that this is achieved. We expect that these co-ordination mechanisms (including, for example, the duty to co-ordinate and cross-Board membership) will ensure that the FCA's consumer interests are represented appropriately in the PRA's decision making processes.

Your letter also queried why the insurance objective was articulated as "*contributing to* the securing of an appropriate degree of protection". As explained in the White Paper, regulation of insurers presents particular challenges not mirrored in regulation of deposit takers. Therefore, the Government has proposed a separate objective for insurers which recognises the unique role for the PRA in promoting protection of insurance policyholders as part of its prudential responsibilities. However, the Government recognises that this special role will not by itself deliver appropriate protection for policyholders; the FCA's generic responsibility for consumer protection

will also apply, particularly in pre- sales situations. This is why the Government has defined the PRA's policyholder protection objective in terms of making a contribution, rather than being solely responsible.

The FCA's strategic objective

Your letter notes concerns raised by consumer groups that the FCA's strategic objective- "to protect and enhance confidence in the UK financial system" – could conflict with its operational objective to protect consumers. You asked for clarification on how these objectives reflect the needs of consumers.

In discharging its general functions, the FCA must, so far as is reasonably possible, act in a way which is *compatible* with its strategic objective and *advances* one or more of its operational objectives – consumer protection, for example. The consequence of this structure is that it is the operational objectives, rather than the strategic objective, which will be the key drivers of the FCA's operational decision-making.

The single strategic objective for the FCA, expressed in terms of confidence in the financial system, is intended to provide a unifying 'umbrella' objective for the FCA, cover the many roles and functions which the FCA will perform. I believe the concept of market confidence will be very helpful in this regard, given that the financial crisis and the failures of the current regulatory regime clearly damaged confidence in the UK's financial system. Recognising and addressing this will be, I believe, essential to restoring trust in the financial system.

However, as you note in your letter, stakeholders have expressed concerns that the strategic objective could be interpreted in such a way as to stop the regulator taking decisive action against firms, particularly in the short term, on the grounds that such action may undermine confidence. I do not agree with the interpretation put forward. It is of course right to note that disciplinary actions against firms for widespread misconduct, such as mis-selling, may well have a short term effect on confidence in the regulated firms concerned and potentially the system as a whole. However, on balance, such action will ultimately have a greater impact in protecting confidence by demonstrating that the regulator is prepared to act to tackle misconduct.

Nevertheless, while I do not agree with this interpretation, I would note that the Government has committed to revisiting the strategic objective. In line with stakeholder views, we will consider how we can better reflect the importance of positive consumer outcomes while ensuring that the scope of the strategic objective remains broad enough to cover all of the FCA's functions, including those in relation to the regulation of markets. This work will include consideration of alternative suggestions, such as an objective to "maintain a fair and transparent market". As you note in your letter, in taking this forward, we will also work to implement the recommendations made by the Independent Commission on Banking, which concern the strategic and efficiency and choice objectives. I look forward to receiving the Committee's recommendations and observations in this respect.

Securing an appropriate degree of protection and the definition of "consumer"

Your letter also raised two points in relation to the FCA's proposed consumer protection operational objective: why the objective refers to an 'appropriate degree of protection' for consumers rather than simply consumer protection; and why consumer is defined so broadly for the purposes of this objective. I will set out the policy rationale for these two matters together as they are linked.

Starting with the second of these issues, I should clarify first that while the current definition in the Bill does reflect the definition in FSMA (which of course already extends to sophisticated professional investors, for example, where they use the services of an authorised person in conducting investment activity) the new definition set out in the new section 1C is in fact broader than the definition of consumer which currently applies for the purposes of section 5 of the FSMA (see sections 425A and 4258).

This is because the Government wishes to fully integrate the UK Listing Authority within the FCA, and is therefore making provision to bring the specific functions currently set out in Part 6 of FSMA into the wider governance framework for the FCA.

Under the current FSMA arrangements the FSA, in discharging its functions under Part 6, is not required to act in accordance with its general duties specified in section 2 of the FSMA (see paragraph 2 of Schedule 7 to the Act and the special list of "have regards" in section 73). The Government believes that it would be odd for the functions under Part 6, which will form a core element of the FCA's markets remit, to continue to be discharged outside the framework of the statutory objectives. Therefore we have decided to extend the objectives such that the FCA may only exercise its powers under Part 6 (which fall within the definition of "general functions") in cases where this would advance at least one of the FCA's operational objectives.

To fully accommodate this policy decision it is necessary to expand the definition of "consumer" in two key respects so that the definition now covers:
(a) persons who invest or may invest in financial instruments without using the services of an authorised person; and
(b) the range of services is extended for example, to include services and the services provided by sponsors and primary information providers who provide services to issuers of securities (section 1C(4)(f) to (i)).

The purpose of the first change is to ensure that the FCA can discharge its general functions under Part 6 of the FSMA (official listing) for the purposes of protecting the full range of investors even where they do not engage the services of an authorised person in making their investment decisions.

The second change is needed to ensure the FCA can discharge its general functions to protect those persons who use the services of certain types of service-provider which do not carry on regulated activities but do provide key services to participants in the financial system. For example, as a result of the extension of the definition the FCA may also exercise its functions under that Part (as amended) to require primary information providers, when providing services to issuers of listed securities, to have in

place back-up arrangements to minimise disruption in the event of the technical failure of the systems used to disseminate information to the market.

Witnesses were of course correct to note that some persons who fall within this extended definition may be sophisticated professional investors who may, therefore, require a lower degree of protection than other investors when transacting in the market. This is no different to the position under the current definition of consumer under which, for example, a sophisticated counterparty may use the services of an authorised person in making an investment decision.

Turning to the first issue raised under this heading, the inclusion of the phrase "an appropriate degree of protection" in the FCA's consumer protection objective reflects, therefore, the fact that the appropriate level of protection may differ for different classes of consumer. We are keen to ensure that the FCA has the ability to secure the right degree of protection for customers in the financial services industry whether the customer concerned is an ordinary retail customer or a sophisticated participant in the financial markets.

The Government feels very strongly that this degree of flexibility and differentiation is necessary, as an objective solely focused on 'securing protection' could be counterproductive. For example, if the regulator were not able to differentiate we would expect that the regulator would potentially base its single approach to protection on the needs of those who are most in need of protection, namely ordinary retail consumers. Applying such an approach across the board could have a number of negative consequences, including stifling the market by applying disproportionate or excessively burdensome regulation where it is not needed, which could in turn have repercussions for innovation, access and cost. Alternatively, the regulator may wish to avoid that cost and target its single approach somewhere in the middle, meaning that some ordinary retail consumers might find themselves with less protection than under a differentiated approach.

As per the current arrangements under FSMA, the "have regards" specified in section 1C(2) make clear that in deciding what degree of protection for different kinds of consumer may be appropriate the FCA must consider, for example, the differing degrees of experience and expertise which different consumers may have.

S348 of FSMA

Finally, your letter raises witnesses' concerns that the FCA's commitment to transparency and disclosure will be constrained if section 348 of FSMA is carried forward in its current form. You asked me to consider whether changes can be made to section 348, consistent with EU directives, to increase the openness of the new authorities. I am happy to confirm that this is an issue the Treasury is looking at carefully, and will let you know of the outcome of this work in due course.

I hope that this response has been helpful in setting out the Government's rationale on these policy issues and will inform the Joint Committee's deliberations on these matters. I understand that you intend to write on a regular basis to clarify certain of the Government's policy and legislative proposals. I very much welcome this approach and

look forward to a continued and open dialogue with you throughout the remaining months of the pre-legislative scrutiny process.

3 October 2011

HM Treasury – supplementary written evidence

Memorandum of Understanding

Thank you for your letter of 31 October to the Financial Secretary. I am very grateful to you and the Joint Committee for your work in scrutinising the Draft Financial Services Bill.

As you note, I had intended to provide the Joint Committee with a draft of the crisis management Memorandum of Understanding between the Treasury and the Bank during scrutiny of the Draft Financial Services Bill. However, as you know, the Treasury Select Committee has been working on substantial recommendations on the arrangements for crisis management, which have only very recently been published.

Given this, I feel it would be preferable for the Government to wait to produce a crisis MoU which can take the TSC's recommendations – and, indeed, those of your own Committee – into account. Otherwise, we might well be producing a draft MoU which would need to be revised almost immediately.

However, I appreciate your concern that the Joint Committee's scrutiny of the Bill should be as substantial as possible. In order to assist you in this, I can set out the broad areas that we would expect that MoU to cover:

- The distinct responsibilities of the Treasury and the Bank (including the Prudential Regulation Authority) in financial crisis management;
- How the Governor's duty to notify the Chancellor of risks to public funds would work. This would include:
    - A description of how the Bank would assess whether there was a material risk of circumstances arising that could reasonably be expected to lead to the use of public funds;
    - What the notification would be expected to contain;
    - Arrangements for updating the notification (if circumstances change) and for withdrawing a notification once the risk has passed;
- What would happen after the notification has been made, including arrangements to keep the Chancellor fully informed until the risk to public funds has either crystallised or passed and arrangements for provision of information and coordination between the Treasury and the Bank group.
- The process of developing options for managing the risk to public funds, bearing in mind that:
    - The Bank is primarily responsible for assessing and analysing options and providing the Chancellor with an assessment of these options;
    - The Chancellor must be able to ask the Bank to analyse and assess alternative options or provide additional information (for example in relation to the propriety and value-for-money of the proposed options);
    - The Bank, where it is acting as resolution authority, must have clarity about the options it should pursue, given the risk to public funds; and

    - The Chancellor must have sufficient time to make a fully informed decision where public funds will be at risk.

- The ability of the Chancellor to ask the Bank to implement the option chosen to resolve the risk to public funds, including acting as the Treasury's agent where appropriate. The scope of any direction power underpinning this will also be clarified.
- Arrangements to enable the Treasury to ensure the UK's compliance with international obligations where necessary, particularly obtaining state aid approval from the European Commission.
- Arrangements for ensuring timely and appropriate communication with Parliament and the public.

I hope this is helpful. The Financial Secretary and I would be happy to expand upon this when we give evidence to the Committee on 15 November.

14 November 2011

HM Treasury – oral evidence (QQ 1005-1076)

TUESDAY 15 NOVEMBER 2011

Evidence heard in Public Questions 1005 - 1076

Members present:

Mr Peter Lilley (Chair)
Mr Nicholas Brown
Baroness Drake
Mr David Laws
Lord Maples
Lord McFall of Alcluith
David Mowat
Mr George Mudie
Lord Newby
Mr David Ruffley
Lord Skidelsky
Baroness Wheatcroft

Examination of Witnesses

Witnesses: **Rt Hon George Osborne MP**, Chancellor of the Exchequer, and **Mr Mark Hoban MP**, Financial Secretary, HM Treasury, examined.

Q1005 Chairman: Chancellor and Financial Secretary, welcome and thank you very much for agreeing to appear before the Committee. I know you have to be away at 4.50, Chancellor, and we will let you go, but we may wish to retain the Financial Secretary and grill him further in your absence. This is the last of our final evidence sessions of those that have taken place in this building. We have had them in the Grimond Room, the Wilson Room and finally the Thatcher Room. You may make of that what you will.

Could I begin by asking you how you envisage legislating for the Vickers Report or your response to the Vickers Report? To what extent will it appear in this Bill and in subsequent legislation?

Mr Osborne: First of all, Mr Lilley, can I thank you and your colleagues for spending so much time on the pre-legislative scrutiny of this legislation? Given its size and importance, it has been a good use of Parliament's time and, I hope, will both improve the Bill before we publish it in its final form and also help Parliament's scrutiny of the Bill when it is introduced. I am very appreciative of that.

With the Vickers Report, we commissioned a report and we have received its recommendations. There may be some features of its recommendations which we are able to put into this Bill, particularly, for example, ensuring that the FCA has a proper regard to competition. We have taken the view—and this is a view shared by John Vickers himself—that to try and shoehorn hastily drafted clauses that would implement the ring-fencing part of the Vickers Report into this very important piece of legislation, which is about the crucial issue of how we as a nation supervise financial services, would have been a mistake and would have risked creating poor legislation. We are absolutely committed to putting the Vickers Report into legislation, but we think it is more appropriate to do that with a separate piece of legislation, which we are also committed to introducing.

Q1006 Chairman: One point that has been made to us is that defining the maximum and minimum boundaries of the ring fence will be extremely important, and trying to define it in a way which does not lead to subsequent boundary disputes that might preoccupy the Financial Policy Committee to take its eye off the underlying goal of stability will be very important. Do you think that is going to be possible or is there simply no way of defining it that will not lead to some uncertainties and further revisions or litigation from banks if they want to get their way and redefine themselves?

Mr Osborne: We are confident that we can implement the ring-fencing proposals in a way that improves financial stability rather than undermines it, and helps regulators rather than distracts regulators. What we propose to do is this. Between now and Christmas, and probably closer to Christmas, we will publish the Government's response. My current ambition is to do that in the middle of December, although I might wait and see what your Committee has to say on the subject if it becomes clear that you have substantive things to say. It is certainly our intention to publish our response to the Vickers Committee to answer these points in detail in the middle of December. As I say, I am confident that we can implement Vickers in a way that enhances stability rather than detracts from it.

Q1007 Chairman: I have one further question that arises from Vickers. There is a lot of comment about the timetable being up to 2019. Some have interpreted that as being both aspects of the recommendations: both the ring-fencing and meeting their enhanced capital requirements. On the enhanced capital requirements, clearly, there is a conflict between rebuilding capital and ensuring a growth of lending at this phase of the cycle. How do you see that being resolved? Do you think it could conceivably be intensified by the Vickers proposals?

Mr Osborne: At the moment, if we are talking about the situation today, of course there are regulatory requirements subsequent to the crash that have increased the amount of capital that banks are required to hold. We have the Basel agreement internationally that this should be done by 2018. I suspect that, if you had a person running a bank sitting here at the moment, it is not the regulatory requirements they are currently seeking to meet but the market's requirements on this. The market is demanding that the banks, in the current very volatile situation, hold more capital.

When it comes to the impact of the Vickers changes, I think they will be good for the UK, the UK economy, the City, British banking and British industry. The judgment of when to introduce them was partly a judgment I asked John Vickers to make. He came to the

conclusion that the backstop for the implementation of his reforms should be 2019. That is basically the same time scale as the Basel requirements and the Basel timetable internationally. Just as I have trusted his judgment in some other respects, I trusted his judgment on this and I think he has got the balance right. That does not mean there will not be certain parts of his report that could be introduced earlier. Indeed, he does himself set some earlier deadlines, for example, in some parts of his report that are about competition and helping people to change their current accounts and the like. He has made his own judgment. I think it is a good one and we should stick, basically, with the international timetable on the implementation of the bits of the report on ring-fencing and the like, but we will publish a detailed timetable of the implementation in December.

Q1008 Mr Mudie: Chancellor, I want to ask you a couple of questions on the FCA's financial stability objective. You will have read that Barclays and HSBC raised the difficulty about the vagueness and lack of definition of the financial stability objective. They describe it as an undefined concept. They have suggested maintaining a sustainable supply of credit to support the economic policy of the Government, including its objectives for growth and employment. Do you accept that a lack of definition is going to cause a difficulty? Secondly, if so, is there not ground for moving to something that is much more defined and positive?

Mr Osborne: In a second I will ask my Financial Secretary to say something about this as well, if you will allow me. This is going to be a real team effort introducing the Bill.

Q1009 Mr Mudie: Which one is the hard one and which one is the soft one?

Mr Osborne: He, of course, deals with the hard questions. I will make a general observation and then come to the specifics. The general observation is this. I think this is a challenge for Parliament and, indeed, for the financial system. There was no shortage of laws about regulating our banks in 2007. There were reams of laws sitting on the statute book. There was no shortage of definitions of what financial stability meant. What there was a lack of was judgment. Indeed, Lord McFall's Committee, when he was Chair of the Treasury Select Committee, wrote an excellent report, "Run on the Rock", which highlighted the lack of judgment. In the end, we can have a debate here about the precise definition of this or whether you should expand the definition of that, and maybe we will come on to those issues, for example, when we talk about the crisis resolution, the memorandum of understanding and the like, but I would say this. You cannot prescribe for every circumstance in legislation for something as complex as financial services and the financial system. We have to rely on judgment. The best thing we can do is ensure, whether it is with the Financial Conduct Authority or the prudential regulator, that they are empowered to make judgment calls.

We know financial stability when we see it. We have been explicit in saying that, of course, we don't want the financial stability of the graveyard. We want a financial stability that is consistent with economic activity, a growing economy and a competitive banking system. But, ultimately, I do not think any group of MPs or group of Government Ministers can prescribe in all circumstances what that should look like. We should set up a system where there are clearly prescribed responsibilities for the Financial Conduct Authority and make sure we get the very best people in to do it—I think we have found a very good Chief

Executive of the FCA—and then trust them to get on with the job while holding them accountable for the decisions they make.

If I was to point to one principle behind the entire change we are making, it is that we would wish to emphasise more than was the case in the past the role of judgment calls on what is going to keep our system safe, competitive and prosperous. Mark, do you want to say something?

Mr Hoban: It is quite difficult to set some metrics to determine what financial stability is. Mr Mudie, there was a debate that you and I participated in when the Financial Services Bill went through Parliament prior to the last election and how you define what financial stability is. That is why it is important that the FPC, which has a broad range of members, looks not just at the current financial system but at some of the threats that are on the horizon as well and responds to those. One of the problems about focusing on something specific such as the supply of credit probably gives undue emphasis to that, when there may be other risks to financial stability out there on which the FPC should also be focusing.

Q1010 Mr Mudie: I would have said that the Chancellor, when he came before the Treasury Select Committee, improved on the Bill because he put forward a definition of financial stability. He said, "I would define financial stability as a financial service industry that is serving the broader interests of the economy, that is not requiring taxpayers' money to support it, that is not contributing to excessive leverage nor to excessive credit contraction." In the context of my question, I would support that rather than what is in the Bill, but we would still be left with defining what "serving the broader interests of the economy" is so that we were being fair to the FPC and the Bank of England.

Barclays and HSBC have put it on the table. They would say that the growth of the economy and the supply of credit should be fixed and guided toward making sure we have a certain growth level or a certain employment level. They have defined it. You have gone into the same territory, Chancellor, but left it vague. Is there no ground between the two of you to come together and get something that would enable the Governor of the Bank of England to come before us and be accountable? We cannot say he is accountable if we do not have any definition or targets as we have in the Monetary Policy Committee.

Mr Osborne: I would say the definition I gave the Treasury Select Committee may be a little bit more specific but it does not include metrics.

Q1011 Mr Mudie: It shows a good attitude, Chancellor.

Mr Osborne: I am glad you agree. We have created a system where we are putting judgment front and centre. We have the Financial Policy Committee sitting over the whole system and taking a view on systemic risks. We have the prudential regulator looking at the prudential soundness of individual firms. We have the Financial Conduct Authority looking at the conduct of business and the integrity of the market. You could make this Bill twice as long quite easily, but I am not sure that would actually improve financial regulation.

I think the objectives are well understood. We have been clear about what the risks are that should be avoided. It is very clear that the use of public money is something that triggers, in effect, a crisis and triggers the involvement of the Chancellor, which I am sure we are going

to come on and talk about. Our ambition is a financial services industry and a financial system that serves the entire economy, that is not supported by the taxpayer, that is competitive, that gives people choice and gives people an adequate supply of credit.

Q1012 Mr Mudie: Chancellor, you have unerringly put your finger on it when you said yourself, "I don't want the stability of the graveyard."

Mr Osborne: Yes.

Q1013 Mr Mudie: The Governor and the Financial Policy Committee have the right to turn round and say, "What level of activity do you want, Chancellor? If I am going to be judged on my performance, you have to tell me what the objectives are." That is all I am saying. You have done it unerringly in terms of broadly saying what you do not want. Now we would love you to tell us what you do want.

Mr Osborne: One of the changes we have made to the legislation has been to ask the Financial Policy Committee to have a proper regard for economic activity in conducting its business. That is partly in response to the representations that were made to us in the consultation. I completely agree with you that this is a very fine judgment. It is, frankly, a judgment that the Government and Parliament have to wrestle with as well, which is getting the balance right between stability, security and growth. In the end, a well-regulated financial system should be able to provide both.

Q1014 Lord Skidelsky: The Treasury Select Committee has endorsed the use of Charles Goodhart-type indicators of financial stability. In particular, it has endorsed the idea that they be made public and publicly monitored. The danger that I see is for any of these indicators becoming a fetish almost, set in stone, so that any minor deviation from it sets in motion a disturbing market momentum in one direction. What is your view? Do you think they should be made public? I am not suggesting that one should use indicators. Of course one has to use indicators, but should they become the subject of continual public scrutiny by being placed in the Bill?

Mr Osborne: First of all, as a Government, we will properly and formally respond to the Treasury Select Committee report. It would not be fair to the Treasury Select Committee to respond here and not do a proper formal response. I have seen their recommendation in this regard. I would say two things. First, there is always the risk of the measure becoming the thing that distorts actual activity. The second thing I would say is that it is much more difficult in this field than it is in inflation targeting to find a single measure or set of metrics.

I respect your experience and knowledge, and I do not know whether you would agree with me, but there are decades of work that have gone into thinking about monetary policy. Inflation targeting and the regime we have in place, not just in Britain but around the world, are based on many decades of academic work and trial and error, and learning from the mistakes of what went wrong in the past.

The thinking on financial policy and macro-prudential control is much less developed. This is a much newer and certainly less developed area of policy making. Certainly, I would not feel

confident today to say there is a set of metrics and a set of tools which I am absolutely certain is what is required to provide that macro-prudential stability.

I have asked the Interim Financial Policy Committee which we have created to look at what those tools might be. They will come back to us as Members of Parliament and seek our approval for those tools, should the Government agree with them. They are also thinking about how best to carry out their job. I do not think they are yet in a position to set up everything. You would have to ask them, but my understanding is that they are not in a position to say, "These are all the tools and metrics we need to use." As I say, this is an area of policy making which is much less developed than monetary policy making.

Q1015 Lord Newby: I have a couple of questions about the powers of the FPC. It has been suggested that, while they will have the powers to direct the PRA and the FCA about which macro-economic tool they should use, they cannot say how quickly they should use it and the means by which they should use it. They say, "We would like you, broadly speaking, to do that", but they cannot say, "And we would like you to do it by a week on Tuesday by doing X, Y and Z." Do you not think that is an undue constraint and should they not be given that power?

Mr Osborne: Maybe Mark could say something on that.

Mr Hoban: We have talked quite carefully about what the correct relationship should be between the FPC and the FCA and the PRA, both of whom could have a role in implementing some macro-prudential tools. It is very much down to the two main regulators to decide how to follow through the FPC's proposals. They have the technical expertise on how to implement them and will need to work through that properly. Recognising the point you made about that interaction, the PRA and the FCA do need to go back and say, if they have not complied with the FPC's direction, why they have chosen not to. That does make a much tighter relationship between the FPC, on the one hand, and the two regulators, and it is a better balance and a straight power of direction.

Q1016 Lord Newby: The other issue which has been raised by the Bank is that they think there will be advantage in the FPC being able to gather information directly so that they will be able to be well informed about what is going on, not least in respect of the shadow banking sector, where there is a sense that in future there is going to need to be much more intervention than there has been in the past, and certainly a lot more monitoring of potential risk. Do you think that additional power to give the FPC that direct information-gathering ability will be helpful?

Mr Hoban: The challenge is that you do not want to have duplication with the different bodies gathering the same information more than once. You do need to make sure that the FPC has the information it needs to do its job properly. One of its roles—and you alluded to shadow banking—is to think about the perimeter issues quite carefully and what should and should not be regulated. Our view is that the current balance of information-gathering powers between the FPC and the PRA and the FCA is about right.

Mr Osborne: The other point I would make is that we have deliberately put these two organisations under the same umbrella of the Bank of England. Although the PRA is operationally independent and a subsidiary, it is nevertheless, of course, chaired by the Bank

of England Governor, and the Chief Executive is a Deputy Governor of the Bank of England. One of the things we have sought to do is to bring all the same people into the room who are dealing with these issues. While, of course, we can examine whether the Financial Policy Committee has a power to direct the prudential regulator and so on, let us remember that in the real world we are dealing with the same people directing themselves and being aware of the same amount of information in many respects. The logic behind putting these organisations under the aegis of the Bank of England, and indeed the Governor of the Bank, was precisely so that you did not get three different organisations working in a vacuum and not really communicating with each other.

Q1017 Mr Laws: Chancellor, you have already indicated that, in the macro-prudential tool area, the policy is much less developed than in monetary policy. I know you have also said that you do not want to produce all your responses to the Treasury Select Committee's report here when you are going to do something more formal, but does the underdevelopment of this area not indicate that we could do with more substantive consultation with Parliament and through the Treasury Select Committee before some of these things are introduced?

Mr Osborne: The short answer to that is yes. I would certainly want Parliament, whether through the Treasury Select Committee or other forums, to take a close interest in the macro-prudential tools that the Financial Policy Committee will have. The Financial Policy Committee at the moment is an interim body. It is both assessing the current situation in an interim and non-statutory way in that sense, and has quite a lot on its plate at the moment doing that job. But it is also looking at what tools it might need to do its job permanently and what statutory tools it might require. It will then come back to the Government and say, "We think we need A, B, C and D." Maybe it will be around leverage ratios, counter-cyclical capital requirements or loan-to-value ratios. It will come back with some suggested instruments. Obviously, we, as a Government, will have to make a decision about whether we think they would be appropriate instruments to give the body or, indeed, whether it requires additional instruments. Then we will have to come to Parliament and seek the approval of both Houses of Parliament for those tools. These are very important instruments of policy.

This goes to the heart of real issues for the people that we represent in the House of Commons. This is about whether you can get a mortgage. This is about whether your small business can get a loan in a particular environment. These are very important issues, even if they feel quite technical. I would hope that Parliament takes a very close interest in this. As I say, it is a newish area of policy. I am not aware of any other country in the world that is as far ahead as we are in trying to develop formal structures to undertake this macro-prudential work. There are all the advantages of innovation and all the disadvantages that there is not an easy route map to follow.

Q1018 Mr Laws: You indicated that some of these macro-prudential tools could be pretty sensitive for the public out there—the voting population. When Lord Turner was giving evidence the other day—I do not know whether you have seen all of his evidence—he was pretty supportive in this area. But he picked out a number of things that he would have wanted to do if he could have replayed 2003 to 2007 again. Some of them sound sensible and pretty uncontroversial. One of them was, essentially, to burst the property price bubble

to avoid it getting out of control rather than relying upon the interest rate by controlling the amount of mortgage lending—the loan-to-value ratios which you have just mentioned. That sounds very sensible, but it would also be extremely sensitive for many of our constituents, who might find it more difficult to get the credit they need and might also question some of the people who are making those types of decisions.

Without asking you to pre-empt the process of consideration that you and the FPC are currently going through, are you looking at any ways of trying to control, limit or improve the amount of public accountability in these areas which are going to be very sensitive? In other words, are there any areas that you would be inclined already to rule out? Would you have sunset clauses for some of these powers? Do you think there is going to be a democratic deficit between the Bank's existing accountability and these areas which are going to give it very significant new powers?

Mr Osborne: First of all, I would hope that this is an area that your Committee would take an interest in and advise on. It is a classic dilemma. On the one hand, we want to maintain democratic control and oversight for accountability. On the other hand, the whole purpose of this area of policy making is that you do not get politicians, who are vulnerable to the temptation of trying to win a general election, taking the punchbowl away when the party is really getting going, in the housing market, for example. In monetary policy we have found a good set of arrangements, where the Chancellor of the elected Government is accountable to Parliament. He sets the inflation target, and then the Monetary Policy Committee is independent in meeting that target. The Bank Governor is accountable to the Select Committee and others for his Committee's success in meeting that target. We have found a good balance.

This is more difficult partly because, as we were just discussing with Mr Mudie, there are not such straightforward metrics as inflation targets, or certainly none that I am aware of at the moment. You have to get that balance right between giving them the tool and then giving them the operational independence to deploy the tool, even when it may be very politically inconvenient to the Government of the day. That is the challenge. That means we have to be very careful, given that these are significant powers that have a real effect on real people's lives, about what tool we are giving and in what circumstances we would expect it to be used. But we have to think long and hard before suggesting that Parliament could override the use of the tool. Maybe that is something we should think about, but it would come with a downside. There was a temptation in 2005 or 2006—and this would be true potentially of any Government, not just the Government that was in office at the time—to keep the housing market going and find good excuses for why this was a long-term trend rather than a bubble.

The root of all this is trying to find a way to deal with asset price bubbles better than Alan Greenspan suggested, which was to let them explode and clean up the mess, because four years on we are still cleaning up the mess.

Q1019 Mr Laws: As a last question, is a sunset clause or a sunset element to some of these powers one way, potentially?

Mr Osborne: Yes; that is something we could absolutely consider. As I say, I am not claiming for a second that the Government have all the answers in this field. This is a new area of policy making. It is a new issue for Parliament to get engaged with. It is an area where, in this

legislation, we are creating a framework for this to operate, but nothing in here is specific about the tools that will be used. When we have those tools, partly on the advice of the Interim FPC, we will come to Parliament and seek Parliament's approval for them.

Q1020 Lord Skidelsky: I would like to pursue the theme of the underdevelopment of the tools. After all, there was a huge amount of incorrect risk weighting in the lead-up to the recession, but we still seem to be relying on risk weighting in setting up our capital requirement. Why should one think the FPC would be better in the future than in the past? Is this a matter of learning? Some of us might argue that these risk weightings, or a great number of them, are bound to be fictitious because we are not in a position to know what the real risk weightings are. Under those circumstances would it provide a sufficient backstop to just have risk leverage limits or something like that, because otherwise one might be in a position of thinking that one has something secure and is learning more about things but is actually perpetuating the same kind of mispricing of risk in one's judgments that one had before?

Chairman: Excuse me, Chancellor, I am obliged to tell their Lordships that there is a vote in the Lords. If they are staying here, then we need not adjourn.

Lord Skidelsky: I am much too interested in the reply to go and vote.

Mr Osborne: It depends how they are going to vote, Mr Lilley.

Chairman: Can you pair between yourselves?

Lord McFall: We are voting with the Government.

Mr Osborne: You see how sensible they are in the Lords, Mr Lilley.

Chairman: Absolutely; in that case we can continue.

Mr Osborne: I have a lot of sympathy with what you are saying, Lord Skidelsky. No one would claim that the risk weightings are perfect and capture risk completely accurately. I have a lot of sympathy with the idea of a leverage ratio as a sort of backstop additional tool.

In the end, if you get the right people on the Committee and the right people at the Bank, then they have to be able to exercise discretion and judgment. Let me take a specific example which is not directly related to the FPC but is related to the PRA. When RBS sought to take over ABN Amro in the autumn of 2007, they complied with every single rule. There was no shortage of rules about the takeover of banks or the need to get FSA approval. Every single box was ticked. But there was no one in the system empowered to say, "Actually, maybe this wholesale funded bank should not be taking over this Dutch investment bank four or five months after the credit markets have frozen, and maybe someone needs to ask them some questions about the big picture", even though they were complying with all the individual rules.

I would hope that one of the things you will be able to say as a result of all of these reforms is that a takeover like that would not have happened, and would not be allowed to happen, because the prudential regulator, the Governor of the Bank, the FPC and others would have had lots of different alarm bells flashing. The FPC would have spotted what was happening to

credit conditions in the economy and the freezing of the credit markets. The prudential regulator was being a prudential regulator and asking questions. In the end, I do not think there is any piece of legislation that you can prescribe and say, "They were not compliant with clause 41, section A." You trust that you have good people who feel empowered to make a judgment call about what is right for the broader system.

Mr Hoban: I would add a point on capital. Of course one of the tools that would potentially be available to both the FPC and the PRA would be the ability to require a bank to hold additional capital against a particular class of liabilities. If you do not believe sufficient capital is being held against a growing activity—perhaps a new product that has been devised—you could ask that institution to hold more capital.

Q1021 Lord Skidelsky: But you would still be holding capital against weight attached to the risk.

Mr Hoban: You could go beyond, potentially, the weight that is attached to the risk in Basel III. You could go further than the minimum requirements set out in Basel III.

Q1022 Lord Maples: There has been a certain amount of concern on the Committee, Chancellor, about possible conflicts between the FPC and the MPC. I will give you an example. In the run-up to the crash, the MPC focused solely on consumer inflation by one measure or another—a target which you have continued—and ignored the asset price bubble because RPI inflation was relatively low. There are many people who would now argue in retrospect that interest rates were too low during that period and allowed the asset price bubble to build up. If that situation were to recur now, that problem would be left with the FPC. I am not sure it is an adequate answer to say that the Governor is Chairman of both, but nevertheless he is, but they would be saying to the MPC, "We have a problem here because we have this huge asset price bubble blowing up in the property market and you are keeping interest rates low." They would say, "Yes, because the RPI is low." The FPC would then be forced to use macro-prudential tools like loan-to-value ratios or increased capital requirements or risk weighting or whatever.

First, do you see this as a problem? How would you see it resolved? It could be awkward for the Treasury if such a conflict were to develop. Secondly, have you thought of giving the MPC a broader inflation target that is simply consumer or retail prices?

Mr Osborne: At a time like this, when there are concerns about inflation, frankly, to go in and change our monetary policy arrangements and our inflation target would be quite a dangerous thing. We have to convince the world that we are serious about dealing with inflation. We are serious about dealing with inflation, and the MPC is serious about dealing with inflation, but people might have suspicious motives, however honestly and well-intentioned we were, if we started saying, "I think we will start changing the remit of the MPC", at a time like this. I have thought that was not the right thing to do.

Equally, you would have to ask the Governor and the members of the MPC at the time, but, of course, part of their job of hitting their inflation target was made a lot more complicated by what then happened in the financial system. You could argue they would be better informed by the work of which they would be aware that the FPC was doing on systemic financial risks and asset price bubbles and the like. But giving them two targets or some sort

of merged target would be a mistake, particularly at a time like this. That is why we came to the conclusion that you had to create a separate body with different tools and have a go at dealing with asset price bubbles and other features that undermined the stability of the financial system.

It may well be the case that higher interest rates in 2005-06 would have helped, but I am not sure they are the only tools that would have prevented happening what, in the end, happened.

Q1023 Lord Maples: You are content, then, if you leave the inflation targets the same—I understand your reasoning—that it would then fall to the FPC to use its tools to correct what, essentially, it would be seeing as a monetary excess in a particular asset. It is usually property of one form or another, whether commercial or residential property. They would then not have at their disposal any normal monetary policy instrument. They would have to use the sorts of things I mentioned like loan-to-value ratios or macro-prudential tools. You would be content that that would be the case, because they would be making the kind of decisions which David Laws was talking about.

Mr Osborne: Obviously, I would not want to give the FPC control over interest rates. I think that should stay with the MPC. I do not want to give the MPC lots of different tasks because then it might achieve none of them. Again, it comes back to the institutional arrangement here. We have created in the same institution a body that is targeting inflation, a body that is looking at systemic financial risks, and a body that is prudentially regulating individual firms. I would argue that putting them all in the same institution does allow a bit of a sharing of knowledge. The Bank executives who are responsible for monetary policy are also the Bank executives who are sitting on the Financial Policy Committee. They are the same human beings, and one would assume they are making use of all the information that is available to them.

Q1024 Mr Brown: I want to ask you about the Governor's duty to notify you if a crisis is looming and there is going to be a call on public funds. We have your letter which you very helpfully sent to the Committee about the memorandum of understanding. The wording in the legislation uses the phrase "material risk". Do you think it is sufficiently well defined?

Mr Osborne: First of all, I want to apologise to the Committee because I had hoped to produce a draft MoU for this hearing. I took the decision that, given that the Treasury Select Committee—and this is not a criticism of the Select Committee because they were doing other very good, worthy and important things—only produced their report on all of this on 8 November, if I had rushed out a draft MoU, it would 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.

On the material point you make, first of all, the MoU will go into this in greater detail. Again, it is going to be one of those things on which you could spend 50 pages trying to prescribe exactly what is a material risk and exactly when the Chancellor and the Government should be informed. We will be clear about the parameters, but, nevertheless, in the end, you have to rely on the judgment of the Governor acting under his statutory responsibilities to inform the Chancellor when there is a not immaterial risk to public funds. That partly depends on

the size of the company involved and the risk of it happening as well as the sums of money involved. You could have a large amount of money that is certainly at risk in a small firm, or you could have a huge amount of money which may only be a risk in a smaller number of circumstances in a very large systemic firm, but it is very important the Chancellor hears about that as well. It would be difficult to prescribe it to the last detail.

Both this Governor, and I am sure his successor in due course, will be under no illusions that, if public money is likely to be deployed, then the Chancellor needs to know. To be fair, although people keep saying "Look at the 1980s. Look at Johnson Matthey and Nigel Lawson was not told in time", the reason we have been deploying that example for the last 20 or 30 years is because it was clearly wrong. The Bank of England acknowledged at the time it was wrong and lots have been learned from that and from subsequent problems over the last couple of decades.

Q1025 Mr Brown: Are you worried about the risks posed by the shadow banking system in the United States? The sums of money involved are huge. It seems to me that a principal reason for its functioning at all is to evade regulators. Do you think your new structure will be able to get a good enough sense of what is happening there and what risks are posed? Even if they do understand it, do you think they will tell you soon enough?

Mr Osborne: First of all, again, one of the advantages of this legislation is that it creates a system whereby people can exercise some judgment. Almost by its nature, shadow banking is quite difficult to regulate to the nth degree because there are always going to be, in our world of regulatory arbitrage, people trying to get around the rules in order to make money. I feel we are going to be creating a body of people who are empowered to make some of these judgment calls, to spot the wood for the trees. I would certainly expect them, if there was something developing which could potentially lead to the use of public funds or the other two conditions prescribed in the legislation, to inform the Chancellor; absolutely.

Q1026 Mr Brown: Would you be informed in private or would this be a public notification?

Mr Osborne: The legislation sets out how the notification is made and the method of making that notification public. I can ask Mark to say more about the detail of it, but there are circumstances in which that can be withheld until it is judged appropriate. Of course, there were interventions that the previous Government made, for example in RBS and HBOS, before they fell over in the autumn of 2008, which were not made public at the time. I think that was a sensible decision. It is established practice that things can be kept secret, provided—and the Bill provides for this—there is a proper method for making them public at the appropriate time and a proper method of audit: i.e. making sure that formal notifications have taken place, minutes have been kept, letters have been exchanged and the like which can come to light later. Mark, is there anything more you want to add?

Mr Hoban: One of the features of this regime is increased transparency so that people can hold the authorities to account when things have happened. It is partly why there will be biannual reports produced by the FPC, for example, so that people can understand what risks are identified and how people responded to them, whether it is the shadow banking issue that you raised, Mr Brown, or others. That is quite an important part of this regime and it will ensure that accountability to the wider public and to Parliament is strengthened.

Q1027 Mr Brown: In the future, and I do not want to personalise it, do you think *the* Chancellor under the Act has sufficient powers to get his own way if there is a disagreement between *the* Chancellor and *the* Governor over what to do if it seems to the Chancellor that a call on public funds may be emerging but we are not quite there yet? In other words, you are trying to pre-empt a difficult situation before it gets any worse.

Mr Osborne: First of all, the responsibilities are clear. Responsibility for financial supervision of stability until there is a material risk to public funds rests with the Governor. Once there is a material risk to public funds, then the Chancellor must be responsible and accountable for that. The MoU is going to spell out in more detail the respective responsibilities and powers of the Chancellor and the Governor. As I say, I apologise that I have not produced it today but I wanted to take into account some very specific recommendations in this area from the Treasury Select Committee. As I have indicated in my letter to you, Mr Lilley, we are going to look at the ability of the Chancellor to commission advice and ask the Bank to analyse and assess advice that the Chancellor puts before the Bank. Of course, we are going to consider the ability of the Chancellor, in the words I have written here, "to ask the Bank to implement the option chosen to resolve the risk, including acting as the Treasury's agent where appropriate". That is where the Chancellor would want the Bank to undertake something. There is, of course, a power of direction in the 1946 Bank of England Act.

Q1028 Mr Brown: It is a bit of a weapon of last resort, is it not?

Mr Osborne: The memoirs of my immediate predecessor made it clear that he did at one point consider using the power of direction but decided that it was—using words for him—a bit of a nuclear option. We are looking at this whole area of policy and looking at what powers the Chancellor should have in the circumstances you describe when there is a disagreement between the two institutions. That will be spelt out in the MoU.

I would make two observations, if I may briefly. First, it is generally incumbent on the people who do this job and the person who becomes Governor of the Bank of England to make sure they try and get on well with each other. There is nothing you can put in legislation or in memorandums of understanding that is going to prescribe for that. Secondly, there is an institutional bias, which you might regard as quite a healthy tension in the system, between Bank Governors, who are always concerned about the solvency of things, and Chancellors, who are always concerned about the liquidity of things. In other words, Chancellors and Governors would always like to think that somehow the Central Bank has some magic pot of money that it is going to produce, with the mystery of central banking, and solve the Chancellor's problem. The Bank Governor is sometimes the person who has to say, "Actually we are dealing with an insolvent institution here and this is going to need public money. You are going to go and have to tell the taxpayers the truth about it. There is not some magic pot of money." Equally, Central Bank Governors can be very concerned about their balance sheet and they should be equally concerned about the liquidity in the system.

There is a tension there, which is sometimes quite a healthy tension. Bank Governors tend to see things as solvency problems; Chancellors and Finance Ministers tend to see things as liquidity problems. You could argue that these things are playing out at the moment in the eurozone.

Q1029 Mr Brown: Finally, you referred earlier to the significant powers that we are putting into the Bank under the Governor. The Bill proposes no change to the structures of accountability to Parliament. Effectively, accountability is still through Ministers and through the Bank's regular meetings with the Treasury Select Committee. Do you think there is a case for some other parliamentary scrutiny focused specifically on the regulatory functions that are now coming firmly under the Governor in the Bank of England?

Mr Osborne: This must be a matter for Parliament and particularly for the Treasury Select Committee. They should certainly consider how they are best going to scrutinise these new arrangements and the tools that the FPC may have. Partly that is a matter for them. Obviously, when it comes to the actual legislation and the face of the Bill, I do not want to sound like a stuck record, but there are some specific recommendations from the Treasury Select Committee about changing the Court of the Bank of England into a supervisory board and, indeed, the role of the Treasury Select Committee. I do not want to pre-empt our response to them, but we are considering them very carefully.

Q1030 Chairman: Chancellor, you made an interesting point there that Central Banks focus on solvency and have a reluctance to use their liquidity powers. None the less, quintessentially, the historic purpose of a Central Bank is to be lender of last resort and to provide liquidity—

Mr Osborne: To solvent institutions.

Q1031 Chairman: To solvent institutions, but, of course, if does not do so, then they are likely to be found insolvent, because any bank which tries to sell off its longer-term assets—and all banks borrow short and lend long—will find it difficult to get their full long-term value in a fire sale. Is there not a conflict, and are you satisfied that the legislation will not discourage the Bank from acting as lender of last resort when it is required?

Mr Osborne: Of course, the Central Bank is the lender of last resort, but, as I have just said, it is a lender of the last resort to solvent institutions. The longer something is illiquid the more it becomes insolvent, but it is equally the case that sometimes you have to confront the truth that a bank is insolvent and, however much you tide it over month to month, its fundamental situation is not going to improve. I was not there in the room when these decisions were taken over Northern Rock, for example, in the winter of 2007, but there was clearly, as we now know from various memoirs that have been produced, an argument between the Government of the day that said, "Frankly, this is just a liquidity problem and the funding markets will reopen. This wholesale funded bank is not insolvent", and the Governor, who was arguing, "Hold on, this is insolvent and you have to make a difficult decision to nationalise the institution or do something else with it."

It is not bad sometimes in policy making to have a bit of creative tension—and I stress the word "creative"—where people are coming at things from different angles and have different concerns. Inevitably, politicians are reluctant sometimes to tell the taxpayers that they have to pay out money to bail out a bank. That is not a very popular thing to do. Central Bank Governors sometimes have the function of holding politicians' feet to the fire. Equally, it is very important for Central Banks to be aware of their responsibilities as the genuine lenders of last resort to institutions that are perfectly solvent were they able to get funding but,

partly due to some circumstances totally beyond their control and things that are temporary, they cannot get access to liquidity.

Chairman: We hope to discuss these things a bit further with the Governor. If further issues arise, perhaps we could get back to you on that. Meanwhile Baroness Wheatcroft has a question.

Q1032 Baroness Wheatcroft: I have a very quick question. Ring-fencing clearly is not the total antidote to bank failure, but it is a move toward simplification and orderly resolution should a bank fail. Vickers was very clear about that. As you said at the beginning of your remarks, Chancellor, he was of a view that, as far as capital requirements were concerned, then fitting in with Basel made sense. My understanding was that he saw no reason why ring-fencing should not come in sooner and, indeed, he might advocate that. Do you think there will be disappointment among the public that at the end of 2011 we are talking about bringing in ring-fencing in 2018-19? Can you give us any indication why you think it could not be done sooner? The banks who have given evidence to us seemed resigned to it, albeit that they would wish it not to happen. They accepted that it was an inevitability. Perhaps they would like it to happen when the individuals concerned are not in charge.

Mr Osborne: As I said and as John Vickers himself said, 2019 is the backstop. It does not mean that it all happens then. I do not want to pre-empt the response we are going to give to the Vickers Report, which will be in just over a month or in a month.

Q1033 Baroness Wheatcroft: But, without pre-empting that, you could envisage it being sooner rather than later.

Mr Osborne: I think I would be pre-empting it. I have described 2019, as John Vickers has, as a backstop. The commitment to legislate in this Parliament is very clear.

Q1034 Mr Ruffley: Chancellor, why have you made the FPC a Committee of the Court?

Mr Osborne: I know where this is going, which is—

Q1035 Mr Ruffley: Do you?

Mr Osborne: I know where you are going to, Mr Ruffley, which is that the relationship between the Court, the MPC, the FPC, and indeed the PRA, is all somewhat difficult. This is an area we need to look at, partly prompted by the Treasury Select Committee's recommendations. It is partly that we did not want to tear up the existing institutional arrangements, for example, with the MPC. We thought it was appropriate that the FPC was a Committee of the Court, but that did not mean we wanted to revisit existing arrangements. However, it has been drawn to our attention that it is not as logical as the Treasury Select Committee would wish.

Q1036 Mr Ruffley: Sure, but it is in the legislation, which is what this Committee has been looking at, and we have been concerned about the issue of accountability. Mr Hoban and you have both acknowledged that. Do you think the current Court is fit for purpose, having regard to the fact that we have had evidence that it did not seek to do any root and branch review at all of what happened in 2007-08 in the Bank? I would say, parenthetically, that Sir John Gieve gave evidence to this Committee where he actually shrugged and said, "Well, actually, we"—this is the Bank—"should have asked for more powers in the context of financial stability." Having regard to the performance of the Bank executives, don't you think it would be a good idea to have a serious Court, if it is going to be overseeing the work of the FPC, according to your legislation?

Mr Osborne: The role of the Court is to ensure the efficient running of the Bank as an institution. It is a large institution and employs lots of people. It has a budget and, although it is not a part of the Government in the sense that we would understand it, it is a very important part of the state. Again, I am perfectly happy to accept that the Court's appearance before the Treasury Select Committee was probably not their finest hour. Nevertheless, the people on it are people of real ability, if you go through their CVs and the kinds of jobs they have done.

Q1037 Mr Ruffley: Are they people of technical expertise on financial stability matters?

Mr Osborne: They are people who run Legal & General. There is the Managing Director of Lloyds Banking Group, the Executive Chairman of AIA and others. These are people of real experience in financial services. I do not think there is some other bunch of people out there in Britain who are eminently more qualified to do the job. The Treasury Select Committee has posed a very good question to us and made a recommendation, which is that, as well as making sure that the Bank spends its money well and delivers value for money, should it have some kind of after-the-event scrutiny role of the way that the Bank has performed its functions, for example, on monetary policy? Again, without repeating myself too much, we are considering that recommendation carefully.

Q1038 David Mowat: Chancellor, my question is about how this whole design that we are implementing here links into the international dimension. After you take out the ring-fenced banks, most of the organisations of any size that will be regulated are trans-national. I cannot think of any that could cause a systematic risk that are not trans-national. Does that not imply that whatever we come up with here has to be very robust in ensuring that the global aspects are managed properly? All the businesses will be global and the UK part is only a slither, albeit maybe a larger slither in some cases.

Mr Osborne: It depends on the institution. Clearly, the Royal Bank of Scotland was the world's largest bank when it went bust; it was the bank with the largest balance sheet in the world; it had huge operations in the United States and elsewhere in the world. Ultimately, the UK taxpayer was responsible for the whole lot when it went wrong. For UK-domiciled banks, it is incredibly important that we are aware of, and completely on top of, its global exposures.

With other institutions, for example, an American investment bank, we have to make sure that there is very good international co-ordination of the regulators and there is a good

college of regulators. It is now the case that, with a Goldman Sachs, a JP Morgan or an institution like that, there is now a college of regulators, under the aegis of the American regulator, who has the primary responsibility for those institutions, which brings together the British and others to make sure that we are sharing information across the world.

It is in the area of international policy making, which is least developed, where more needs to be done. It is how we make sure these institutions that live globally don't die nationally. The Lehman Brothers situation, where money was withdrawn from the UK in the last 24 hours and where the legal cases surrounding the UK branch of Lehman Brothers are the most expensive and will be the longest lasting in British history, reminds us of the problems that can be caused when an institution that is not primarily regulated by the UK goes wrong, particularly with the UK's role as a wholesale financial centre. There needs to be more work internationally on how we co-ordinate the regulation of these international universal banks.

Q1039 David Mowat: One approach that we could have taken with this whole Bill is to have said that the biggest thing in town at the moment is Basel III, which we have signed up to. It is a huge effort and it is going to be done by 2019. Therefore, what we need to do in the UK, given the size of our financial sector, is to make sure that we put in place an extremely good implementation of Basel III and all that that means. That might have implied a different structure from the twin peak model you have come up with here.

Mr Osborne: I do not think it would have and I do not think it does require a different structure. This Bill is about the structure of the regulator. It is not about the content of regulation as such. The Vickers Report is in part about the content of regulation. This addresses some of those key questions which arose as a result of what happened. No one was looking at systemic risks in the economy. It is now very clearly the responsibility of the Financial Policy Committee to do that. There was not good co-ordination between the tripartite authorities. There is now clearly one institution—the Bank of England—which sits above this responsibility for financial stability. The respective roles of the Chancellor and the Governor are going to be clearly prescribed and spelt out in the memorandum of understanding and clauses 42 and 43 of this Bill. We are learning the lessons.

There is a big lesson for the British Government, which is that the Treasury needs to maintain its capability and capacity in the financial services policy. We must never think that the war is over, if you see what I mean. We must never think that we are not going to have to intervene and deal with problems. That is the obvious lesson at the moment, but in a number of years, when things are very calm and it all looks like it is ticking along nicely, whoever is the Chancellor at the time needs to remember that lesson as well.

Q1040 David Mowat: You have mentioned that there is a need for the FPC and FCA to be co-ordinated, and you have talked about how that is all going to work. As an example, the Bill is largely silent on the need for the FPC to co-ordinate with the European Systemic Risk Board—the ESRB. You cannot really imagine a crisis happening that would not require a European level response simultaneously to an FPC level response. I wonder whether you have given enough emphasis to all of that, given that those structures are also emerging in parallel with what you are doing.

Mr Osborne: It is very important that we take account of the emerging European structures. First of all, again, this is partly a question of the right individuals, remembering

these are the same people. The Deputy Chair of the European Systemic Risk Board is the Governor of the Bank of England; so he is aware of what the Board is discussing at the European level and he will have responsibilities here in the UK.

There is clearly an area of concern which I know the Treasury Select Committee has identified, which is that there is a risk that the potential directive in this area, CRD IV, does not provide sufficient national discretion to put in place macro-prudential tools rather than something like the Vickers arrangements. We and quite a few other member states—so we are not remotely alone on this—are concerned about that. We have made our point very vociferously. Helpfully, not just the Bank of England but also the European Central Bank have made this point, as has the Financial Stability Board, the international body that looks at all this. We are reasonably confident that the directive will give us the scope to run the kind of regime that is appropriate for a very large wholesale financial centre, which other EU member states do not have. But it is a fight we will be having over this winter.

Q1041 David Mowat: You are right about the CRD IV potential conflict with Vickers. They are saying they have fixed it, but we will see how that emerges. It raises another question about CRD IV and Basel III. Why do you think we are the only country that needs ring-fencing, given that the participants of Basel III apparently do not feel that they do, or should they go back and review it?

Mr Osborne: We have enough on our plate dealing with the UK financial system. The only thing I would say is that the Vickers Report has generated a lot of interest in other countries. Certainly, in France, I am aware that there is now quite an active political debate about whether they should be adopting something akin to the Vickers proposals. Literally, the name "the Vickers Report" is something which is currently at the heart of the French political debate. Other countries are looking at the work we have done. Whether it is on Vickers or the Financial Policy Committee and macro-prudential tools, we can take some pride in the UK Parliament that we are at the moment leading the argument.

Q1042 Chairman: I will ask one question following on from that about CRD IV. Is it your understanding that that will constrain the powers of the UK regulator to pursue the sort of prudential anti-cyclical policies that it wishes to do, or that it won't? Do you know why they want to impose a maximum as well as a minimum?

Mr Osborne: It is certainly my intention that the final directive does not prescribe the ability to run a macro-prudential regime in a country like the UK. The concerns here have been led not just by the UK but, for example, by the Swedish Finance Minister. They have had experience in the 1990s of what can go wrong in their country with the banking system. He has led the organisation of a number of Finance Ministers to express their concerns about the original draft of CRD IV. The Commission have made changes. They are aware of the issue. The European Central Bank, the Financial Stability Board and, indeed, the IMF have all raised concerns with them. There is certainly a lot of pressure on the Commission to get this right. Our objective is to get a directive that allows the UK to do what the UK needs to do to protect British taxpayers from the consequences of financial failure in the UK and, also importantly, to protect the world from what goes wrong in the UK. One of the interesting things the IMF has shown up is that, when it comes to financial services, we are probably the most interconnected country with the greatest capacity to cause problems for the rest of

the world if we get our regulation wrong. What we are talking about here is not just important for the health of the British economy and the security of British taxpayers, but it is also important for the security and safety of the world economy.

Q1043 Chairman: Thank you very much. I know you have to depart and we have kept you three minutes beyond your deadline. We are very grateful to you for coming and would be even more grateful if you will leave the Financial Secretary behind.

Mr Osborne: I am delighted to leave the Financial Secretary behind.

Q1044 Baroness Wheatcroft: I would like to ask you a bit more about the FPC, if I may, Mr Hoban, in particular about the make-up. The Chancellor has talked a lot about the need for judgment to be exercised and that judgment was clearly not exercised in the way that you might have hoped it would be. The FPC as currently constituted has a majority of Bank insiders on it. Do you think that is right, or is there an argument to be made—as some have made to us—of having a majority of outsiders on the FPC, people who are bringing their experience and their take on what is going on in the world outside Threadneedle Street?

Mr Hoban: It is an important question and we have spent some time thinking about what the correct balance is between Bank members and external appointments. Of course, the external appointments are just the four independent directors plus the CEO of the FCA as well. It broadly matches the composition of the MPC and there is a degree of consistency there. If you look at the individuals from the Bank on the Committee, they all have a vital role to play in identifying the risk to the stability of the financial system. There is a risk of creating something that is too unwieldy.

Q1045 Baroness Wheatcroft: But there is a risk of the same people talking to themselves on the different committees within the Bank.

Mr Hoban: That is why it is important that you have a good group of external appointments—people who can bring their understanding of how financial markets work alongside the technical expertise of people who work in the Bank.

Q1046 Baroness Wheatcroft: But are you happy that they should be the minority?

Mr Hoban: Yes.

Q1047 Baroness Wheatcroft: The other question that has come up is how difficult it may be to recruit people, both to the FPC and into regulation generally, given the prevailing salaries in the outside world. Is that something you see as being an issue? It certainly has been in the past.

Mr Hoban: If you take the FPC for a moment, there is a real intellectual challenge here for members of the FPC. People are interested in becoming members of the FPC and maybe they reach a point in their career where they are looking for something fresh to do.

Q1048 Baroness Wheatcroft: Public service.

Mr Hoban: Public service; absolutely. There are people who are on the FPC at the moment who are of a very high calibre and have not been put off by that issue.

Q1049 Baroness Wheatcroft: What about regulation?

Mr Hoban: With regulators, it is a challenge. When I talk to regulated firms they are keen to make sure we keep the cost of regulation down, but we do need good people in the regulators. So we need to think about what we offer to ensure that we attract and retain good people. That will always be a challenge for the regulators. Firms often complain about the frequency of rotation of their supervisors. Of course, it would help if they stopped hiring them.

Q1050 Baroness Wheatcroft: We have had three Bank representatives before us and they were all refugees from regulation. Are you of the view then that you will at least have to match private sector salaries?

Mr Hoban: There are different attractions for people. There are people for whom salary is important, but there are those who feel that the policy role they have or the engagement supervision are the things that interest them. Some simply see it, perhaps, as a staging post in their career. A lot of people would join a regulator in the same way that they would join Government, perhaps. It is something at the start of their career or at a point in their career to help build their CV. I understand that in the States there is a much more free flow of people between regulators and industry. There are risks attached to that, but you need to get the balance right.

Q1051 Baroness Wheatcroft: There are some within the industry who think that perhaps the only solution is to have a proper secondment scheme, whereby firms would send people for two or three years to the regulator. The Governor was not at all enamoured of that idea. How would you feel?

Mr Hoban: I have to say I have a slightly vested interest in this, Baroness Wheatcroft, as I was seconded from PWC to IMRO for a year. I can see the merits of it, but there is a concern that, if that move between one and the other is too frequent, you are creating people who are insiders. If they are at the regulator, are they having an eye to their next job? It works in some sectors very well. It works in the Takeover Panel very well, so there are good examples out there, but one has to be aware of the risks of that method.

Q1052 Lord Maples: Following on with a couple of points, there is a feeling among us and a lot of other commentators that we are making the Governor an incredibly powerful figure here. In fact, Sir Alastair Darling, when he gave evidence, used the phrase “sun king”. There is a feeling of what we can look at within the structure which you want, which most of us are happy with, that reduces that somewhat. The FPC is not just a majority of one executive: it is the Governor, his three deputies and two of his staff. It is really difficult to see that that

is not the Governor having six votes and the other guys having five. These people's careers largely depend on him. I think you will find some push on that. The only way to solve it is to have a majority of non-execs, but you have sort of answered that question with Baroness Wheatcroft.

The other area is this. How strongly do you feel that the Governor should be Chair of the PRA? This is another way of somehow trying to share out the power a bit here. The Governor is Chair of the FPC and the MPC, but he should not sit on the PRA—the regulatory authority itself.

Mr Hoban: When we looked at the structure of the new regulatory architecture, this question arose of where the PRA should sit. Does it sit outside the Bank group or does it sit inside? We took the decision that there were synergies within the Bank family, as it is described, that would be fully realised if the PRA was part of that. It strikes me that, in an organisation where the PRA is a subsidiary of the Bank of England, it would be right for the Governor to Chair it. It makes sure that the information flow that helps generate those synergies works well and I think the Governor chairing the PRA is the right way of achieving that.

Q1053 Lord Maples: You seem very relaxed about the "sun king" aspect of it. Here is someone who essentially has most of the votes on the Monetary Policy Committee. He has most of the votes on the Financial Policy Committee and is Chair of the PRA. Hopefully, you are going to bolster up the Court. So far, it has been a pretty supine supervisor of the Governor. We are creating a post here which is hugely powerful and influential, with very little accountability.

Mr Hoban: The first thing I would say is that I am not sure that the Bank executives would see themselves as a Governor's block vote in these circumstances.

Q1054 Lord Maples: Does the Chancellor have your vote?

Mr Hoban: Sorry?

Q1055 Lord Maples: I expect the Chancellor has your vote in rather the same way as the Governor has the vote of these people.

Mr Hoban: But it does not stop discussions taking place. What is important is to make sure that there is accountability built into the system. We have sought to maximise accountability in a range of different ways. I talked earlier on about the biannual report, for example, that the FPC will publish on financial stability. It sets out the risks the FPC has identified and what it thinks the responses are. That will be a public document. In the same way that the MPC minutes help inform people of the thinking of the MPC, it will be available for people to look at and to question. It will enable the TSC, for example, to challenge the FPC on its judgment. There are plenty of ways in which the views of the FPC can be challenged and the existing governance arrangements in place.

Q1056 David Mowat: I would like to ask a very quick follow-up to that, Chairman, which is on the MPC. Has there been an instance of one of the Governor's direct imports ever voting in a different way from the Governor?

Mr Hoban: I am sure there has, but we can write to you and let you know.

David Mowat: That would reinforce that point then.

Q1057 Mr Mudie: I hope you have noted the Governor's answer in the Select Committee when asked if he did not think he had too much. He said, "Yes. If I had to give anything up, it would be the Chairmanship of the PRA." I hope you have noted that, because it might make your job easier.

Mr Hoban: I did.

Q1058 David Mowat: —in taking a difficult decision.

Mr Hoban: I am always grateful for any offers that are made.

Chairman: Did you want to come back on insurance, Mr Mowat?

Q1059 David Mowat: Very quickly; thank you. Are we sure that it is right to put insurance into this twin peak structure in the same way as a bank, given that it is quite hard to see, leaving aside the AIG issue, which is a separate one, the systematic risks of that industry necessarily meriting this whole organisation being thrown at it?

Mr Hoban: Insurers, as with banks, do have complex prudential matters to be supervised. They are taking on a lot of balance sheet risk and there is some synergy there, certainly in terms of skill sets. If you look at some of the holdings of insurance companies, they do invest heavily in the banking system. Mr Brown referred earlier on to the shadow banking system. There was a report a few weeks ago about the FSA's concerns about the relationship between banks and insurers, and the transfer of assets between the two as part of an adjustment to Basel III. As important players in the financial markets with complex on-balance sheet prudential issues to resolve, I think it is right that they are in the same body.

Q1060 David Mowat: But you could have had just a separate insurance structure, rather like the Europeans have with the EIOPA, which just dovetails into that, which would seem to have been more manageable.

Mr Hoban: We took the decision that one of the flaws in the previous architecture was the confusion of prudential and conduct issues within the same body. We thought it was important that you had one body that was responsible for conduct issues and another body that was predominantly responsible for prudential issues. That drove our thinking in terms of the design. To have a separate insurance prudential body would create a plethora of bodies, particularly given that you do have a number of groups that contain both banking and insurance activities.

Q1061 Lord McFall: Financial Secretary, I turn to the issue of the FSA's strategic objective and the maintaining of confidence in the system. I do not think there was any financial firm I spoke to in July or August 2007 that did not have superhuman confidence in the financial system, which crashed the next month. I wonder if confidence in itself in the financial system is enough. The OFT have given us a definition of making financial markets work well for their users. Others have spoken about ensuring a fair and transparent market in the UK. Do you not think we need to go along those suggested lines?

Mr Hoban: I gave evidence last week, Lord McFall, to the Treasury Select Committee on the FCA. We talked at length about the strategic objective and the operational objectives. This is a conduct body. There is a wide range of issues for which it will have responsibility. The challenge in getting the strategic and operational objectives right is to articulate the full range of its roles. I do think it is important that consumers have confidence in the financial system, but that should not be misplaced confidence. Clearly, the role of the regulator is to ensure that that confidence is not misplaced.

Q1062 Lord McFall: But there is no indication on your part that there should be a better definition of the strategic objective.

Mr Hoban: Our mind is not closed.

Q1063 Lord McFall: That is good. Given that there is a consumer responsibility principle, why should there not be an equivalent principle for firms? Again, we have heard some evidence on this. For example, Professor Moloney from the LSE said, "A combination of very limited investor ability to decode complex and detailed disclosures and to assess conflict of interest risk, largely restricted product development and duplication" and so on. She is suggesting that the issue of taking responsibility for decisions should be treated as a very limited concept. Should that not be balanced by consumer protection and one for firms as well?

Mr Hoban: Yes. Senior management should take the responsibility for compliance with the rules. That creates the balance between what is right for the consumer and—

Q1064 Lord McFall: Do you think that will be expressed in the Bill?

Mr Hoban: It is in the Bill, yes.

Q1065 Lord McFall: There are two contemporary issues. First, as you know, a lot of work was done by the previous Treasury Committee in the last Parliament on the issue of financial inclusion. RBS signed up to the basic bank agreements. They are excluding basic bank accounts from their network at the moment. Given that a lot of effort was taken with all the companies to ensure that we had a unanimous policy on free ATMs, particularly in low-income areas, do you not think this will go against financial inclusion? I put it to you that, in terms of the interchange fee, it will upset the whole technical balance. Financial companies have come to me and said, "Look, if RBS continue with this and treat people as second-class citizens, we will have to do the same. So the interchange fee will go." Given that the Government will have Universal Credit in 2013 paid into bank accounts and it is going to

make people more financially excluded, would you give us an undertaking that you will look at that issue with the Royal Bank of Scotland so that we continue the financial inclusion agenda which all parties have signed up to in the past?

Mr Hoban: Indeed, Lord McFall, and it is something that we take very seriously. I am keen to ensure that people have access to a wide range of financial services, and we will engage with the banks as appropriate on those matters.

Q1066 Lord McFall: Are you quite happy with the Money Advice Service programme and what they are rolling out at the moment?

Mr Hoban: I am a great supporter of the Money Advice Service. It is absolutely vital if we are to enable consumers to engage much more in budgeting, identifying their financial needs and looking at products that meet those needs. The Money Advice Service plays an important role in that, but it needs to think how it maximises its reach and how to engage with as many people as possible. I know that is a key part of their business plan.

Q1067 Lord McFall: I wonder about their business plan. They are restructuring and going from 150 staff down to 77. I notice in the paper this weekend—and I am not having a go at the Chief Executive—that here is a body looking for financial inclusion, and you have a Chief Executive on £350,000, twice the salary of the Prime Minister, with a staff in the new year of 77. The Prime Minister has 60 million people he is looking after. I am informed that three directors have been appointed in the last eight or nine months on six-figure salaries as well.

Given that there is a gap in the market, and particularly after RDR and it has been acknowledged, is there not a case in advance of this for you getting the NAO to look at the value for money element in that so that we ensure that this organisation is fit to give people financial advice and that their objectives are realised?

Mr Hoban: Clearly, the view of management is that the organisation as currently structured does not deliver its objectives, and that is why it is going through a review of its business plan. I would make a broader point, which is to say that one of the things this Bill does bring in is to ensure that the FCA, the PRA and other related bodies are now subject to the NAO. That is quite an important way of ensuring that they do get value for money.

Q1068 Lord McFall: What I am saying to you is that, ahead of any possible problems, is there not a case for you as a Minister to look at that so that you have that information on your desk and you can assure us? That is all I am looking for.

Mr Hoban: MAS is accountable to the FSA, and I am sure the FSA and indeed the MAS will have heard very clearly what your views are.

Q1069 Lord McFall: But they are not like any other public body or public servant where there is transparency in it. For example, civil servants' pay is always transparent. This is not the case here. There is a case for it being looked at even further. I am looking for a bit of urgency on your part.

Mr Hoban: Lord McFall, the key thing and the key way in which we will judge the success of the Money Advice Service is whether it reaches out to people or not. The Money Advice Service is putting together its business plan. It is accountable to the FSA for that. I want to see them deliver results.

Q1070 Mr Laws: I want to follow up very briefly on one of Lord McFall's questions. You mentioned that there is a firm responsibility as well as a consumer responsibility. Could you define what you think a firm's responsibility to a consumer is when it sells a financial product?

Mr Hoban: It depends on what sort of sale it is and whether it is a sale or advice. There are very strict legal rules around that. What I want to see is a retail financial services sector where the consumer is at the heart of it, where there are good products for firms to sell and for consumers to buy, and good quality advice out there. One of the changes in our approach is a move to a much more outcomes-focused approach to regulation and ensuring that the consumer does get a good deal. That is why we have beefed up the competition aspect, for example, of the Bill. Ultimately, it is the responsibility of firms to comply with the rules of the FCA. Those rules will set the ground rules for the interaction between firms and consumers.

Q1071 Mr Laws: Do you think the firms have a duty to go beyond their technical legal responsibilities? In a situation where a firm has provided very clear financial advice about risks, for example, which one might consider a discharge of its reasonable responsibilities to a consumer, do you think that is broadly enough? If a firm considers that the product it is selling to a consumer might not be fully understood by the consumer or might not be in the consumer's own best interest, even though it has provided a lot of information, does it have a responsibility to not go ahead with that sale to the consumer, either because of its concerns about the level of comprehension or about the effects of the financial instrument on the consumer's own interest?

Mr Hoban: It is in the interests of firms to ensure that consumers do understand the products that they are buying because it then minimises the risk of problems further down the track. I would encourage all firms to explain the products they are selling as clearly as possible and to make sure that consumers do understand the risks attached to those products. One of the aspects of my role which I least enjoy is looking at letters from colleagues where, clearly, consumers have not understood the products that have been sold and have not understood the full risks. That is not a very satisfactory outcome for either the industry or the consumer and there should be much more emphasis on ensuring that consumers understand it. That is why I am very supportive of financial capability. You cannot just rely upon firms to do this. You need to ensure that consumers have support to understand those products.

One of the initiatives I am pushing through at the moment is on simple products so that people know what a product does for them. The motor insurance market in the UK is a very competitive market. People know what it is they are buying and they can shop around, compare and take responsibility for what they are buying. That is a good example of how financial markets can work. That means that consumers do understand the products they

are buying. I want to see more of those, and that is why I am pushing ahead on simple products.

Q1072 Mr Laws: As a final question, do you think that responsibility for firms to act with integrity and to go beyond their technical legal obligations is reflected strongly enough on the face of this Bill to match the consumer responsibility, which almost appears to be a "let the buyer beware" type of responsibility?

Mr Hoban: No, because we are very keen—and in the operational objective it refers to "appropriate" consumer protection—to make sure that this is a differentiated regime and that different consumers are dealt with in different ways. The needs of a consumer buying a pension policy are very different perhaps from the needs of a consumer buying a car insurance policy. We need to make sure that those steps are in place to give consumers proper protection. That does mean, and it is set out in the Bill, thinking about these areas of how much consumer knowledge it is reasonable to expect, how complex a product is and things like that. The Bill does get the balance right, but it is an area that I continue to focus on.

Q1073 Mr Brown: It has been put to us by organisations representing consumer interests that the current financial services legislation is an excessive constraint on the regulators on putting in the public domain information that the consumer organisations believe should be in the public domain. We have heard from Treasury Ministers that section 348 of the existing legislation is under review. Are you able to say anything to us about how that is getting on?

Mr Hoban: Can I make a broader point and then I will come back to section 348?

Q1074 Mr Brown: I am presuming you are the Minister dealing with this.

Mr Hoban: I am indeed the Minister dealing with this, yes. One of the things that I am very keen to do is to ensure that there is much more transparency in the regulatory process. That is why I am very keen to see the powers that are in the Bill on the publication of warning notices. That is a thing that does not happen at the moment. I think it is right that consumers should know if someone has got to that point in the enforcement process. I am very keen to make sure that people are aware when advertising promotions have been withdrawn because they are misleading. Again, that is a power that is in the Bill. They are important ways to help consumers know what is happening, but it acts as an important check on product providers and firms in the financial services sector. My goal in all of this is to maximise transparency and do as much we can to make sure that information is available to consumers. We are still looking very carefully at section 348. If there is more we can do to make it clearer as to what the boundaries are of what can and cannot be published, we will do so.

Q1075 Mr Brown: May I ask just one final question, with your indulgence, Chairman, about the Ombudsman Service? As you know, this sector has two separate Ombudsmen with functions that overlap to some extent. We have heard from Sir Anthony Holland that

there are difficulties in giving effect to the judgments that he makes. Have you had a hard look at the Ombudsman Service and do you think this Bill could be a suitable vehicle for amending the way the Ombudsman roles work?

Mr Hoban: The Financial Ombudsman Service is absolutely vital to consumer protection. It is good that you have someone who is an independent mediator who can reach a judgment in complaints that consumers have made against financial services firms. There have been arguments from the industry about trying to pare back the role of the Ombudsman; others want to boost its role. The way the Ombudsman works at the moment is absolutely right.

The area I am concerned about—we referred to it in the White Paper and it shows the way the thinking is developing—is that the Ombudsman is often left with the task of dealing with cases of mass detriment. Certainly, you will see here a number of complaints—it might be about PPI or a different product—and the Ombudsman is left trying to deal with this. It is not what it was originally set up to do. We are investigating ways in which, where there are cases of mass detriment, the Ombudsman can notify the FCA and get them to opine on their view of the situation so that any appropriate remedies the FCA has that could tackle that could be used. That is the main area of concern I have about the Ombudsman.

Q1076 Mr Brown: What about ex gratia payments?

Mr Hoban: The Ombudsman has a wide remit in what it can do and it does that reasonably appropriately. I have not had a lot of complaints about the type of payments that the Ombudsman can offer.

Chairman: Thank you very much indeed, Financial Secretary, for staying on and doing overtime for which I am sure you will be properly remunerated in due course by your boss. I thank you, and him, for your help in this. We may conceivably have to come back to you with specific problems or questions on particular issues, but we are grateful to you for your help.

HM Treasury – further supplementary written evidence

Thank you for your letter of 24 November about the differences between the statutory objectives of the Monetary Policy Committee (MPC) and Financial Policy Committee (FPC) of the Bank of England.

The differing nature of the remits of the two committees means that it is appropriate that their objectives in relation to economic growth are formulated differently.

The MPC's objectives are formulated so that the duty to "support the economic policy of Her Majesty's Government, including its objectives for growth and employment" is secondary to the primary objective "to maintain price stability". This is because low and stable inflation supports economic growth. There cannot be too much price stability. So by meeting its primary objective – i.e. keeping inflation at an appropriate and stable level – the MPC will support economic growth.

The FPC's objective will require it to contribute to the Bank's financial stability objective to "protect and enhance the financial system of the United Kingdom". Action to increase the resilience and stability of the financial system must however, be proportionate. While the recent financial crisis has demonstrated the catastrophic effects that macro-prudential risks in the system can impose on the economy, disproportionate regulation could be just as damaging. When the Chancellor and I appeared before you, he confirmed that the Government does not seek the "stability of the graveyard". In other words, we do not want the FPC to be able to pursue stability to the point where the financial sector loses its ability to support the real economy. The FPC therefore needs to strike a balance between making the financial sector safer overall without compromising sustainable economic growth in the long term.

This is why the FPC's objective features a stronger growth element than that of the MPC to ensure that the FPC acts proportionally. The FPC's objective requires the FPC to act to address systemic risks that could damage the UK economy but prevents the FPC acting in a way that would seriously damage the capacity of the financial system to contribute to UK economic growth in the medium or long term. This sits alongside an additional requirement for the FPC to have regard to the proportionality of its actions. These provisions were proposed in response to representations from consultees and the TSC that the FPC should be required to consider economic growth as part of its statutory mandate.

This formulation allows – and indeed requires – the FPC to take action to mitigate systemic risks – such as an asset price bubble – because by taking effective and timely action to "lean against" unsustainable credit growth the FPC will be protecting long term economic growth. This is because allowing a bubble to build and then burst would likely have serious negative implications for growth in the medium or long term.

I hope this explanation of the different approaches taken to economic growth in the objectives of the MPC and FPC is helpful to your Committee's ongoing deliberations.

29 November 2011

HSBC – written evidence

Summary of main points

The FPC

- As currently drafted, the objective for the FPC is too narrowly focused on the avoidance of negative outcomes, without an overriding objective related to supporting the proper functioning of the economy; in part this is because it is based on an insufficiently clearly defined concept – "financial stability". The objective should more closely parallel that of the Monetary Policy Committee, and should focus on ensuring a stable and sustainable supply of finance to the economy.
- The FPC's accountability should also parallel that of the MPC, and should include cost benefit analysis and economic impact assessment of the Committee's recommendations and directions.

The Upper Tribunal

- The Upper Tribunal, as an independent appellate body, must be able to overrule the decision of a regulator, rather than simply remit it back for reconsideration.

Quality of regulatory management and staff

- The quality of regulatory management and staff will be critical to the quality of regulation and the stability of the financial system.

UK competitiveness

- The FCA's operational objectives should be expanded to include a reference to "maintaining the competitive position of the UK."

Competition

- The FCA should not have a primary competition objective.

UKLA

- We support the government's decision to place the UK Listing Authority (UKLA) within the FCA.

The Product Intervention Power

- The safeguards in relation to the FCA's Product Intervention Power are insufficient and need to be strengthened. We have contributed some detailed comments on how this might be done.

Single point of contact/single rule book

- For dual-regulated firms, a single point of contact team for general supervisory matters, and the creation of a joint rule book would be a significant contribution to simplifying and streamlining the regulatory framework.

Introduction

HSBC has provided its responses to specific questions raised by the Joint Committee below.

The Committee is also interested in whether the draft legislation will or could better:

- Prevent another financial crisis;
- Handle a financial crisis;
- Deal with bank failure and protect the public purse.

Preventing and handling another financial crisis

A financial crisis is not defined by the failure of any particular financial institution, but by the actual or perceived cost of withdrawal of the supply of credit from the economy. Withdrawal of credit supply can often be the direct result of the failure of an institution and the ensuing evaporation of liquidity arising from collapse of confidence in the system. Measures to avert financial crisis should therefore be focused primarily on maintaining the appropriate supply of credit to the economy – and the ability to achieve this without additional recourse to the taxpayer – rather than on managing down the risk of institutional failure.

In this respect, we believe the objective of the Financial Policy Committee is insufficiently clear, not least because it rests on an insufficiently clear definition of "financial stability". We would like to propose that a financial system could be defined as stable when it is delivering

- A stable and sustainable supply of finance to the economy
- at a stable and sustainable price, and
- with broadly stable exchange rates.

Since the stable price of finance is the responsibility of the Monetary Policy Committee, we believe stable supply should be the responsibility of the Financial Policy Committee, and the objective of the Committee and relevant legislation should state this clearly. **Credit supply is not stable if it is supported by inadequate capital; and it is not sustainable if regulators demand an inappropriately high ratio of capital to risk weighted assets.**

For this reason, we believe the amendments to the 1998 Banking Act in respect of the Financial Policy Committee should more closely parallel the provisions relating to the role and objectives of the Monetary Policy Committee.

Dealing with bank failure and protecting the public purse

Effective recovery and resolution regimes, which allow core functions to continue to deliver essential services while the rest of an institution fails at the expense of its equity and debt holders, are the complement to the role of the Financial Policy and Monetary Policy Committees in maintaining the stability of the financial system.

<u>Joint Committee questions</u>

1. **Is the separation of prudential and conduct regulation into a "twin peaks" system the right approach?**

We accept that policy is already well advanced in this direction, and support it.

2. What lessons can be learnt from the approach of other countries to regulation of the financial sector?

Other countries, notably in Asia, already use macroprudential policy tools to manage the supply of credit into their economies. Studies have been conducted on this subject by the Bank for International Settlements, the Institute of International Finance and the Brookings Institution, to name a few.

A pertinent observation from Asia would be that both in Hong Kong and Singapore, the financial systems are well regulated, have high equity capital ratios and also make strong returns to shareholders. It is a core philosophy that an efficient and resilient banking system has to generate capital strongly from core activities to support risk taking (credit expansion) and attract external private capital.

3. Is it appropriate to make such major changes to the regulatory system by way of amending legislation, rather than starting afresh?

The central omission of previous legislation was that it provided for management of the price of finance in the economy, but not management of the supply. In that sense, the Monetary Policy Committee lacked its complementary body – the Financial Policy Committee – from its inception. It therefore seems logical that this omission should be addressed by amendments to the 1998 Banking Act, in which the legislative framework for the FPC and MPC should be broadly parallel. And since microprudential regulation will in future be conducted in the context of macroprudential oversight of the financial system, the nature and role of other microprudential bodies and their relationship to the Financial Policy Committee should be set out within the same legislation.

4. Are the accountability and governance arrangements for the Bank of England, FPC, PRA and FCA satisfactory?

FPC

Properly constituted, the new amendments to the legislation will establish a third arm of macroeconomic policy – financial policy – alongside monetary policy and fiscal policy. Under the legislation, two of these arms will be placed under the control of the Bank of England.

Governance and accountability are therefore key, and in general terms those for the FPC should parallel the governance and accountability arrangements for the MPC.

That said, we agree that the FPC should be established as a sub-committee of the Court, with the Court therefore responsible for ensuring that the FPC fulfils its mandate as defined by HM Treasury.

We would also recommend that the FPC's accountability to the Chancellor should parallel that of the MPC. In the case of the FPC, this would require that any policy action it recommends or directs should be the subject of a letter from the Committee Chairman to the Chancellor, copied to the Chairman of the Treasury Select Committee, explaining the background and reasons for any such recommendations or directions, **and providing both**

a cost benefit analysis and an economic impact assessment of such recommendations or directions.

PRA

We broadly support the proposed accountability and governance arrangements of the PRA, including its new duty to engage with practitioners, however we believe that they could be strengthened in four important respects. These are:

- While we welcome the requirement for the PRA to make a report to HMT in the event of a significant regulatory failure, we believe that provision should be made in the legislative framework to guard against disclosure of confidential information that may be contained in such reports. There is a real risk that there is pressure to disclose matters which are simply of interest to the public and not of genuine importance to the matter in hand or future policy;

- We are also concerned about the remit of the Upper Tribunal. Under Clause 20(6)(b) of the Bill, if the Tribunal decides not to uphold the regulator's *(i.e.* the PRA or FCA) decision on appeal it must:

  '[remit] the matter to the decision-maker with a direction to reconsider and reach a decision in accordance with the findings of the Tribunal.'

  We believe that this represents a weakening of the power of the Tribunal and a diminution of the appeals process. The phrase 'in accordance with the findings of the Tribunal' is broad enough to allow the PRA or FCA to depart from the Tribunal's findings. We believe that the Government should reconsider the provisions and maintain the current arrangements. It is essential that there is an effective, robust appeals process in place against regulatory decisions that accords with due process. To be effective, we believe that the Upper Tribunal, as an independent appellate body, must be able to overrule the decision of a regulator, rather than simply remit it back for reconsideration;

- Like the FCA, the PRA should be subject to similar statutory accountability requirements and therefore should be required to hold an annual public meeting with stakeholders, as the FSA is required to do; and

- To strengthen the requirement for the PRA to engage with practitioners, we believe that it should have a statutory practitioner panel with which it is required to consult on proposed rule changes.

FCA

We are broadly supportive of the proposed governance, accountability and transparency arrangements for the FCA. We welcome the statutory consultation requirements and the Government's decision to take forward the proposal to require the FCA to investigate and make a report on potential regulatory failures. We further welcome that the Treasury will have the power to direct the FCA to do this even if the FCA has determined that the triggers for such an investigation have not been met.

We support retention of the statutory panels, which provide an essential external challenge to policy proposals and bring invaluable insight into the practical impacts, costs and benefits of those proposals.

However, we believe that for the FCA's governance, accountability and transparency arrangements to be fully effective, there must be appropriate safeguards for the exercise of its powers. As we discuss in our response to Question 17, we believe that when the FCA exercises its powers (such as the product intervention power) there must be effective mechanisms in place to allow firms to make representations to the FCA, and where appropriate, to appeal FCA decisions. We believe that these mechanisms need to be incorporated into the draft Bill (see further detail below). We understand that the Government wants to avoid rendering the FCA's powers un-usable through overly onerous safeguards. However, we believe that it is possible to create a mechanism that would give firms the ability to challenge FCA decisions, while also giving the FCA the latitude it needs to exercise its powers.

5. Are the FPC's objectives the right ones? Is the concept of financial stability adequately understood for the FPC to be able to perform against its objectives?

"Financial stability" is not sufficiently clearly defined in the legislation to provide an appropriate objective for the FPC. An unclear financial stability objective could build a bias to risk-aversion into the system, which is likely to be at the expense of the economy; and if written into legislation will render government and parliament powerless to regain control of the financial forces which drive economic growth.

The FPC's objective should parallel that of the MPC. Where the MPC is responsible for maintaining a stable price for finance, the FPC should be responsible for maintaining a stable and sustainable supply of finance to the economy. Stable and sustainable supply is defined as a flow of credit for which the supporting capital is both adequate and appropriate to match the associated risk. The FPC's objectives might therefore be redrawn as:

a) to maintain a stable and sustainable supply of finance to the economy, and
b) subject to that, to support the economic policy of Her Majesty's Government, including its objectives for growth and employment.

In this context, financial stability might be defined as a situation in which the economy enjoys a stable and sustainable price for finance, and a stable and sustainable supply of finance. To this might be added the importance of stability in exchange rates.

6. Should the FPC be limited in the actions it can take which might affect the growth of the financial sector?

Once the FPC's objectives are appropriately defined, and accountability appropriately established, including the requirement for cost benefit analysis and economic impact assessment of policy directions and recommendations, there would be no reason to impose limits on the actions which the Committee might take.

7. How will the interaction between macro-prudential policy and monetary policy be handled by the FPC and the MPC?

The MPC assesses inflation risks and responds by setting interest rates. The FPC should assess levels of systemic risk in the financial system and respond by adjustments to capital requirements, particularly through the risk weightings on specific asset classes. These two activities should in most cases be complementary, but in rare instances where this may not be the case, the Governor of the Bank of England, who chairs both Committees, should be the arbiter, and should, in consultation with the Court, provide a full explanation for any subsequent policy decision, in writing, to the Chancellor. An additional option might be occasional joint meetings of the two Committees.

8. Has the right balance been struck between the powers of the FPC and the powers of the Treasury?

Not in the legislation as drafted. Balance would require adjustment of the FPC's objective and the additional accountability measures suggested in this response.

9. Can Parliament take an informed decision about the proposals for the FPC without details of the macro-prudential tools at its disposal?

More clarity is needed about the data and indicators from which the FPC will derive its judgements; about the processes which it will employ for assessing those data and indicators; and about the possible impact of a range of macroprudential tools which might be available to it. This should not, however, prevent the Financial Policy Committee from developing its activities. The Financial Stability Reports and the records of the Committee's meetings should provide Parliament with sufficient material, on an ongoing basis, to hold the Committee to account where it may be necessary to do so.

10. Does the draft Bill adequately deal with the risks posed by the shadow banking system?

It should be an objective of regulatory reform to keep the majority of credit formation and maturity transformation inside the regulated sector, rather than driving it outside, and attempting to pursue it through extension of the regulatory boundary. This is more likely to be achieved if the FPC is set the objective of maintaining a stable and sustainable supply of finance to the economy. A financial stability objective which became focussed on risk aversion would be more likely to constrain the regulated sector and drive credit formation, credit intermediation and maturity transformation into the shadow sector.

Separately, additional work under the auspices of the Bank for International Settlements, e.g. Committee for the Global Financial System (CGFS) Paper 36 has explored how macroprudential regulation might capture activities within the shadow banking system when required. This research should be considered as the draft Bill is refined.

11. Are the PRA's objectives clear and appropriate?

We broadly support the PRA's objectives and believe they are appropriate. We support the emphasis given to financial stability as an objective of the regulatory system and the operational objective of promoting the safety and soundness of PRA authorised persons. We further welcome the clarity of the 'efficiency' and 'proportionality' principles. While we agree that the 'responsibilities of senior management' principle properly holds senior management accountable for securing compliance with the regulatory framework, we believe

that this could usefully be expanded to encompass the role of the Board in conducting oversight over senior executive management.

We also welcome the decision by Government to add a specific statutory insurance objective which recognises the range of firms the PRA will regulate.

12. Are there any risks in the Government's proposed 'judgement-based' approach?

We fully support a judgement-based approach, and while it will give rise to risks, we believe that those risks can be mitigated. It will be essential that the FCA and PRA are transparent about the underlying factors which have led to specific judgements so that firms and individuals have the scope to correct factual errors and present alternative views. There may be cases where the relationships which are driving rule-making, for example, between capital and financial stability, are not necessarily as clear cut as the regulator may consider and due consideration must be given to alternative views.

In order to exercise sound judgment and have credibility, and in light of the scope of its responsibilities, the PRA and FCA must take steps to ensure that they have the right spread of experienced regulators and practitioners drawn from the industry. That will mean putting in place a structure for employment and remuneration that encourages the best individuals to seek roles with the regulators, potentially as part of a career which includes both the private and public sectors.

13. Is the Government's approach to 'orderly' firm failure satisfactory?

Work remains to be done on resolution regimes, in particular to ensure that they can be effective across borders. We believe that the recommendations of the Independent Commission on Banking should be seen and assessed in this context, i.e. they should be examined to identify whether there are cost-effective *ex ante* structural changes which the government should initiate in order to ensure resolution regimes are effective at a time of institutional crisis; or whether Recovery and Resolution regimes, coupled with the role of the FPC to maintain stable credit supply, are likely to be sufficient to maintain the stability of the system as a whole without *ex ante* structural changes.

14. Given that the PRA and the FCA will inherit FSA staff does the draft Bill do enough to ensure a new regulatory culture and a more proactive approach to regulation? Will these two new bodies have staff with the appropriate skill and expertise?

We believe that creating a new regulatory culture and establishing a more proactive approach to regulation will be a substantial challenge for the PRA and FCA, but the draft Bill does provide them with the tools to develop a new culture and a more preventative and intensive regulatory approach.

While legislation will set the framework within which the PRA and FCA will operate, we believe that it will be the responsibility of the senior management of both bodies to establish and embed the regulatory culture that will guide their activities. Therefore, the staff that make up the senior management of the PRA and FCA will be critically important and it will be incumbent upon them to establish the new bodies' regulatory culture.

In relation to the skills and expertise of FCA and PRA staff, we believe that experienced regulators with the right knowledge and experience will be vitally important under the new structure, focused as it is on a move to judgement-led decision-making. We believe that if the FCA and PRA are to exercise judgement wisely and have credibility, then they will need the right spread of experienced regulators and practitioners drawn from the industry, and the legal and accounting professions. We are concerned about the current high staff turnover at the FSA, as, if unchecked, we believe this could lead to a situation in which there will not be sufficient expertise available under the new structure.

We also believe that it is important that the Business Analysis Team at the FCA is appropriately staffed with economists and experienced analytic staff. This team will determine when the FCA should intervene in markets or in relation to particular products and ensuring it has the necessary expertise should be made a priority.

15. Are the FCA's primary objectives appropriate? Is significant emphasis given to the promotion of competition?

We are broadly supportive of the FCA's objectives and believe them to be appropriate. We welcome the fact that the FCA's strategic objective is focused on 'protecting and enhancing confidence in the UK financial system'. We believe that having a single strategic objective, complemented by three operational objectives, provides a framework that is both narrow enough to provide clarity of purpose but broad enough to be flexible.

Operational Objectives

We support the FCA's proposed operational objectives, in particular 'securing an appropriate degree of protection for consumers'. We believe, however, that how the FCA defines 'an appropriate degree of protection' will be of critical importance. In this regard, we welcome Section 1C which sets out the factors that the FCA must 'have regard to' when considering what degree of protection for consumers may be appropriate. In particular, we welcome that the FCA must have regard to 'the differing degrees of risk involved in different kinds of investment or other transaction'; we believe that this will be important if the FCA is to achieve its aim of improving the focus on wholesale matters. In addition, we welcome that the FCA will recognise 'the differing degrees of experience and expertise that consumers may have'. We believe that this should allow the FCA to take a flexible and balanced approach to consumer protection.

We also welcome the fact that the FCA, in considering what degree of protection for consumers may be appropriate, must have regard to 'the general principle that consumers should take responsibility for their decisions.'

We believe, however, that the FCA's operational objectives should be expanded to include reference to 'maintaining the competitive position of the UK'. We believe that maintaining the UK's competitiveness is vital to encouraging and supporting enterprise and to the overall health of the UK financial services industry. It is also important to avoid activities migrating to jurisdictions outside the regulatory footprint of the FCA.

Competition

We agree with the Government that a single overarching objective, complemented by a general duty to discharge its regulatory functions so as to promote competition where this is not incompatible with its strategic and operational objectives, provides the right competition mandate for the FCA.

We do not believe that the FCA should have a primary competition objective, as suggested by some, as this would expand the FCA's remit and inevitably distract it from its other responsibilities. The FSA has been accused of being spread too thinly as a result of its wide remit of financial stability, consumer protection, public awareness, market confidence and reduction of financial crime. A narrower remit for the FCA, which the Government has set out, will lead to better clarity of purpose, avoid conflicts of interest and create a more focused approach, which in turn should lead to better outcomes for consumers.

In addition, a primary competition objective for the FCA could lead to duplication and potentially less effective regulation, as the OFT (to be succeeded by the Competition and Markets Authority) already has a primary objective to promote competition. The White Paper does not provide sufficient clarity about whether the FCA or the OFT will be the lead regulator on competition matters, and we would welcome further detail on this in due course. If the Government does intend for the FCA to lead on competition matters then it will be essential for it to have the right expertise, which we believe the FSA does not currently possess. Overall, we believe that any decision to afford a primary competition objective to the FCA would run the risk of a piecemeal, disjointed approach to the application of competition law.

Price Regulation

We are concerned about the adverse impact possible price controls could have on competition, innovation and choice for consumers. If products are transparent and easily comparable, competition between providers should keep prices low, without the need for price interventions. We find it difficult to square the statement in the FSA Approach Document that the FCA will not be a price regulator with the suggestion that powers will be exercised following an assessment of prices and charges, as it seems the former will inevitably follow the latter. It will be critical that the FCA makes clear how and when prices and charges would be assessed and what powers might be used.

16. Are the responsibilities of the FCA towards the regulation of markets appropriate?

We are broadly supportive of the proposals for markets regulation by the FCA. We welcome the fact that the existing arrangements will largely continue under the new regime. In addition, we support the Government's decision to place the UK Listing Authority (UKLA) within the FCA.

We believe that it is important to ensure that the new regulators distinguish between retail and wholesale customers, and that they avoid allowing retail regulatory approaches to 'leak' into wholesale regulation where they are not appropriate.

17. Does the draft Bill strike the right balance between the responsibilities of consumers and firms? Are the FCA's new powers in the area of consumer protection appropriate?

As we discussed in our response to Question 15, we are broadly supportive of the FCA's 'consumer protection' operational objective set out in the draft Bill. In particular, we welcome the fact that the FCA, in considering what degree of protection for consumers may be appropriate, must have regard to 'the general principle that consumers should take responsibility for their decisions.'

However, we believe that the new powers that the draft Bill confers on the FCA are extremely broad and should be subject to strengthened safeguards. As a result, we do not believe that the Bill has yet struck the right balance between the responsibilities of consumers and firms. We make detailed comments on our concerns in relation to the FCA's proposed powers below.

Product Intervention Power

We agree that protecting consumers from detrimental products is an essential part of a conduct regulator's role. We believe that this must be balanced against the need to provide firms with the "safe harbour" certainty they need to undertake their business. We therefore welcome the Government's view that the FCA's new product intervention power should only be used 'where it is appropriate and proportionate, and where it will provide clarity to consumers and firms.' We note with concern, however, that this wording has not been reflected in the draft Bill and we believe it should be.

We welcome the fact that the FCA will consult on and publish a statement of policy governing the circumstances in which it may make temporary product intervention rules. We also welcome that the FCA will not be able to automatically 'renew' any temporary product intervention rules when they expire. In addition, we support the flexibility that the legislation gives the FCA in terms of the length of time a temporary product intervention rule can last. We think it is important that where the FCA believes a ban of less than the maximum 12 months is appropriate, or where it believes that as a result of changing circumstances a ban should end earlier than planned, that it has the ability to do so. Lastly, we support the recognition in the White Paper that the new power is unlikely to be appropriate in relation to the protection of professional or wholesale customers.

We do not believe that these safeguards go far enough, however, and believe they need to be strengthened in the following ways.

Scope of the power

The circumstances in which the FCA may exercise the product intervention power are very broad. The legislation states that the FCA may make rules appearing 'necessary or expedient' to advance not just its 'consumer protection' operational objective but also its 'efficiency and choice' operational objective. We do not believe that the FCA should be able, under normal circumstances, to exercise this power under its 'efficiency and choice' operational objective. The White Paper makes clear that the purpose of this power is to protect consumers from products that are causing or are likely to cause mass detriment. We believe therefore that it makes sense that the power should only be exercised under the

FCA's 'consumer protection' operational objective. We believe that it would be sensible for the 'efficiency and choice' operational objective to be treated in the same way as the 'market integrity' objective as set out in Section 137C(b). Namely, that the FCA could only exercise the product intervention power under its 'efficiency and choice' objective if the Treasury by order authorised it to do so.

In addition, the actions that the power allows the FCA to take in relation to a product are also extremely broad, such as prohibiting entry into any agreement whether or not it relates to a product or service provided to a customer. Given the scope of this power, we believe that provision should be made in the Bill requiring the FCA to exercise its power in a way that is appropriate and proportionate to the circumstances of the case and the objectives it is seeking to achieve both as to the manner and length of the intervention. Although the Government has stated that it expects the FCA to use the power 'where is it appropriate and proportionate', there is currently no provision to this effect in the Bill.

Representations and Appeals

We believe that firms should have the right to make representations to the FCA on a decision to exercise the product intervention power before it takes effect and that the FCA should be required to take those representations into account (as opposed to 'have regard' to them). We also believe there needs to be a right of appeal to the Upper Tribunal for firms against a decision by the FCA to exercise the product intervention power. We believe that it is essential that the appeals mechanism has the ability to consider the underlying merits of cases and should not be restricted to judicial review grounds; the Competition Appeals Tribunal provides an effective model. We believe these additional safeguards are justified by the potential impact a decision to ban a product could have on firms, consumers and the market. We believe that these safeguards should be incorporated into the legislation.

Consultation and Cost-Benefit Analysis

Sections 138N(5) and 138N(6) set out how the FCA cannot make further product intervention rules containing the same, or substantially the same, provision as in the initial rules until the 'prohibited period' has ended. We believe that given the 'prohibited period' is just one year, this could give rise to a situation in which the FCA could ban a product for 12 months, wait a further 12 months (the 'prohibited period'), then ban the same product again without consultation or cost-benefit analysis. We believe that this could, in some instances, be tantamount to the permanent product intervention power being exercised but without the same safeguards.

We therefore believe that a more effective system for the exercise of the temporary product intervention power is necessary. We believe that when the FCA issues a temporary product intervention rule, it should be required to consult and perform a cost-benefit analysis during the initial period for which the product is banned to determine whether the ban should be made permanent. If the FCA determines that it does not intend to make the temporary ban permanent, the temporary ban should be discontinued even if it has not yet reached the length of time set out in the initial rule. The FCA should only then be permitted to reintroduce a temporary ban on a product that has already been subject to a previous ban where there has been a material change in circumstances. This would effectively make

the 'prohibited period' set out in Sections 138N(5) and 183N(6) redundant.

Financial Promotions Power

We welcome the fact that the FCA will be free to revoke or amend any direction it gives under this power following representations from a person to whom notice is given. We also welcome that the FCA will be able to exercise discretion over the information it includes in the publication of the direction.

However, we believe that these safeguards need to be strengthened in order to make them fully effective and balanced. We believe that it should be made a formal requirement in he legislation for the FCA to consider and take into account the representations made by the person to whom the notice is given.

We are also concerned about the circumstances in which the FCA will give directions under this power. As currently drafted, Section 137P(1)(b), provides that if a financial promotion has not yet been published, the FCA will be able to give a direction if it considers that the promotion 'is likely to' contravene financial promotion rules. We believe that this formulation is too broad and the Bill should be amended so that the FCA can only give a direction in relation to a financial promotion that has not yet been published if it 'would' contravene financial promotion rules. Furthermore, we believe that a direction under this power should only be given in relation to a promotion that has not yet been published if the FCA considers that it likely to be published if the direction is not given.

Clause 137P(11) would require the FCA to publish information about a direction even if, after hearing representations, the direction is revoked. We consider this to be illogical and unfair given that it would cause unjustified reputational damage. We believe that the legislation should be amended to prohibit the publication of information relating to a direction that has been revoked.

Early publication of disciplinary action

We continue to believe that the power to publish an early enforcement warning notice poses major risks to firms which could suffer unjustified reputational damage before having had the opportunity to challenge the accuracy of the facts. We also believe that the design of this power carries the real risk that individuals and firms will be dissuaded from making representations to the FCA as the reputational damage will have already been done, and could be viewed as a barrier to due process.

We welcome the safeguards provided for in the Bill, but believe that they should be strengthened. We welcome the fact that the new power will not be expressed as a 'duty', giving the FCA discretion over the power's use. We also welcome that the FCA will, when deciding whether to disclose, have to consider whether the publication of information would be unfair to the person with respect to whom the action was taken (or was proposed to be taken).

We believe, however, that firms must have the express right to comment on the notices and whether publication is appropriate (as opposed to simply being consulted) and the FCA should be required to consider and take into account those comments. We also believe that if the FCA publishes a notice in spite of comments that it is not appropriate to do so, it

should be required to explain why it is not unfair to proceed with publication. We believe that when determining the fairness of publication, the FCA should be required to take into account indication of a challenge to the notice as well as reputational impact. Finally, we believe that provision should be made in the Bill which requires the FCA to state in any information that it publishes that it is an early warning notice and the right to dispute has not yet been exhausted.

18. Are the prudential regulatory responsibilities of the FCA towards FCA-only regulated firms given sufficient emphasis and detail?

We believe that the White Paper is relatively light on detail in relation to the FCA's prudential responsibilities in relation to FCA-only regulated firms. We would welcome further detail on this subject from the FSA in due course and would expect it to undertake further consultation.

19. Will the new regulatory arrangements reduce the risk and cost of dealing with miss-selling of financial products?

We believe that on balance the new regulatory arrangements should reduce the risk and cost of dealing with mis-selling of financial products. The Government and FSA have set out how the FCA is going to take a 'preventative' approach to regulation that will be based on earlier intervention with greater scrutiny of firms' product design processes. We believe that an approach that combines early intervention with greater scrutiny of product design should reduce the risk and cost of dealing with mis-selling and should deliver good outcomes for consumers.

The FCA's product intervention power will be the primary regulatory tool under the new arrangements for tackling financial products that could cause mass consumer detriment through miss-selling. As we discussed in our response to Question 17, we believe that the safeguards in relation this power are currently insufficient and need to be strengthened. Nonetheless, we believe that this power, with the right safeguards, will enable the FCA to intervene early and rapidly to ban a product which should in turn reduce the risk and cost of dealing with mis-selling.

However, we believe that there are risks associated with this new regime. The creation of a more 'preventative' interventionist approach, led by the FCA, runs the risk of restricting innovation and choice in the financial products that are available to consumers. The FCA's product intervention power could contribute to this if it leads to firms devoting fewer resources to the development of new products for fear of intervention on the grounds of mis-selling. It will therefore be important for the FCA to strike the appropriate balance between early intervention to prevent or stop the mis-selling of financial products and giving firms the freedom necessary to innovate and deliver choice for consumers.

20. Are the proposals for coordination between the PRA and FCA clear and adequate? What would be the advantages and disadvantages of having a Single Point of Contact and/or a joint rule book for dual-regulated firms?

We are broadly supportive of the proposals for coordination between the PRA and FCA, but measures to ensure operational coordination will be critical. It is required to ensure that

unnecessary regulatory overlap and duplication is avoided, particularly for dual-regulated investment firms.

The PRA approach document suggests that the PRA will take a 'proactive interventionist' approach to create presumptions of regulatory action in certain circumstances and the FCA will take a more 'preventative' approach, intervening earlier to prevent potential consumer detriment. Absent effective coordination, we believe that there is a risk that judgements to intervene will not be consistent or consistently well informed and that such judgements could restrict innovation and business growth.

We therefore support the PRA and FCA's proposed requirement to coordinate as well as the requirement to draw up a Memorandum of Understanding (MoU). However, we would suggest that the requirement to coordinate should relate to any exercise of a function by one regulator having any material effect on the objectives of the other, be that effect adverse or otherwise.

We welcome the acknowledgement by the Government that the FCA and PRA should, when conducting their annual review of the MOU, consult with regulated firms, consumer groups and others. We would stress the importance of ensuring that this consultation is meaningful and that the views of the industry are fully considered. We also welcome the new requirement for the PRA and FCA to include in their annual reports an account of how well they have coordinated during the year.

We also support the proposal to give the PRA the power to prevent the FCA from taking actions where it considers that these may lead to the disorderly failure of a firm, or wider financial instability. However, as currently drafted, the PRA is not under a duty to exercise this power, even if it has identified an FCA action that would meet the criteria set out in Section 3H of the Bill. We believe that the PRA should be under such an obligation. We there believe that Section 3H(1) should be amended as follows:

'Where the first, second and third conditions are met, the PRA ***shall*** give a direction under this section to the FCA.'

Single Point of Contact

For larger firms a single point of contact team would be essential for general supervisory matters of a more general nature (not covered by specialists within FCA/ PRA). This structure would work like the specifically assigned supervisory teams within FSA today (for larger firms). Such a Supervisory Team would need to interact, as the FSA currently does, with various departments within a dual-regulated firm (such as Compliance, Legal and Finance). The key points of contact within these firms would be the Chief Executive and the Head of Compliance (currently the CF10).

In HSBC's view, in order to facilitate the regulation of dual regulated firms, this would benefit the FCA, PRA, and other regulators globally (or colleges of supervisors) and firms themselves. Without a single point of contact team for general matters, firms are likely to duplicate work by liaising separately with both regulators. There is also a danger that other regulators globally will have the same difficulties where a matter relates to a specific firm's regulation or cross border business. This would be particularly important in crises, resolution and recovery and day to day enforcement matters. Firms are operating in an

increasingly complex environment, with multiple regulators and resolution authorities. Any steps to decrease this complexity will benefit all parties and reduce the cost of supervision.

Joint rule book

We would fully support the creation of a joint rule book for dual-regulated firms as we believe that this would greatly simplify and streamline the regulatory framework within which these firms will operate. We believe a joint rule book would help to ensure a consistent regulatory culture between the PRA and the FCA and would prevent them from diverging over time. We also believe that it would be particularly helpful where competences overlap, for example in relation to systems and controls issues. In addition, we believe the UK should be moving in this direction regardless of the regulatory restructure currently under way given the increasing importance of EU requirements that is limiting the UK's ability to issue separate guidance. Therefore, we feel this is an idea that should be given serious consideration by the Government.

21. How do the proposals in the draft Bill fit within the new European regulatory regime? What freedoms and constraints will the UK have to operate within that regime?

The government has argued, correctly in our view, that new EU legislation, in particular CRD4, should be sufficiently flexible to permit the national exercise of macroprudential policy. We believe that the proposals in the draft Bill and in the draft of CRD4 are compatible in this aspect. The option to use Pillar II of the Basel II Capital Adequacy Regime to adjust risk weightings at the systemic level for specific asset classes, whether because they are demonstrating exuberance, or because they are excessively constrained by their capital treatment, will allow national jurisdictions to manage credit supply into their respective economies.

22. Does the draft Bill contain any proposals or omissions, not covered by the questions above, which cause concern?

None identified.

September 2011

HSBC; Barclays and Royal Bank of Scotland – oral evidence (QQ 692-761)

Transcript to be found under Barclays

HSBC – supplementary written evidence

In your letter of 4th November to Stuart Gulliver, you noted that you would welcome any further comments on the Financial Services Bill or the evidence we presented to the Committee on 1 November.

I would like to raise two points relating to the Financial Conduct Authority's objectives – both its strategic objective ('protecting and enhancing confidence in the UK financial system') and the proposed competition duty.

We believe strongly that the FCA's strategic objective, as set out in the June White Paper and draft Financial Services Bill, provides the right statutory framework within which it should operate: protecting and enhancing confidence in the UK financial system must be at the heart of its regulatory approach. I would go further and say that I think that the objective as phrased is absolutely right. The entire Financial System is based on the principles of trust and confidence. Even the words "credit" and "fiduciary" are both rooted in the words 'trust' and 'faith'. As such, building confidence is the only way that we will achieve empowered consumers and well functioning markets. It has been argued that the 'confidence' element is both "broad and nebulous". We believe that it is appropriately broad, given the broad mandate of the FCA. In terms of it being 'nebulous', we believe that the concept of confidence is both tangible and indeed measurable.

Some commentators have argued that promoting competition should be a primary objective of the FCA. While we believe that promoting competition in the UK should be an objective, we do not think that it should be a primary one for three main reasons:

- Competition is, in our view, the result of firms focussing on understanding and meeting their customers' needs. As such, if the FCA achieves it's objectives as currently drafted, it will inevitably lead to increased competition in the marketplace.

- There already is a regulatory infrastructure focussed on competition. Thus, it could lead to duplication and less effective regulation given that the OFT already has a primary objective to promote competition (and its proposed successor - the Competition and Markets Authority); and

- If the Government does intend the FCA to lead on competition matters then it will be essential for it to have the right competition expertise - we do not believe it currently has that, and nor that it could easily be built at a time when the FCA already faces a major recruitment challenge.

Overall, we believe that any decision to confer a primary competition objective on the FCA would run the risk of a disjointed approach to the application of competition law, and a possible failure to balance the interests of consumers and firms. We therefore hope that on the FCA's strategic objective and its relationship to competition, the Committee will recommend that the final legislation will adhere to the wording proposed in June.

We are continuing to follow the Committee's work with interest and I look forward to the publication of its report in due course. Please do not hesitate to contact me if we can be of any further help to you.

29 November 2011

HSBC – further supplementary written evidence

You wrote to me on 30 November asking for clarification of answers I gave to questions from Lord Maples in my evidence to the Committee on 1 November. I have set out below responses to the three matters which he raised.

1. VALUATION OF INVESTMENTS

Lord Maples raised the point that "investments were sometimes valued at the same discount rate as the cost of money to the bank and that where this showed a profit over cost, that profit was booked in full before the investment had matured fully". At HSBC, as is the case for the industry in general, the recognition of profits and losses on transactions is determined by the accounting classification in accordance with International Financial Reporting Standards (IFRS).

Where HSBC acquired assets principally for the purpose of selling or repurchasing in the near-term, then these instruments would be reflected at fair "market" value; this is set out in Note 2(h) on page 258 of our 2010 Annual Report and Accounts. In respect of the fair value, IFRS gives guidance as to how it should be determined. Where comparable market prices are available, these prices will be used.

In the absence of a specific market price then the future cashflows of the instrument are discounted to determine the fair value. The discount rate used is not a uniform one and, in accordance with market practice, must take into account the characteristics of the instrument being valued. The discounting of cashflows is an established and accepted technique for determining fair value. Such an approach to valuation is not a skewing of accounting policies, but an application of the accounting rules.

Where investments are held on a continuing basis, they are primarily held on an "Available-for-Sale" basis. Any gains or losses on these instruments are not booked to revenue / profit until the assets are sold. HSBC's accounting policy for Financial Investments can be found in Note 2(j) on page 259 of the 2010 Annual Report and Accounts. Some investments held on a continuing basis are classified as "Financial instruments designated at fair value" and gains and losses are taken to the profit and loss account as they arise. In order for a transaction to be classified as such, strict criteria need to be met. These criteria are set out in Note 2(i) on page 259 of the 2010 Annual Report and Accounts. Such a categorisation under IFRS is irrecoverable and cannot be used to influence the recognition of income.

In summary, the use of discounted cashflows for valuation is not itself unethical or designed to increase immediate profits. At HSBC we have had, in the years up to the banking crisis and thereafter, robust processes in place to ensure investments are appropriately classified and valued.

2. COMMITMENT FEES

Lord Maples suggested that "sometimes up front commitment fees on loans were increased to allow a lower running interest rate and the whole fee was booked as revenue in year one". I can confirm that we are not aware that this is a current practice, or has been the practice, at HSBC. Only fees earned for work completed on originating a transaction ("Arrangement fees") or fees linked to an underwriting risk may be taken directly to profit and loss; and in any event, only once the transaction has been completed. All other fees are deemed to form part of the effective interest rate, and are therefore deferred and recognized as income over the life of the loan. These amortised fees are recognized in the profit and loss account over time as Interest Income.

3. PROPRIETARY TRADING

Lord Maples also suggested that "a practice had developed of a bank's proprietary trading desk taking a short position against a security sold to a client, through a put, CDS etc". In your letter you note that "he was not referring to normal market maker positions, but specifically to Prop Trading Desk activities in the knowledge of the details of the security sold to the client".

We can confirm that HSBC has not engaged in this sort of activity. For a short period of time, HSBC had a small number of proprietary trading desks but they did not sit well with HSBC's customer-centric culture and they were disbanded nearly a decade ago in 2002. Importantly they did not engage in the activities you describe or activities that could reasonably have been construed as unethical. In HSBC, we are satisfied that our risk appetite, activities and conduct are entirely consistent with serving efficiently the needs of our clients through activities that are mutually beneficial.

I trust that this response addresses the issues raised by Lord Maples, as set out in your letter. Please let me know if I can be of further assistance.

5 December 2011

ICE – written evidence

ICE is a provider of global market and clearing services; and has invested significantly in the UK. We welcome the opportunity to respond to the Committee's call for evidence on the draft Financial Services Bill (the "Bill" and the "Call for Evidence") amending the Financial Services and Markets Act 2000 ("FSMA").
ICE Futures EU (the 'Exchange'), a UK Recognised Investment Exchange ('RIE'), and ICE Clear EU (the 'Clearing House'), a UK Recognised Clearing House ('RCH'); have set out a joint response below.

General Comments

Clarity, continuity and stability in UK regulation of financial services are key to delivering the goals of the Bill. In addition we believe key elements are:

- Effective coordination between the new regulatory bodies e.g. the Bank of England (the "Bank") and the Financial Conduct Authority ("FCA"); and between UK and international regulatory bodies such as the European Securities and Markets Authority ("ESMA");
- Wholesale markets being strongly represented within the FCA;
- Regulation being proportionate to the risks identified and rigorous in its impact analysis;
- The new regulatory bodies being both accountable and transparent;
- The importance of the European and international policy agenda, both during the transition phase and thereafter.

Specific Responses

We have set out below a response to some of the Committee's numbered questions:
1. The new regulatory structures are more complex than the "Twin peaks" system referred to would imply. Recognised bodies (i.e. exchanges and clearing houses) are currently supervised by the Financial Services Authority ("FSA"). In the new structure supervision of exchanges will transfer to the FCA (the successor body to the FSA); supervision of clearing houses will transfer to the Bank (not the PRA). In addition, ESMA, interfacing in the UK with the FCA, will have an EU wide role, yet to be fully detailed, but which will include some oversight of clearing houses and exchanges pursuant to the European Markets and Infrastructures Regulation ("EMIR") and the Markets in Financial Instruments Directive ("MIFID") and related EU legislation. Coordination and information sharing between these bodies will be challenging, but is key to a successful regulatory system, and indeed to a thriving financial services industry in the UK.
4. Regulators must be fully transparent and accountable in respect of regulatory policy development and their supervision and enforcement activities. It is not yet clear how this will be achieved through governance or other arrangements, but at a minimum this should involve detailed market analysis, full and responsive consultation, an acknowledgement of commercial drivers, disciplined internal and external processes, fully taking account of the principles of good regulation, and proportionate and timely actions and decisions. In addition we believe the regulators should be mindful of the competitive position of the UK, as far as they are able. Further, whilst some provision is made in the Bill in respect of accountability and governance for the FCA and the PRA, we believe similar standards and protections should apply to the Bank given its role in regulatory policy development and supervision.

15. We support the proposed FCA strategic objective of protecting and enhancing confidence in the UK financial system. However, the operational objectives run the risk of the regulation of wholesale markets being given insufficient priority within the FCA. We would also encourage similar standards being applied to the Bank in its oversight of clearing houses. Finally, we note that there can be a conflict between the robustness of infrastructure and the promotion of competition, which should not be to the detriment of the UK financial system. For example, promotion of competition in respect of risk management at clearing houses would likely increase systemic risk.
16. We support the proposed integrity objective for the FCA, and agree that the FCA should promote the orderly operation of the financial markets. On the regulation of Recognised Bodies, however, we are concerned that the proposals remain high level with little or no detail, evidence or rationale. While we understand that this detail will be forthcoming in secondary legislation and subsequent regulatory rule makings our comments at this stage are limited to strongly supporting the retention of Part XVIII of FSMA, and questioning the need for the proposed, but yet to be detailed, minor technical changes. More specifically:

Exchanges and clearing houses are a substantial part of UK financial services infrastructure and undertake important regulatory and risk management functions, supported by the current Recognised Body regime in FSMA. Market infrastructure was a key stabiliser during the financial crisis, operating effectively throughout. The regulatory functions and international standing of UK exchanges and clearinghouses must be maintained in a manner consistent with the status of an exempt body, and be mindful of their role as part of the regulatory regime e.g. monitoring and enforcing compliance with their Rules.

Any amendment of the current regime must be evidenced and set out a clear rationale; and any new powers given to regulators in their supervision of exchanges and clearing houses must be proportionate, accountable and transparent in their application. Given the stated objective of "reducing the burden of regulation and improving the quality of regulation"[180] regulatory proportionality needs to be given priority in consideration of any amendment to the Recognised Body regime.

Recognised bodies are currently subject to extensive notification requirements set out in FSMA,[181] the Companies Act 1989[182] and Chapter 3 of the FSA's REC Source Book (the "Notification Rules"). The FSA already has broad information gathering powers, including the power to make further rules requiring a Recognised Body to provide "…at such times or in respect of such periods as may be specified, such information relating to the body as may be specified". In addition, Recognised Bodies must be able and willing to cooperate by the sharing of information or otherwise with the FSA, with any other authority, body or person having responsibility in the UK for the supervision or regulation of any regulated activity or other financial service or with an overseas regulator.[183] Given the breadth of the current information gathering powers, the need for them to be extended has not been established. If demonstrably necessary, any new information gathering powers need to meet the requirements of proportionality, accountability, transparency and relate to specific requirements all within the terms of the proposed legal framework.

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[180] HM Treasury's Consultation Paper "A new approach to financial regulation: building a stronger system" (Cm8012).
[181] Sections 293(5), (6), (7) and 300B(1).
[182] Section 157.
[183] Paragraphs 6 and 20 of the Schedule to the Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchange and Clearing Houses) Regulations 2001 SI 2001/99.

> Significant proportions of the regulatory regime for both clearing houses and exchanges will be dictated by European legislation – EMIR for clearing houses; MiFID for exchanges. In addition, ESMA will act as coordinating body for parts of this legislation, albeit that the extent of its role is yet to be defined.

To conclude, we support legislative change which demonstrably contributes to, and does not risk overburdening or otherwise impairing market efficiency stability or confidence in the UK financial system. The draft Bill contains much which we support, but significant detail is yet to follow in EU or subsidiary legislation and/or rules. We would emphasise that amendments to the Recognised Body regime have yet to be evidenced as necessary and proportionate, with a real risk of unintended adverse consequences, including damage to the integrity, and reputation of Recognised Bodies as efficient, neutral and trusted in the delivery of infrastructure with less flexibility for regulatory oversight or compliance.

September 2011

Institute of Chartered Accountants in England and Wales – written evidence

INTRODUCTION

1. We are writing to provide evidence in response to the call for evidence by the Joint Committee on the draft Financial Services Bill. ICAEW would be pleased to provide oral evidence on any aspect of its submission.

WHO WE ARE

2. ICAEW operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, we provide leadership and practical support to over 136,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. We are a founding member of the Global Accounting Alliance with over 775,000 members worldwide.

3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. We ensure these skills are constantly developed, recognised and valued.

EXECUTIVE SUMMARY

4. ICAEW believes that the new regulatory structure introduced by this draft Bill – the macro-prudential work of the Financial Policy Committee (FPC), together with the clear focus of the Prudential Regulatory Authority (PRA) on the financial soundness of deposit takers and insurance companies – has the potential to reduce the probability and severity of a future financial crisis in the UK. However, history suggests that financial crises will continue to emerge from time to time. It would be wrong to suggest that this draft legislation could completely prevent another financial crisis.

5. This new regulatory structure could be better positioned to handle a future financial crisis, because the authorities crucial to dealing with a crisis – the prudential regulator, bank resolution authority and monetary authority – will all be part of the Bank of England group

6. In our view, the key route to dealing better with bank failures and protecting the public purse is the establishment of robust bank resolution plans, including international coordination on bank insolvencies. Legislators considering this draft legislation must be mindful of the influence of current processes to tackle remaining substantial challenges on this issue, including work by the FSA and the Financial Stability Board in Basel on how bank insolvencies are handled across borders.

7. The lack of a clear definition for what 'financial stability' actually means will be a crucial issue in establishing the new regulatory framework. This lack of clarity could make it difficult to hold the new regulators to account on whether they are meeting their objective of ensuring financial stability. We recommend that it is defined in secondary legislation that should be kept under regular review.

RESPONSES TO SELECTED DETAILED QUESTIONS

Q1: Is the separation of prudential and conduct regulation into a "twin peaks" system the right approach?

8. ICAEW supports this approach. Better outcomes are likely to be achieved through specialist 'prudential' and 'conduct' regulators each focusing on their different objectives. Specialisation makes it easier to build up expertise amongst regulators and provides focus for their efforts. These benefits are likely to outweigh the fact that sometimes prudential and conduct issues can interact – for instance, large compensation payments (e.g. for mis-selling) can have prudential significance.

Q3: Is it appropriate to make such major changes to the regulatory system by way of amending legislation, rather than starting afresh?

9. ICAEW supports the Government's approach through amending legislation, partly because significant aspects of the FSMA do not seem to be changing as a result of the reforms, but also because it may help to minimise the already long period of uncertainty for regulatory staff, associated wastage rates and loss of expertise. Starting afresh would probably entail a longer period before the reform legislation was enacted.

10. In view of the scale of change to the regulatory structure and processes envisaged, we believe that the new legislation should place a statutory duty on the Chancellor to commission an independent post-implementation review of the effectiveness and efficiency of the new arrangements after they have been in operation for (say) three years. This should focus particularly on the efficacy of proposed innovations, notably the objectives and performance of the FPC, the increased role of judgement in regulation, and the more proactive and interventionist role of the FCA.

Q4: Are the accountability and governance arrangements for the Bank of England, FPC, PRA and FCA satisfactory?

11. We generally agree with the proposed arrangements.

12. ***Recommendation:*** In order to make provision for unforeseen circumstances, it should be confirmed that the Treasury's power of direction over the Bank in the Bank of England Act 1998 would apply to the responsibilities of the Financial Policy Committee.

13. In addition ICAEW believes there is a strong presumption that the accountability mechanisms should be the same for the FCA and the PRA. We are not sure why it is proposed in the draft Bill to retain some elements of the FSA accountability regime

for the FCA alone (and not the PRA) – the statutory Panels and the requirement to hold an annual public meeting are retained only for the FCA.

Q5: Are the FPC's objectives the right ones? Is the concept of financial stability adequately understood for the FPC to be able to perform against its objectives?

14. There is no generally agreed definition of 'financial stability', even amongst professional financial economists. This is a significant issue because the objectives of the FPC are framed in the draft Bill in terms of 'systemic risk' and that in turn is defined in terms of 'the stability of the UK financial system'. In addition, there is little recent experience of use of macro-prudential tools or of possible trade-offs with other economic objectives.

15. There is no easy way to solve this issue, because financial systems are very multi-faceted, and no system is typically perfectly stable – financial stability is generally a matter of degree. The only time the position is clear cut is during extreme episodes, such as the near collapse of the banking system in 2008-09.

16. ***Recommendation:*** In view of the reference to financial stability in the draft primary legislation, what this is to be taken to mean at any given time should be set out by the Treasury in secondary legislation. Given the complexities in this area, the Treasury should consult publicly on a draft of the relevant instrument.

17. It is important that the Court's role in determining the financial stability strategy of the Bank be used a further opportunity to engage in public consultation on how this term should be understood in the context of the work of the FPC.

18. It will also be important that in publishing its decisions, the FPC gives a clear account of why particular developments pose a threat to stability and how any policy action taken is likely to mitigate such threats.

Q6: Should the FPC be limited in the actions it can take which might affect the growth of the financial sector?

19. ICAEW believes that the FPC should be required to take account of the likely impact of its work on the economy generally. Policy initiatives to promote financial stability may have side-effects or costs of various kinds, and these need to be considered in judging whether an action would be proportionate.

20. The mandate of the FPC means that it is particularly likely that its work will have an impact on the financial sector. While in principle there may be no reason to be concerned about that sector more than any other, ICAEW does believe that account needs to be taken of the particularly important role played by the financial sector in the UK economy.

21. ***Recommendation:*** Partly for that reason, ICAEW believes that the accountability provisions in the Bill should be strengthened to require the FPC to publish alongside any direction or recommendation an assessment of the impact on: (1) financial

stability; (2) the financial sector more broadly; (3) the overall economy; and (4) a summary of the anticipated overall benefits and costs of the policy.

Q7: How will the interaction between macro-prudential and monetary policies be handled by the FPC and the MPC?

22. We imagine that institutionally this will be facilitated by cross-membership of the FPC and MPC as well communication among staff within the Bank.

23. However, that cannot remove the fact that, especially in stressed conditions (as currently), it is possible to conceive of a conflict between monetary policy and financial stability. For example, 'excessive' domestic leverage could mean that the level of interest rates appropriate to meet the inflation target would pose a clear threat to stability of UK banks.

24. ***Recommendation:*** Prior to introduction of the Bill, the Treasury should consider how conflicts between the objectives of the MPC and FPC would be addressed.

Q8: Has the right balance been struck between the powers of the FPC and the powers of the Treasury?

25. ICAEW feels it is appropriate to allocate the granting of a macro-prudential power to Parliament and the Treasury, while decisions over when and to what degree to use it are taken by a technical committee, the FPC.

26. ***Recommendation:*** However, we think it is important that a mechanism is put in place for Parliament and the Treasury to keep the use of macro-prudential powers under review, especially as it is possible that extensive use of them could have broader economic and social implications – financial stability is not a 'free good'.

27. For instance, adoption of conservative housing loan-to-value ratios would probably contribute to the stability of mortgage lenders. But this could come at a cost of making it more difficult to fund owner occupation, especially for first-time buyers. The Treasury will need to keep under review whether such costs are at an acceptable level. It will be important to keep the impact of the macro-prudential measures taken together under consideration, and not just the effect of individual tools in isolation.

28. We recommend that the secondary legislation grants authority to use particular tools only for set periods of time, following which Parliamentary renewal would be required. A maximum time period could be set in the primary legislation e.g. three years.

29. It might also be appropriate in some circumstances for secondary legislation to specify the ranges within which a tool could be used – for example, a maximum could be set for the additional regulatory capital which the FPC could require the PRA to mandate in particular circumstances.

Q9: Can Parliament take an informed decision about the proposals for the FPC without details of the macro-prudential tools at its disposal?

30. ***Recommendation:*** ICAEW believes that prior to consideration of the Bill, Parliament should be given information about the tools which are currently envisaged. However, further tools may become appropriate as the FPC gains experience, and as economic and financial conditions change.

Q10: Does the draft Bill adequately deal with the risks posed by the shadow banking system?

31. The FPC will be able to recommend to Government that the perimeter of regulation be changed. But it should be borne in mind that 'shadow banking' is likely to be internationally mobile, so action just in the UK may not be overly effective.

32. ***Recommendation:*** One way in which to constrain the size of the shadow banking sector, if that were desired, would be to limit its access to finance and other facilities from banks and other parts of the regulated financial sector – though to be effective this would need to be agreed on an international basis.

Q11: Are the PRA's objectives clear and appropriate?

33. Yes. We support the Government's decision to include a specific insurance objective.

Q12: Are there any risks in the Government's proposed 'judgement-based' regulation?

34. The proposed approach appears to call for the regulator to make judgements about the soundness, or otherwise, of regulated firms' strategy, prudential position, conduct practices, and/or risks posed to financial stability – which is something intended to go beyond monitoring compliance with specific prudential or conduct rules.

35. To some degree this exists in the present regulatory arrangements. For example, there is a long history in the UK of bank regulators considering whether additional capital should be held under what is now called 'Pillar 2'.

36. New challenges would arise however if such judgements were to extend more frequently to strategic matters. Judgement must be deployed within a clearly-defined framework, in a way which is targeted on the regulators' statutory objectives, well informed, proportionate and consistent across firms and markets. There is a risk that the regulator could lean excessively on the side of caution, perhaps particularly regarding proposed business expansion overseas where the UK-based regulators might perceive significant additional risks but little direct benefit to the UK.

37. Conversely, there may be difficulties recruiting and retaining a sufficient number of senior regulatory staff who are in a position to make judgements of the kind envisaged – in which case the issue would be too little challenge to firms' management rather than too much.

38. ***Recommendation:*** ICAEW believes that the PRA and FCA should both establish independent, internal Quality Assurance functions to provide an assessment of how

judgement is being applied. It would also be appropriate for the regulators to establish a committee along the lines of the FSA's Regulatory Decisions Committee, with members independent of line-management regulatory decision takers, which would need to consent to judgement-based decisions above a certain level of materiality to a firm.

39. In view of the issues raised by any sense that a regulator was substituting its own business judgement for that of firms' senior management, the best approach might be to bring judgement to bear on the 'prices' of different courses of action – notably through capital and liquidity requirements – rather than a 'binary' decision about whether certain types of business activity are to be permitted or not.

40. It is not clear to what population of firms a judgement-based approach would be routinely applied – to take the PRA as an example, presumably it would mainly be brought to bear on the 'larger' banks, insurance companies and securities firms.

41. A further issue is how the approach will dovetail with the highly detailed rules contained in the financial sector EU Directives and other European requirements. The UK authorities have an obligation to ensure that these requirements are observed, and some mechanism will be needed to deliver that – bringing judgement to bear on 'big issues' will not in itself be sufficient to achieve compliance with the UK's European obligations.

Q13: Is the Government's proposed approach to 'orderly' firm failure satisfactory?

42. ICAEW supports the objective of making it possible for firms to fail in an orderly way. Where that is credible, it strengthens market discipline (especially for firms which deal significantly in wholesale markets).

43. However, it is currently recognised that arrangements are not yet in place which would allow the largest and most complex firms to fail in an orderly way – cross-border differences in insolvency regimes being one difficulty (see for example the FSA's CP 11/16 *Recovery and Resolution Plans*).

Q14: Given that the PRA and the FCA will inherit FSA staff does the draft Bill do enough to ensure a new regulatory culture and a more proactive approach to regulation? Will these two new bodies have staff with the appropriate skill and expertise?

44. Financial sector regulators around the world typically experience difficulties in attracting and retaining sufficient numbers of well-qualified and experienced staff – because of the gap usually found between salaries in the regulator and in the private sector. Against that background, and the need to maintain expertise, it is appropriate for the FSA's staff to be 'inherited' by the new regulators.

45. On a related point, we would caution against any attempt to bring remuneration in the PRA into line with that found in the rest of the Bank of England group. While acknowledging the potential advantages of some PRA staff working on the 'career' basis found in the Bank, we think it is very important that the PRA continues the FSA

approach whereby significant numbers of staff join from the private sector at various stages in their career. This has made available to the FSA a large amount of up-to-date expertise regarding how the financial sector operates in practice.

Q15: Are the FCA's primary objectives appropriate? Is significant emphasis given to the promotion of competition?

46. Broadly yes.

47. ***Recommendation:*** However, we consider that the FCA should have an explicit objective of reducing financial crime (as the FSA currently does). This would best be considered in the context of the future of all of the public agencies which deal with economic crime. Economic crime can have very corrosive long-term effects on economic efficiency, and it is important that the subject receives sufficient attention. The FSA has recently had some notable successes in this sphere, and that momentum should not be lost.

Q16: Are the responsibilities of the FCA towards the regulation of markets appropriate?

48. Our main concern is that the focus of the FCA may become excessively focused on protection of retail consumers, and wholesale markets may receive insufficient attention. A related issue is that wholesale markets may come to be viewed primarily in terms of any relatively direct linkages from them to retail consumer products – which is not to deny that the shape of demand for products from retail 'end users' can have a significant bearing on the operation of such markets.

49. A further concern is that the very broad definition of a 'consumer' in the draft Bill may lead to approaches best suited to retail regulation being inappropriately applied to wholesale market transactions among professional counterparties.

50. The proposed establishment of the Markets Panel in the draft Bill goes some way to alleviating these concerns, but we believe that further steps are necessary.

51. ***Recommendation:*** The amended FSMA could require the FCA to 'have regard' to relevant differences between wholesale and retail markets, and that a minimum proportion of the FCA Board members have significant wholesale markets experience.

Q17: Does the draft Bill strike the right balance between the responsibilities of consumers and firms? Are the FCA's new powers in the area of consumer protection appropriate?

52. ICAEW believes that the emphasis in the draft Bill, and in the FCA launch document, on consumer protection is appropriate – provided, as noted immediately above, that this does not 'crowd out' other aspects of the FCA's responsibilities, particularly regulation of wholesale financial markets.

53. The asymmetry of information between producers and consumers is very marked in financial services, particularly for products where performance can be assessed only

after a significant period of time. This is at the root of many of the mis-selling episodes in recent decades. Against that background there is a strong case in principle for the FCA to take a proactive and robust approach to consumer protection.

54. This suggests that the Government is right to propose additional powers for the FCA (compared to the FSA), and to be looking further at ways in which cases of (actual or potential) 'mass detriment' can be addressed.

55. A clear challenge in practice stems from the multiple potential causes of consumer detriment (for example, inappropriate product design; misleading descriptions etc), and the large number of financial products available. This underlines the importance of stronger consumer financial education, so that consumers are better able to protect their own interests – though that is inevitably a long-term goal.

Q18: Are the prudential regulatory responsibilities of the FCA towards FCA-only regulated firms given sufficient emphasis and detail?

56. We believe that further emphasis is needed.

57. ***Recommendation:*** It should be clarified whether the purpose of prudential requirements for FCA-only firms is just to allow them to 'fail safely' or whether for some FCA-only entities there is an objective of minimising the probability of failure in the first place.

58. Another issue is whether for investment firms a single 'rule book' should be agreed jointly by the PRA and the FCA, given that some firms may move between the FCA-only and dual-regulated categories from time to time (in either direction), and also the desirability of avoiding the creation of incentives for particular types of business to take place in either FCA-only or dual-regulated firms.

59. Given the role of EU legislation in setting at least minimum prudential requirements for many types of FCA-only firm, arrangements will need to be put in place for co-ordination between the PRA and FCA on the relevant negotiations.

Q19. Will the new regulatory arrangements reduce the risk and cost of dealing with mis-selling of financial products?

60. They have the potential to do so.

61. ***Recommendation:*** Given the range of providers and products from which retail consumers can choose, success will require the FCA to establish a broadly-based consensus as to what 'proper' selling looks like, and be prepared to take robust, proactive action against shortcomings from that standard. This is not just a matter of distribution channels, including clear and complete descriptions of the main features of products and high-quality advice where that is given. As recognised in the new regulatory approach, product design is important too.

Q20. Are the proposals for co-ordination between the PRA and FCA clear and adequate? What would be the advantages and disadvantages of having a Single Point of Contact and/or a joint rule book for dual-regulated firms?

62. The draft Bill highlights the importance of co-ordination mechanisms. However, it will be very important that senior managements of the PRA and the FCA develop a culture of co-operation at every level in these organisations, especially to avoid unwarranted burdens on dual-regulated firms.

63. We are not sure what the advantage would be of a general Single Point of Contact, as suggested by some stakeholders, given that for dual-regulated firms substantive expertise on prudential and conduct matters would be in two different organisations (the PRA and the FCA respectively). Indeed, use of a Single Point could slow down communication between the regulators and dual-regulated firms, as information would have to be assembled and passed through a single channel.

64. A joint rule book, as some propose, might have greater potential, as in some areas the requirements of the PRA and FCA would be expected to be similar (for example as regards governance and high-level systems and controls). However, in other respects it could be little more than a pasting together of prudential and conduct material sourced from the PRA and the FCA respectively.

Q21. How do the proposals in the draft Bill fit within the new European regulatory regime? What freedoms and constraints will the UK have to operate within that regime?

65. We believe that significantly greater attention needs to be paid to how the new UK regime will dovetail with the role of Europe, notably EU Regulations and Directives and the emergence of the European System of Financial Supervision, especially the European Systemic Risk Board (ESRB) and the three European supervisory authorities.

66. It needs to be clarified how the work of the FPC will interact with that of the ESRB. As regards micro-prudential supervision, arguably existing EU Directives already place significant constraints on the style and substance of micro-prudential regulation. In ICAEW's view, more needs to be done to articulate how the Government's proposals are consistent with those Directives, and also how the often highly-detailed rules in them will be monitored and enforced in future.

67. It should be borne in mind that the present direction of travel in Europe appears to be towards supervisory 'rule books' which are harmonised significantly further than now across the 27 EU member states, and this is likely to impose additional constraints on unilateral action in the UK. For example, the recently released Commission proposal which would implement Basel III in Europe is (as currently drafted) to a considerable extent a maximum harmonisation proposal with regard to the rules on bank capital. This would limit the extent to which the UK could impose additional requirements.

68. The scope for unilateral UK action is also likely to be constrained in practice by 'passporting' rights whereby many types of EU financial service provider have freedom to branch into other EU member states, including the UK, subject primarily to the prudential requirements of their home regulator. As 'branched in' firms are therefore not subject to most UK prudential requirements, business might gravitate to non-UK EU firms if UK prudential requirements were significantly more demanding than the European norm.

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Institute of Financial Planning; Association of British Credit Unions Limited (ABCUL); Association of Financial Mutuals; Building Societies Association; Association of Independent Financial Advisers; International Regulatory Strategy Group; Financial Services Practitioner Panel; FSA Smaller Businesses Practitioner Panel; Financial Services Consumer Panel and Office of the Complaints Commissioner – oral evidence (QQ 438-557)

Transcript to be found under Association of British Credit Unions Limited

Institute of Insurance Brokers (IIB) – written evidence

The Institute of Insurance Brokers (IIB) is a trade association for insurance brokers operating across the UK. Its members are mainly small firms which provide a vital service to consumers and businesses in their role as professional intermediaries, advisers and risk managers.

It is a widely held view that FSA regulation, designed for banking and investments, was imposed inappropriately on insurance intermediaries with the result that the level of regulation exceeds the limited risks posed by brokers. As we see it, the development of the new regulatory regime presents the Government with an ideal opportunity to facilitate a fairer, more proportionate approach. The decline in the availability of independent advice for consumers, which has coincided with a significant reduction in the numbers of insurance broking firms, is exacerbated by the disproportionate demands of the regulatory system and spiralling compliance costs.

We appreciate the opportunity to provide evidence to the Committee and our comments relate to those questions and issues in the Draft Bill which most affect insurance brokers and other insurance intermediaries.

1. Is the separation of prudential and conduct regulation into a "twin peaks" system the right approach?

The relationship between insurance intermediaries and insurers is fundamental to the operation of insurance markets throughout the world. Insurers are set to be dual-regulated by the PRA and FCA whereas intermediaries will be regulated solely by the FCA. Whilst we support the moves towards more robust prudential oversight, it is important that the demands of the "twin peaks" system do not hamper the ability of insurers to develop and innovate in partnership with intermediaries. As far as intermediaries are concerned, we feel it is important that the legislation facilitates a more transparent and proportionate approach to prudential and conduct regulation. We would like to see regulatory barriers lowered wherever possible to promote business development and innovation.

We welcome the requirement for the regulators to submit annual accounts to the Auditor General but the Bill does not directly refer to the costs of regulation which have escalated in recent years and are likely to increase significantly under the new regime. The level of fees and levies (which, for insurance brokers, are by far the highest in the EU) along with the cost of compliance threatens the viability of some firms. We would therefore advocate statutory provision for more transparency over budgeting and fees, including making a requirement for annual consultation on fees and regular reviews of the classification of fee-payers. The current FSA consultation process does little to reassure regulated firms about the value their substantial fees represent and this leads to doubt as to whether resources are being used wisely and effectively. Bearing in mind the relatively low risks their activities pose, we have long argued that the cost/fee basis needs for insurance brokers and other small intermediary firms need fundamental revision.

4. *Are the accountability and governance arrangements for the Bank of England, FPC, PRA and FCA satisfactory?*

The FSA makes its own rules, interprets and enforces them (often with harsh penalties) so its apparent lack of accountability has raised a good deal of concern across the sector. We are delighted that the Bill makes provision for additional accountability mechanisms, including

independent reviews. In view of the shortcomings associated with the FSA, we suggest there should be a requirement for the FCA to report on its own efficiency and effectiveness. This might be achieved by extending the criteria for the annual report to the Treasury (under Schedule 1ZA.11).

Whilst the high-level arrangements for governance appear to be satisfactory, we have mentioned in response to the FCA's "Approach to regulation" document that the interests of the many and varied activity groups within the financial services sector are not adequately represented. It is essential that the FCA be well informed and motivated to act decisively on matters which concern the lower-profile sectors of the market. We feel, therefore, that Practitioner Panels could play a more useful and significant role in the regulatory process and the Committee should take this opportunity to ensure that the Bill empowers them to make a truly worthwhile contribution.

The panels consist of practitioners from a wide range of disciplines. On the Smaller Business Consumer Panel, currently, there is only one insurance broker amongst representatives of IFA's, mortgage intermediaries, friendly societies, credit unions etc. The panel members seem to have little in common apart from the fact that the FSA regards their employers as 'small firms'. There is scope to improve the way industry knowledge is harnessed.

14. Given that the PRA and the FCA will inherit FSA staff does the draft Bill do enough to ensure a new regulatory culture and a more proactive approach to regulation? Will these two new bodies have staff with the appropriate skill and expertise?

Under Part 1A of the Bill, we note the body previously known as the Financial Services Authority will be known instead as the Financial Conduct Authority. We are concerned that, as the FCA will be created using the existing FSA infrastructure, it will be 'business as usual' with the main discernable change being the redesign of the corporate logo. Whilst we appreciate the need to minimise the cost of change and disruption for staff, we feel the new regulator must take bold and decisive measures to overcome the root causes of poor and inappropriate regulation. As mentioned above, there is scope to improve the way industry knowledge is harnessed and utilised, with particular regard to the development of best practices and standards. Our members have complained to us over the FSA's lack of understanding and empathy with regard to operational aspects of their businesses. We suggest formally involving industry experts, professional bodies and trade associations to inform and assist on technical matters and to help in the development of best practices and standards.

17. Does the draft Bill strike the right balance between the responsibilities of consumers and firms? Are the FCA's new powers in the area of consumer protection appropriate?

There must be a suitable balance between encouraging diversity and effective competition in the market on the one hand and ensuring that consumers are protected on the other. The moves towards educating consumers about the products they purchase are important but there are significant cost implications for regulated firms and the benefits of the Money Advice Service may prove difficult to discern. We believe consumers should be suitably informed to enable them to take responsibility for their decisions.

18. Are the prudential regulatory responsibilities of the FCA towards FCA-only regulated firms given sufficient emphasis and detail?

The FCA will be responsible for the prudential supervision of around 24,500 firms. This will necessitate a highly efficient regulatory reporting and monitoring system. We would again stress the importance of the regulator taking into account characteristics of each type of regulated firm when setting the prudential criteria and reporting arrangements. The current emphasis on the 'adequate resources' principle enables the regulator to impose what may be considered to be unrealistic capital requirements on some firms. We feel the regulators must be capable of being challenged on their assessment of individual requirements where the situation is not covered specifically by a rule.

19. Will the new regulatory arrangements reduce the risk and cost of dealing with miss-selling of financial products?

We support the Treasury proposal to require the FCA to publish and consult on a set of principles governing the circumstances under which it will use any product intervention power. Any new powers must be invoked with caution so that they do not have the effect of stifling enterprise and innovation. With this in mind, we would like the Government to ensure that the powers provided in this Bill do not evolve into a formal product pre-approval regime.

21. How do the proposals in the draft Bill fit within the new European regulatory regime? What freedoms and constraints will the UK have to operate within that regime?

We are concerned that such fundamental changes are taking place ahead of the review of the Insurance Mediation Directive (IMD). It is essential that European developments including the IMD and Solvency II are taken into account in devising this legislation.

22. Does the draft Bill contain any proposals or omissions, not covered by the questions above, which cause concern?

1. Under Part 1A of the Bill, the body previously known as the Financial Services Authority is to be known instead as the Financial Conduct Authority. We are concerned that the FCA, which is funded by regulated firms, could therefore be exposed to liabilities incurred by the failed regulatory body, the FSA. In our view, the FCA should begin with a clean sheet, with any ongoing liabilities of the FSA passing to the Treasury. However, it is not clear whether Part 5.25 of Schedule 3, which would provide the FCA with an exemption from liability in damages, would have retrospective effect.

2. The IIB believes there is a case for an immediate and urgent review of the FSCS funding arrangements as part of these regulatory reforms. There is a strong case for ring- fencing the liabilities of deposit takers and, for the purpose of the compensation scheme levy, separating professional insurance brokers from opportunists selling insurance on the back of other products and services. The FSA has delayed consulting on a new funding model for the FSCS because of international developments but we would urge the Government to take action on this matter as quickly as possible so that new rules may be in place by April 2012.

Thank you for considering our comments. In view of the diversity of firms in the financial services industry and the array of issues being addressed, we feel it is essential that stakeholders are given the time and opportunity to contribute towards the establishment of the new regime. The Government should ensure that the FCA or PRA does not introduce,

through expediency, inappropriate measures which could hinder market efficiency and competition, particularly in some of the lower-profile, yet economically and socially important, sections of the market.

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Intellect – written evidence

Summary

The Draft Bill, whilst addressing failures in the assigned roles of/and boundaries between the Tripartite regulatory authorities, does not address the failings in the 'abilities' of regulators which the financial crisis exposed. Nor does it provide for the tools that the new regulators should now have in order to fulfil their objectives and prevent another financial crisis.

Problem:
The financial crisis exposed the weakness of the UK's financial services regulatory framework, in particular the asymmetry of information between the regulators and financial services providers. Specifically:

- Bank's failed to collate and interpret risk data of suitable quality so that they could identify the risk that they were holding across their disparate operations
- Regulators were ill-equipped to interpret the sheer quantity of sub-standard risk data being received from banks and turn it into actionable information

Result:
The financial crisis was not identified in good time and action taken by regulators (and indeed banks themselves) to prevent it. This was a massive failure of corporate governance and was ultimately responsible for the depth of the crisis and the depth of the public bail out of stricken banks.

The Government had to step in and save RBS and HBoS without full knowledge of the risks that the banks faced, and an accurate assessment of what impact their collapse would have posed to the financial system as a whole. Similarly in the US, a slowed response time resulting from poor actionable data meant that regulators had to choose between saving one of Lehman Brothers and AIG. The decision was made to let Lehman Brothers fail, demonstrating the inability within the regulatory system to react quickly and effectively.

There has been little change in the quality of this data since the financial crisis, with no body taking ownership of this issue, and consequently there remains a gaping hole in the reform of the financial system which has not yet been filled. The Draft Financial Services Bill should address this.

Solution:
In short – 'Better data, more often'. Banks need to undertake significant internal changes to reform their ability to collate accurate risk data, and to improve access for regulators to it so that they can adequately perform their supervisory and financial stability objectives.

However, there needs to be provision within legislation or directive from a regulator to establish a means to compel banks to improve their risk frameworks, as the banks themselves will not voluntarily undertake such reforms to a suitable standard.

Recommendations:

- **A requirement for the regulatory authorities to conduct an evaluation (or gap analysis) of the tools it needs to fulfil their financial stability vs current capability within a specified timeframe of its existence**
- **A legal requirement for regulators to review their risk monitoring capabilities on a periodic basis**
- **Legal obligations for banks to meet the prescribed standard of risk data, as established by the regulators**
- **Legal provision for the establishment of an Office for the Chief Information Officer, within the regulatory architecture, to ensure that risk data standards are improved and maintained by financial institutions**

Intellect is the trade association for the UK technology industry. Our members provide the technology that underpins the entire financial system.

Intellect response – shortcomings of the Draft Bill

Responding to the Joint Committee's overarching question: 'Will the new financial services bill protect against crisis?'

Intellect, the trade association for the UK technology industry, believes that the Draft Bill, whilst addressing the failures in the assigned roles of/and boundaries between the Tripartite regulatory authorities, does not address the failings in the 'abilities' of regulators which the financial crisis exposed. Nor does it provide for the tools that the new regulators should now have in order to fulfil their objectives and prevent another financial crisis.

The problem

Ultimately, the Draft Financial Services Bill does not focus on an important corporate governance issue that is crucial to reform of the financial system – empowering the regulatory authorities (specifically the Financial Policy Committee and the Prudential Regulatory Authority) with the tools that are required to perform the financial stability objectives that they have been assigned and that the Draft Bill sets out. Specifically this is the collation, sharing and interpretation of substandard risk data – the foundation upon which PRA and FPC supervisory decisions will be made.

As the financial system undergoes one of the most significant periods of regulatory scrutiny since the 1930s, there is currently a once-in-a-generation opportunity to tackle some of the fundamental, underlying problems within the financial system. It could be argued that whilst the reform options that are being examined are wide reaching they do not, in many cases, bury down into the crutch of the problem. This is the '**plumbing**' of the system. I.e. how data is collated and how it flows to those bodies (i.e. the regulators) that need access to it in order to act to avoid another crisis. If the opportunity is not taken now, at this critical juncture, to address the clearly visible deficiency of substandard reporting data and the risk that this poses to the health of the financial system, it could take another crisis before it is addressed.

On a more granular level the problem has been demonstrated to be:

- The inability of banks to collate and interpret risk data of suitable quality so that they can identify risk that they are holding; and

- The inability of banks to then deliver risk data of suitable quality to regulators so that the build up of systemic risk can be monitored and mitigated. Regulators were ill-equipped to interpret what was already a poor standard of risk data

It was this inability to interpret the sheer quantity of risk data from banks that meant that the financial crisis was not identified in good time and actions taken to prevent it. There has been little change in the quality of this data since the financial crisis and consequently there remains a gaping hole in the reform of the financial system which has not yet been filled. The Draft Financial Services Bill should address this.

On a systemic level, the financial crisis exposed the weakness of the UK's financial services regulatory framework, in particular the asymmetry of information between the regulators and financial services providers and revealed the dangers of systemic risk. In effect, there was a failure on two levels:

- The banks themselves were either not able or not willing to prioritise the reporting of enterprise risk to board level. That banks were taking excessive risks during the economic boom has, in hindsight, exposed this failure of corporate governance.

- Regulators received significant amounts of data from banks but were unable to interpret it, were unable to make informed judgements and therefore unable to make decisive interventions in the market. That there was no standardised format to this data meant that in trying to build up an holistic picture of the financial system, regulators were not only trying to compare apples and pears, but oranges, bananas, and so forth.

The result was that the prudential regulatory system was not equipped to manage systemic risk. The information gap between the tripartite regulatory authorities and the financial institutions slowed the response to the financial crisis. Whilst the Government was able to step in and save RBS and HBOS, albeit at a high cost, this was undertaken without full knowledge of the risks that the banks faced, and an accurate assessment of what systemic risk their collapse would have posed to the financial system as a whole.

In the U.S. where the regulatory system suffered from the same deficiencies, a slowed response time meant that the authorities could, to all intents and purposes, only act to save one of Lehman Brothers and AIG. The decision was made to let Lehman Brothers fail, demonstrating the inability within the regulatory system to react quickly and effectively. That it was expected that Lehman would fail in the months leading up to the autumn of 2008 makes the inadequacies of the data available to regulators even more shocking.

On the issue of timing, the regularity of data submission to regulators by individual banks is of significant concern and has also not been addressed, either by ongoing reform so far or the Draft Financial Services Bill. Whilst each bank will be different, in most cases the standard can be measured in weeks rather than days and this represents a significant problem for two main reasons:

- Much can happen over the space of a few weeks and the health of a particular bank can deteriorate significantly over this time. Any risk or liquidity issues that arise in between scheduled reports will have time to get significantly worse, and require a significantly bigger response from the regulators, than if reporting was on a more frequent basis. In effect, the seeds of another financial crisis could be sown before the regulators are aware of what has happened – if indeed it is then able to interpret the data that it receives from the bank.

- When another risk event occurs, regulators will almost certainly require 'on-demand' data from banks so that the impact of the event can be analysed and act accordingly. Many banks have reporting frameworks that are an integration of data, analysis and people intervention across multiple business units. These processes rely upon manual intervention and are often difficult to change at short notice. It will take significant changes to current reporting systems within banks for this to take place. Without frequent and accurate data from the banks, the ability of the regulators to make decisive and effective interventions in the financial system is severely hindered and it may be too late for action to be taken to save a particular bank. We saw this first hand in the responses of the UK and US authorities during the financial crisis, and very little has changed since. In a worst case scenario, a regulator acting on poor data in a financial crisis could actually exacerbate the situation. The Senior Supervisors Group, which includes representatives from regulators across multiple countries, including the UK, stated in a document published at the end of 2010, that 'some firms still require days and weeks to completely aggregate risk exposures; few firms can aggregate data within a single business day."[184]

The Governor of the Bank of England has stated that there is no need for banks to provide more data to the regulators so that they can perform their regulatory duties. This may well be true – what is needed is **'better data, more often'** – that can be collected, analysed and turned into information that the regulators can act upon if required. Much of the data that is supplied by banks to regulators will mean very little to them in its current format and in effect there is a great deal of 'wastage' – i.e. data that is collected but cannot be usefully interpreted of used in any constructive way. It may well hold valuable information therein, but not enough and/or it cannot be analysed sufficiently by regulators under current circumstances. At the very least, the right data, irrespective of its timeliness in normal operations, should be accessible to the bank and the regulators 'on demand' when a risk event occurs. Ultimately, the regulators' toolkit should include the ability to predict and forecast outcomes, based on accurate and meaningful data. Currently, there are no provisions within the Bill to ensure that the regulators will have the right tools for the job.

<u>What is alarming is that the reform of the financial system since the crisis has not taken on board this crucial point.</u> Whilst political focus has been on those whose actions and deficiencies were deemed to have caused the financial crisis (see 'bankers' bonuses' and 'dismantling the tripartite regulatory authorities'), little attention has been paid to learning from the crisis and installing the systems and processes that are required to avoiding another crisis. As things stand, there is still no system in place, or indeed no obligation within the Draft Financial Services Bill to establish such a system, to monitor the build up of risk across the financial system, despite the financial crisis demonstrating that such a resource was badly

[184] "Observations on Developments in Risk Appetite Frameworks & IT Infrastructure", Senior Supervisors Group, P10

missed. As set out in Intellect's response to Question 2), this is an issue that the US has taken note of, and acted upon.

How does this apply to consideration of the Draft Financial Services Bill?

Intellect is aware that this could be interpreted as an operational issue and not warrant inclusion in the provisions of the Draft Financial Services Bill. However, it is the case that unless there is provision within legislation or directive from a regulator to establish a means to receive better data from banks, the banks themselves will not voluntarily reform their own risk frameworks to a suitable standard.

The issue of 'better data' cannot be left to the banks themselves to address under their own volition. Francis Gross, Head of External Statistics at the European Central Bank has stated that regulators must be driving change in standards for reference data if it is going to happen, as relying on the banks to do so would be like "*asking cats to herd themselves*". On a high level, the complexity of the global financial services industry and the products within it have themselves provided something of an opacity which is directly responsible for complicating the task of viewing the whole of the financial services system, and assessing risk therein. There is currently very little motivation for financial services institutions to reduce this opacity as a lack of transparency is conducive to the development of complex and, by that measure, profitable products. In short, it is good for business.

Other sectors, such as pharma, aerospace and the chemicals industry have all increased their own transparency through regulator-enforced modernisation. Within both the pharma and chemicals industries, companies are legally responsible for the quality of the data that they send to the regulator. If it falls below the required standard, legal sanctions become an option. There is no such legal requirement within the financial services sector and as such the quality is below the required level, and there is little motivation for banks to rectify this situation.

That regulators are only starting to appreciate that there are significant holes in the data that banks collect and that they receive, means that legislation – specifically the Draft Financial Services Bill – is required to ensure that regulators are armed with the right tools, and that these tools are available in the medium, rather than long term.

There is currently no provision within the Draft Bill that requires the regulatory authorities to undertake a process of evaluation of the tools that they will require in order to fulfil their financial stability objectives (yet there appears to be very detailed provisions setting out how, and in what format the FPC should deliver financial stability reports – an end result).

In order to ascertain whether or not the provisions within the Draft Financial Services Bill are adequate to prevent another crisis, there needs to be greater consideration of precisely HOW the regulators will fulfil their duties. This is set out in response to Q9, below.

Therefore, Intellect believes there should be a number of key additions to the draft Bill under consideration by the Joint Committee:

- **A requirement for the regulatory authorities to conduct an evaluation (or gap analysis) of the tools it needs to fulfil their financial stability vs current capability within a specified timeframe of its existence**

- **A legal requirement for regulators to review their risk monitoring capabilities on a periodic basis. Risk issues and the ability of technology to assist monitoring these issues change, and the abilities of regulators should also change to reflect this**

- **Legal obligations for banks to meet the prescribed standard of risk data, as established by the regulators, following their evaluation of their required tools**

- **Legal provision for the establishment of an Office for the Chief Information Officer, within the regulatory architecture, to ensure that risk data standards are improved and maintained by financial institutions**

Question responses

Intellect's response to specific questions set by the Joint Committee (below) will build on the above issue. Please note: Intellect has not responded to all questions set by the Joint Committee.

Q2. What lessons can be learnt from the approach of other countries to regulation of the financial sector?

In the United States the Office of Financial Research (OFR) has been established within the US Treasury Department, as a result of the Dodd-Frank Bill. Its remit is to improve the quality of reference data available to policymakers and facilitate more robust and sophisticated analysis of the financial system. In effect, the OFR is permitted by law to demand data from financial companies including banks, hedge funds, private-equity firms and brokerages. It would be able to track information such as counterparties for credit-default swaps and would, crucially, afford regulators the sort of system-wide overview (including darker parts of the market) that will allow it to identify when and where there is a risk to financial stability. The OFR also has the authority to set out new legislation based upon its findings. All this, and the fact that the OFR has recently started defining reporting standards for the financial community, puts it way ahead of the FPC in terms of establishing tools to head off the next financial crisis.

On a more general level, US regulators are significantly ahead of their UK counterparts in terms of their attitude towards setting standards for data. The Commodity Futures Trading Commission (CTFC) has recently set up a sub-committee to help develop accepted standards for describing, communicating and storing data on complex financial products. Members range from traditional operators in the financial system such as Barclays Capital, Thomson Reuters and Citi, through to data experts such as Google. This is indicative of the importance that regulators are attaching to the better management of data as a means to protect the US financial system from risk.

In the US it was appreciated that implementing root and branch reforms to reporting systems in each bank, along a standardised format, is a significant task and as such it is

something that had been avoided since the financial crisis. Banks will not advocate such change because of the cost and disruption it would bring to their businesses, and regulators are largely unaware of the deficiencies in the data that they are receiving. Consequently, there is nobody driving change to this systemic deficiency. The establishment of the OFR was an acknowledgement that change would only come if it was driven by a specific body or vehicle. It would not be the banks or the regulators, so legislation became the driver for change. There is a significant lesson here for the UK.

On a European level the European Systemic Risk Board (ESRB) was established, again by law, in December 2010 under the auspices of the European Central Bank and has a similar function to the OFR. Whilst it is not yet as advanced as the OFR in terms of its use of data, it is also still way ahead of the UK as it has acknowledged that data standards that will allow it to collate information from 75 different member organisations (including the ECB, the EU national central banks and EU national regulatory authorities amongst others) are not sufficient to allow it to undertake its role effectively.

That both these institutions and the Bank of International Settlements have acknowledged that current data standards are insufficient to afford regulators the necessary tools to identify the build up of systemic risk should be heeded by policy makers in the UK and acted upon now, whilst the regulatory system is being reformed.

Q9. Can Parliament take an informed decision about the proposals for the FPC without details of the macro-prudential tools at its disposal?

Intellect does not believe that Parliament can adequately scrutinise the proposals for the FPC without additional details on the tools that the FPC will rely upon, being set out in greater detail.

If the Joint Committee is to effectively evaluate the provisions of the Bill, in particular how achievable objectives of the regulatory authorities are and indeed how they will work together without hindering one-another, it is essential that the details of the tools at their disposal are available to Parliament. However, Intellect does believe that the gap analysis that the FPC should be undertaking to ascertain what, precisely, it needs to fulfil its financial stability objectives, has yet to be undertaken fully.

There needs to be a concerted period of introspection and evaluation on the part of the FPC where it can identify what monitoring capabilities it wants to have in three or four years time. Once it has identified the capabilities that will allow it to perform its stated objective of effectively monitoring and mitigating risk, it can prescribe the 'reverse engineering' of the relevant system and processes.

As HM Treasury has stated in one of the many documents leading to this Draft Bill, '*the crisis was caused by the failure... of regulators to spot the risks that were building up across the system as a whole'*[185].

The Bank for International Settlements recently stated that "*The recent financial crisis highlighted shortcomings in policymakers' ability to measure systemic risk. Gaps are evident in both the analytical framework and the available firm-level and aggregate data that policymakers and*

[185] 'A new approach to financial regulation: judgment, focus and stability, HM Treasury, p3

market participants use in making decisions. These gaps hinder market participants in pricing and managing risk and policymakers in monitoring and responding to vulnerabilities. This experience should prompt improvements in macro surveillance and data collection.'[186]

However, Intellect believes that there should be provision within the Bill for the FPC to undertake such a task, and to periodically review their risk monitoring capabilities in line with the changing nature of the financial system, the banks within it and the technology that underpins all risk monitoring.

As this response sets out, the regulatory failings that the last financial crisis illustrated in terms of corporate governance and the monitoring of systemic and institutional, risk have not been addressed by regulatory responses to the financial crisis to date, nor in this Draft Bill. If the FPC is to be able to fulfil their objectives of ensuring financial stability by monitoring and mitigating risk, there needs to be an explanation of the tools through which this will be achieved and adequate scrutiny by the Joint Committee on the practicality of these proposals. This is as opposed to an assumption by Government that the right tools will be put in place and used. The right tools were not in place for the regulators during the last financial crisis. Merely setting the broad objective of mitigating future crises is not sufficient for the Bill to be effective and will not allow for effective Parliamentary scrutiny of the adequacy of the Draft Bill.

Q.12 Are there any risks in the Government's proposed 'judgement-based' regulation?

As HM Treasury states its blueprint for reform, 'The PRA's approach to supervision will be judgement-led. The nature and intensity of supervision will depend on the risks posed by each firm; while every firm will be subject to a baseline level of supervision to promote and support their soundness and resilience, supervisory effort and resource will focus particularly on 'big picture' issues with potential systemic impact.'

Rules-based regulation has a tendency to be static. A supervisory approach where the regulator is closer to the banks' own data rather than acting upon reports responding to rules, tends to deliver a more dynamic regulatory framework that can adjust to changing risks and market conditions. However, Intellect believes that the robustness of the PRA's judgement-based regulation could be called into question, if it is not able to receive accurate, useful or timely data from individual banks. Therefore as it is the PRA responsible for extracting and interpreting the risk information from individual banks, there should be adequate provision within the Bill to ensure a minimum standard of granularity and accuracy of risk information that is collected by banks and shared with the PRA. The Canadian supervisory framework is a good basis for a principles-based regulatory regime.

It must also be noted that if the information received by the PRA is substandard, this will also affect the ability of the FPC to undertake its own financial stability role, using the aggregated data that the PRA receives.

[186] 'BIS Annual Report 2010/11', Bank for International Settlements, p83

Q13. Is the Government's proposed approach to 'orderly' firm failure satisfactory?

This question can only really be answered when the ICB publishes its final report, and the Government makes a decision about what elements will be implemented and what will not.

Currently there appears to be a number of different organisations all working towards the same end result – the continued provision of banking and payments services for consumers in the event of a failure of a bank. The concept of a ring fence for a retail bank that is currently being evaluated by the ICB (and indeed which has been publically backed by the Chancellor of the Exchequer) is to all intents and purposes, fulfilling the same function as Living Wills.

It could be argued (as Intellect has done in our responses to the Independent Commission on Banking) that the creation of a ring fence for retail banking operations is a costly duplication of effort that will not make retail banking operations any safer or allow for any more 'orderly' firm failure. In fact it could be argued that the division of capital and liquidity – and the concentration of risk into a smaller business unit – increases the riskiness of the retail banking arm and stifles its ability to support economic growth.

Q14. Given that the PRA and the FCA will inherit FSA staff does the draft Bill do enough to ensure a new regulatory culture and a more proactive approach to regulation? Will these two new bodies have staff with the appropriate skill and expertise?

If the PRA is to be able to investigate and tackle risks/vulnerabilities in individual firms, it must understand how people, processes and technology within each firm works, and how changing them can tackle existing risks, but also create new ones. For an industry like financial services that is built upon a platform of technology, it is critical that regulatory authorities are equipped with a full understanding of technology and how its application affects business decisions and the implementation of regulation.

In the case of the PRA, it will be almost impossible for it to set lasting 'rules' effectively, exercise judgement over authorisation issues and, on a wider level, lead on prudential regulatory issues if it does not have a detailed understanding of the technology that not only underpins existing banking institutions, but which drives changes to financial providers' operations and strategies.

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

Similarly, if the FCA is to discharge its objectives effectively, it is essential that it understands how individual bank's operations run and how this affects the service that is delivered to the consumer.

Issues such as lack of consumer choice, high charges for credit and barriers to entry for new market entrants to the financial services industry can all be mitigated to a greater degree by the correct application of technology. It is important therefore that if the FCA is able to protect consumers and ensure market integrity, it has a detailed understanding of the role that technology can, and indeed is, already playing in this sphere. On the other side of the equation, it is equally important that the FCA has an understanding of technology within financial services so that it can identify when, directly or indirectly, it contributes to risk to consumers and the market.

Q17. Does the draft Bill strike the right balance between the responsibilities of consumers and firms? Are the FCA's new powers in the area of consumer protection appropriate?

In the case of the FCA which has responsibility for assessing complaints and mass detriment, consideration should be given to taking quantitative market feedback from social media. Tools now exist to gain valuable insight about firms and products that can offer early an indication of product or service issues causing consumer detriment. Again, the Bill does not sufficiently outline what tools will be at the disposal of the FCA – to the detriment of Parliamentary scrutiny of the Draft Bill.

Q19. Will the new regulatory arrangements reduce the risk and cost of dealing with miss-selling of financial products?

Reducing the opacity of the financial system will have the effect of reducing miss-selling of financial products. As transparency is increased, as will the effectiveness of regulatory scrutiny of financial products and their impact upon consumers.

Q22. Does the draft Bill contain any proposals or omissions, not covered by the questions above, which cause concern?

As an omission from the provisions of the Bill, Intellect believes that the FPC should consider the appointment of a Chief Information Officer (CIO) with responsibility for data integrity and governance of the regulators and assessment of individual firms' own data quality and governance. Regulatory bodies need to view risk from three perspectives – how it is measured; how it is managed; and how it is governed. Consequently the regulatory bodies need to have the resources to fairly assess a financial services providers' ability along all three of these dimensions.

Provision for a CIO within the FPC, will allow the PRA and the FPC receive the right data upon which actionable information can be drawn, such as:

- how good the data and the models within in each institution are;
- how well informed the firm's management is;
- how well thought out the hedges, mitigants and action plans in simulated crises are;
- how can they ensure that the right actions are taken at the right times

As Intellect hopes this response to the Joint Committee's call for evidence has demonstrated, the quality and availability of risk data from financial services providers to regulators was a significant contributory factor to the severity and depth of the last financial

crisis and is a key issue that the draft Financial Services Bill must address. A department within the new regulatory architecture responsible for assuring this data quality is essential for the regulators to be effective.

Conclusions

Intellect believes that the Joint Committee should allocate some of its time to scrutinising:

- The specific tools that the FPC will be using to fulfil its financial stability objectives – do these address the failures that the financial crisis demonstrated
- How it can be ensured the PRA will receive suitable data from banks that will allow it to make sound judgement-based regulation
- If there can be a legal basis, as there is in other industries of lesser economic importance, for obligations to submit high standards of data to regulatory authorities
- If an office needs to be established to ensure that regulators receive the correct standard of information from banks so that they can perform their duties

September 2011

International Regulatory Strategy Group; Association of British Credit Unions Limited (ABCUL); Association of Financial Mutuals; Building Societies Association; Association of Independent Financial Advisers; Institute of Financial Planning; Financial Services Practitioner Panel; FSA Smaller Businesses Practitioner Panel; Financial Services Consumer Panel and Office of the Complaints Commissioner – oral evidence (QQ 438-557)

Transcript to be found under Association of British Credit Unions Limited

Investment Management Association (IMA) – written evidence

Executive Summary

- It is logical in principle to separate prudential and conduct regulation as the objectives of the two are different and can be in conflict. IMA members expect to be regulated on both by the FCA.
- While it is right that the regulators should be completely independent in exercising their supervisory responsibilities there is a need for a clear mechanism for holding them to account over the way in which they do so.
- The sweeping power accorded to the PRA to veto decisions by the FCA has the effect of prioritising stability over consumer protection. Although this may be appropriate on occasion, the power should be more limited in scope and made more transparent. For example, we believe that it should be for the Treasury, and not the PRA itself, to determine whether or not the basis for a decision to veto an FCA decision should be published.
- The scope of the Bill needs to be clarified - while we expect all asset management firms to be regulated by the FCA this requires confirmation.
- The FCA's objectives are broadly correct but its remit does need to be extended to include competitiveness so as not to put the UK at a disadvantage to other jurisdictions, for example when it comes to domiciling/re-domiciling funds.
- The current Financial Services Compensation Scheme needs radical re-design. The enabling powers in the Bill need to reflect this.
- There should be an independent complaints commissioner - appointed by the Treasury - to deal with all complaints about the PRA and FCA.
- The Bill also provides an opportunity for more radical reform and this has perhaps not been fully taken advantage of. For example, the "permissions" regime and Regulated Activities Order are not only out of date but are not in line with EU legislation which is what drives the operating environment for financial services firms today.

1. ***Is the separation of prudential and conduct regulation into a "twin peaks" system the right approach?***

In one sense there is no such clear division in the proposed regime. The majority of firms will still have FCA as the sole regulator. The division is more generally one of separating out those firms whose balance sheet design is such that they need monitoring against distinct objectives because of the level of their potential exposure to disorderly failure and participation in systemic instability. That distinction both underlies the proposed scope and causes the existing uncertainty as to where some firms will end up. In answering this and other questions, it would have been helpful to have seen a draft of the proposed scope order (clause 6 and new section 3G). We are expecting all asset management firms to be supervised by the FCA, but would welcome confirmation; and we think that insurance subsidiaries of asset management firms, which exist only to provide wrappers for pooled investments, do not need to be regulated by the PRA.

That said, there is clear logic in separating prudential and conduct regulation. The objectives of the two are completely different and can be in conflict. It is in the nature of prudential regulation that it pays scant attention to mis-selling and investor protection. Indeed until 2009 the FSA did not fully regulate retail conduct of business by banks, although it did do so

for other distribution channels – direct sales, IFAs, wealth managers, and so on. This reflects a historic lack of engagement by banking regulators with consumer protection issues.

We therefore welcome the proposal for the same regulator to address conduct issues across the board. We return to the question of potential conflict of interest in response to question 4 below.

2. ***What lessons can be learnt from the approach of other countries to regulation of the financial sector?***

We do not think there are many relevant comparators internationally, given the size and complexity of the UK financial sector. The nearest equivalent is the US, where regulation is far more fragmented than in the UK.

3. ***Is it appropriate to make such major changes to the regulatory system by way of amending legislation, rather than starting afresh?***

We do not question the structure the draftsman has chosen. But as a practical matter it does make it difficult and confusing in navigating one's way around such a complex piece of legislation. More generally, it is important that the approach of the new regulators be unconstrained by the past even as it is informed by it.

There is one area however where a completely fresh start needs to be made. The current structure of permissions and the Regulated Activities Order is no longer it for purpose. It stems from legislation which predates the establishment of the FSA and fails to reflect the EU-based rules under which financial firms nowadays operate.

The result is that firms are required to obtain multiple permissions in order to carry out what is in fact a single activity (for example, managing a collective investment scheme). The result is not simply cost and confusion for regulated firms, but also greater difficulty in tailoring rules to different sectors. For example, when the Treasury introduced the bank payroll tax, it sought to define target institutions on the basis of FSA permissions, which meant that a large number of other firms would have been brought within its net without an elaborate exercise to ensure that not covered by the policy were in fact excluded. The Regulated Activities Order is in need of a fundamental overhaul.

4. ***Are the accountability and governance arrangements for the Bank of England, FPC, PRA and FCA satisfactory?***

We believe steps need to be taken to improve the accountability of the regulators for the way in which they discharge their responsibilities. It is of course right and proper that the regulators should be completely independent in the exercise of their judgment; there should be no room for Government or Parliament in the process of supervision and enforcement.

But the regulators need to be held to account for how well they have met their statutory duties. For example, in the last three years defaults by FSA-regulated investment intermediaries (including, but not exclusively, Keydata Investment Services) have led to some £460 million of compensation under the Financial Services Compensation Scheme. These have entailed significant costs for other firms who for the most part had no connection with the activities giving rise to the compensation claims. While it is accepted that there should not be a "zero failure" regime, and that where compensation is due it is properly for the industry, not the taxpayer, to fund, it is reasonable to ask:

- Whether the losses by investors, and the consequent compensation bills, could have been reduced by earlier regulatory intervention; and
- What lessons the regulator should learn for the future.

While it is welcome that there will be a duty on the each regulator to investigate itself, there appears however to be no mechanism by which these questions can be subjected to independent scrutiny, short of the "nuclear" option of an independent Treasury-initiated review under section 14 of FSMA. (That power does not extend to the regulation of clearing houses now that is moved to the Bank of England and it is unclear why there should be such an omission.)

We are of the view there should be a single independently appointed **complaints commissioner** able to determine all FCA and PRA complaints; this would prevent co-ordination complaints falling between two stools. The appointment and removal should be by the Treasury.

We would like to see a more public role for the **non-executive directors** of the regulators. This could in part occur at the Annual Public Meeting but also we would like to see fuller discussions of the FCA Board's reasoning for supporting or opposing specific rule changes. Dissenting comments should be recorded. Commonly we find the publication by the SEC of supporting and dissenting positions on regulatory issues very helpful; the publication of voting by members of the Monetary Policy Committee provides another precedent.

We note as regards **annual reports** the PRA must carry out a public consultation but have no annual public meeting, whilst FCA must have such a meeting but are not required to consult. We are not convinced that there is a good policy reason for such differences.

Finally the new powers place an even greater burden on the FCA to ensure that its internal processes are of the highest standards. A number of changes were introduced by the FSA in the wake of the enforcement process review following criticisms made by the Financial Services and Markets Tribunal (as it was) in the Legal & General case, including the separation of supervision and enforcement from the **Regulatory Decisions Committee**. But the speed at which the FCA may be expected to act in relation to some of its new powers demands a much more explicit statement of the processes and protections be put in place (or preserved in the transition from the FSA).

We have a particular concern about the power in section 3H for the **PRA to veto proposed actions by the FCA**. As noted above, the interests of a prudential and a conduct regulator respectively may sometimes be in conflict. Section 3H in effect provides that in such an event financial stability considerations shall always override consumer detriment. We welcome the provision in section 3J for the details to be laid before Parliament, which would allow public debate of the case. But section 3J (7) gives the PRA sole right to determine that publication would be against the public interest. We believe this places far too much power in the PRA's hands, and that non-publication should be subject to a much more rigorous test.

Section 3H would seem to apply even in cases where the FCA is the competent authority for the purpose of consolidated supervision – for example in the case of an insurance company owned by an asset management firm. We see no reason why the PRA should have an override power in such cases.

Nor is it acceptable that PRA might veto a decision by FCA to prosecute.

5. ***Are the FPC's objectives the right ones? Is the concept of financial stability adequately understood for the FPC to be able to perform against its objectives?***

We do not have any specific comments about the objectives of the FPC as set out in section 9C. Any actions to dampen shocks or manage credit bubbles would be welcome.

We welcome new section 9E(2), the duty to seek to avoid prejudicing the advancing by the FCA and PRA of their objectives. New section 9E(3)(c) is also welcome, the need to have regard to the international obligations of the UK; this is a concept we would like to see advanced to the FCA (and PRA).

6. ***Should the FPC be limited in the actions it can take which might affect the growth of the financial sector?***
7. ***How will the interaction between macro-prudential and monetary policies be handled by the FPC and the MPC?***
8. ***Has the right balance been struck between the powers of the FPC and the powers of the Treasury?***
9. ***Can Parliament take an informed decision about the proposals for the FPC without details of the macro-prudential tools at its disposal?***

We would suggest that there should be clarity as to what tools FPC would have in practice. Presently, the very existence of the FPC and the market intelligence gathering needed to support it, is likely to provide benefits to the regulatory system compared to the recent past even if there are few tools at its disposal.

10. ***Does the draft Bill adequately deal with the risks posed by the shadow banking system?***

The wide remit of the FPC and the objectives of the PRA should be sufficient to deal with any perceived risks. The actions that might need to be taken would likely have to be globally co-ordinated by their very nature. If it were felt UK components of the shadow banking system were insufficiently or inappropriately regulated then the scope of PRA-regulated activities could be altered by order.

11. ***Are the PRA's objectives clear and appropriate?***

We question whether the PRA's objectives are too focussed upon the UK. We would expect a provision such as at new section 9E(3)(c) for the FPC to be replicated in new section 2B.

12. ***Are there any risks in the Government's proposed 'judgement-based' regulation?***

Yes. Our concern of course extends to the quality of supervision and competence of those who might judge, but this is a issue of management style and culture ultimately. Our real fear is that FCA will approach issues "through a single lens" as may have occurred in the past with, for example, the Treating Customers Fairly initiative. TCF is a proper standard and a useful tool but it cannot be the sole lens through which other supervisory judgements are made.

13. ***Is the Government's proposed approach to 'orderly' firm failure satisfactory?***

Firms should be allowed to fail, however just because some firms fail, it should not be concluded that the regime is flawed. But on the contrary when a firm does fail it should not be seen as a confirmation that the regime has operated successfully. Firm failure is not evidence of regime failure but neither should it ever be a badge of success. Therefore the prudential requirements placed upon all firms must seek to ensure that they could absorb

significant losses before failure and the consequent cost that falls on the same industry through the FSCS.

In terms of crisis management, the original separation of powers between FSA and the Bank of England under section 7 of the Banking Act 2009 is arguably diminished by the PRA and the Bank of England now needing to consult one another and for the PRA to agree that the threshold conditions are no longer met. Given the policy behind section 7 was to use FSA as a safeguard, the Government should review the impact of this function being transferred to a subsidiary of the Bank of England.

We also think that the provisions on recovery and resolution plans and other crisis management issues have not sufficiently considered the role of the FCA as the body principally responsible for client asset protection policy. Orderly failure will demand thought is given beforehand to client assets (as the FSA is currently proposing) and that area is the preserve of FCA.

14. Given that the PRA and the FCA will inherit FSA staff does the draft Bill do enough to ensure a new regulatory culture and a more proactive approach to regulation? Will these two new bodies have staff with the appropriate skill and expertise?

We agree that this will be a real challenge for both regulators. These questions are however fundamentally for management to address, not legislation.

15. Are the FCA's primary objectives appropriate? Is significant emphasis given to the promotion of competition?

We agree broadly with the three objectives as currently stated. However we believe they need to be augmented by requiring it to ensure that the UK does not suffer competitive disadvantage relative to other countries (a different point from the promotion of competition where we are broadly happy with the Government's proposal). Examples of this are quite common in the funds world. For example, the FSA's rules are in some respects more stringent than those of other EU jurisdictions such as Dublin and Luxembourg, whose funds may nevertheless be distributed in the UK with an EU passport. Thus the FSA rules have the perverse effect that funds which would otherwise be based in the UK (and within the FSA's jurisdiction) are instead based in Luxembourg, with no benefit in terms of investor protection. An explicit competitiveness remit would help to counter such absurd situations.

16. Are the responsibilities of the FCA towards the regulation of markets appropriate?

Yes. The Government's White Paper Cm 8083 refers at several points (for example paragraph 1.40) to users of financial markets, such as institutional investors, being "consumers". While we welcome the implicit acknowledgement that investors (the "buy side" of the market) are in a very different position from the "sell side" it is important that this should not translate into any suggestion that comparable levels of investor protection regulation are appropriate. Wholesale investors are in a completely different position from retail ones, and this needs to continue to be recognised.

17. Does the draft Bill strike the right balance between the responsibilities of consumers and firms? Are the FCA's new powers in the area of consumer protection appropriate?

We support proposals for a step change in consumer protection; we were the first body to call for an increase in the levels of deposit protection during the crisis and we supported the introduction of the consumer redress scheme powers.

Nevertheless the new section 137C (product intervention) is almost unlimited in its width. While we understand that there is a need to consider product intervention on a much more proactive basis, the proposed clauses give unprecedented power to the FCA. We think there is still a need for greater thought about how it might operate especially in relation to authorised persons providing cross border services and with contracts formed under the laws of other countries. Alongside a legitimate concern to ensure that consumers do not suffer detriment, there is a need to provide some level of legal certainty so as not to deter all product innovation in the UK.

18. ***Are the prudential regulatory responsibilities of the FCA towards FCA-only regulated firms given sufficient emphasis and detail?***

We think this is satisfactory; the real issue lies with ensuring prudential debates in Europe are informed from an investment firm perspective and not merely that of banks. We should record however that our interaction with CEBS over the remuneration principles was entirely positive.

19. ***Will the new regulatory arrangements reduce the risk and cost of dealing with miss-selling of financial products?***

It is to be hoped that bringing all retail conduct of business regulation together in a dedicated regulator will mean the application of uniform standards to all distribution channels. Up to now most of the focus of regulation, for example the Retail Distribution Review, has been on independent financial advice, but there have been several instances in recent years of mis-selling in non-advised sales environments. The new arrangements may, if effective, offer the prospect of improved standards.

20. ***Are the proposals for co-ordination between the PRA and FCA clear and adequate? What would be the advantages and disadvantages of having a Single Point of Contact and/or a joint rule book for dual-regulated firms?***

Where rules derive from EU directives impacting firms in FCA and PRA, such as the capital requirements directive, there will be a need to preserve a consistent and coherent approach. But in practice we expect this will be more relevant to the exercise of supervisory judgments than an issue for the rules themselves.

Otherwise, the number of FSA rules impacting investment managers which are wholly domestic in origin is not large. This will become even more apparent as the European Supervisory Authorities address harmonisation across the Single Market.

We think it vital that the desire of the FCA to have better market intelligence does not lead to duplication by it (or the PRA) of work conducted at the Bank of England. We consider that the market intelligence unit of the Bank of England is likely to be the central place for a large part of the market intelligence that needs to be gathered. It should share that intelligence with the regulators.

21. ***How do the proposals in the draft Bill fit within the new European regulatory regime? What freedoms and constraints will the UK have to operate within that regime?***

There is not a perfect match between the PRA/FCA and the new European regulatory authorities, which are sectoral rather than functional in nature. For the reasons given in response to questions 1 and 19 above, we believe that the proposed UK structure has significant advantages over the EU one.

But it will present significant challenges for the new UK regulators, since there will be only one seat on the Board of each: for the PRA in the case of the European Banking Authority and European Insurance and Occupational Pensions Authority, and FCA in the case of the European Securities and Market Authority. It will require the PRA to liaise closely with the FCA on conduct issues within EBA and EIOPA; equally FCA will have to ensure it seeks input from the Bank of England on markets and exchanges.

We consider that this inconvenience is significantly outweighed by the benefits of having a single integrated conduct regulator.

22. ***Does the draft Bill contain any proposals or omissions, not covered by the questions above, which cause concern?***

We have concerns about the proposals for the **financial services compensation scheme** (Clause 33 of the draft Bill). This provides broadly similar powers to make a scheme as in FSMA, but split between the FCA and PRA. It is unclear how this responsibility will be divided between the two, or how differences of view will be resolved. Our understanding is that it is the intention that the two regulators would respectively make rules for different parts of the scheme. We are unconvinced that the high level co-operation duties will be sufficient to ensure a joined-up set of rules.

We fear that regulators making different rules about different parts of the scheme could result in a *de facto* separation into two schemes, one for PRA firms and one for FCA firms. In that event it could be that investment managers became liable for all mis-selling compensation under FCA jurisdiction, including those of products of PRA firms like banks and life insurers, and not just those in respect of investment products. This would be unacceptable.

The FSA have said that they plan to review the operation and funding of the present scheme. Our experience of the Keydata case (see response to question 4 above) has led us to the conclusion that in its present form it contains significant flaws, particularly as regards the arrangement for cross-subsidy between different levy-paying classes, and we have opened a dialogue with the FSA about this.

Our principal point is that if one group of firms is to be asked to cross-subsidise a default giving rise to compensation, there needs to be a reasonable degree of affinity between that group and the firm where the default took place. Otherwise the liability for cross-subsidy should extend across all firms covered by the scheme.

Many investment managers are manufacturers of an approved product – a UK authorised fund. We believe they should ring-fenced from any liability resulting from actions of firms which intermediate securities. At present there appears to be better regulatory treatment in terms of FSCS risks for a firm that manufactures a fund in continental Europe and passports it in to the UK than vice versa.

The historic problem with the FSCS sub-classes partly arises because most classes are organised on a manufacturer/distributor basis – insurance and mortgages are such examples. The issue with investments is that most manufacturers are issuers (PLCs and SPVs) and so not within the FSCS ambit. As a result the existing rules require fund manufacturers to be the sole subsidising body for distributors of a range of products unconnected with funds.

We believe this is fundamentally wrong and is detrimental to the UK as a fund management centre. To avoid this we believe that the powers in Clause 33 should be limited so as to require that rules should meet the following criteria:

- No firm shall be required to cross-subsidise a failure in another unless there is affinity between the products and services concerned
- Where no such affinity exists, and cross-subsidy is necessary, a levy shall be applied to all firms covered by PRA or FCA.

The role of the FSCS is such that its governance and powers should be reviewed. The size and nature of its role in compensation and resolution suggest that it should be seen as a stand-alone entity whose rules are made or approved by the Treasury, not by the regulators. We also consider that:

- FSCS should have its own rule-making powers to facilitate its activities, for example in relation to single customer views and other preparedness issues.
- Based on our experience of the Keydata debacle, we consider that, alongside investors being compensated, the FSCS should have power to review firms who might contribute to the ultimate funding of the losses, or to require FCA so to act.
- While the FSCS will commonly pay out investors upon a default, it should be within its powers (perhaps exceptionally) to "wait and see". This might involve a declaration that a person has suffered detriment but that payment of some or all of the compensation can await what happens to a product. Thus if they bought a 5 year bond and expected no payout until year 5, it may be appropriate to wait until the maturity date before paying compensation, since the underlying investment may have recovered to the point where it can pay out, notwithstanding that an intermediary has defaulted.

All these points stem from our belief that the FSCS should be seen as a mature body in the regulatory system and not merely as a mechanical implementer of rules made at a time when (as will always occur) some events were just not foreseen.

September 2011

Investment Management Association; British Private Equity and Venture Capital Association (BVCA); Association of Private Client Investment Managers; Association for Financial Markets in Europe (AFME); and National Association of Pension Funds – oral evidence (QQ 351-437)

Transcript to be found under AFME

Investment Management Association – supplementary written evidence

1. During the evidence session involving IMA[187] Chief Executive Richard Saunders, various questions and comments were made concerning defined contribution (DC) schemes. This supplementary memorandum provides some additional information in the hope it will assist the Committee in its deliberations.

2. UK private sector work-based pension provision has historically been focused on what are legally defined as occupational (trust-based) schemes. In this respect, the legislative and regulatory framework broadly fitted the traditional 'three pillar' pensions model:

    - The state pension was in the first pillar.

    - Occupational pensions were classed as the second pillar and regulated by the Pensions Regulator (TPR) which replaced the Occupational Pensions Regulatory Authority (OPRA).

    - Private (effectively retail) pensions were classed as the third pillar and primarily regulated by the Financial Services Authority (FSA).

3. The major complication that has arisen in the last decade has been the emergence of contract-based provision in the workplace, which has effectively blurred the distinction between the second and third pillars. It has introduced a model of employer-based pensions provision where the product appears retail (and may in most respects be identical to that offered in the retail market), but the distribution is still much more institutional, operating via the employer and different kinds of adviser and/or consultant. For the end beneficiary, a trust-based and contract-based DC scheme may look virtually identical. Indeed, in essence, they are the same, even if the governance and protection frameworks are wholly different.

<u>How to regulate workplace DC?</u>

For regulators, the current situation is not as simple as a compartmentalisation between contract-based (falling to the FSA) and trust-based provision (falling to TPR). TPR has significant responsibilities in a number of areas such as compliance with stakeholder pension regulation, pension scheme administration and broader employer compliance, particularly in the context of the automatic enrolment initiative scheduled to being in 2012. The potential complexities in this area have been addressed in a memorandum of understanding between the FSA and TPR

[187] The IMA represents the asset management industry operating in the UK. Our members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the in-house managers of occupational pension schemes. They are responsible for the management of nearly £4 trillion of assets in this country. These include authorised investment funds, institutional funds (eg. pensions and life funds), private client accounts and a wide range of pooled investment vehicles.

4. The Table below illustrates the IMA's understanding of the main areas of FSA and TPR responsibilities with respect to pensions provision:

Pension Provision	**FSA**	**TPR**
Occupational pension schemes (OPS)	☑ The FSA regulates UK-based asset and fund management firms and personnel who provide the investment components of different forms of pension. ☑ The FSA regulates many but not all of the constituent investment components (eg. UK fund managers are FSA-regulated, but the investment vehicle may not be if it is overseas-domiciled).	☑ TPR regulates OPS, including scheme administration. ☑ TPR has responsibility for employer compliance with regulatory requirements (eg. falling behind with contributions). ☑ TPR works with schemes and is engaged in the process of promoting improved standards of governance.
Personal pensions, including group personal pensions (GPP) and stakeholder products	☑ The FSA regulates the marketing and sales of personal pension and annuity products through Conduct of Business (COB) rules. ☑ The FSA regulates the prudential risks associated with pension product and annuity provision. ☑ The points made above regarding regulation of asset and fund management firms, personnel and products hold true here as well.	☑ Stakeholder schemes have to be registered with TPR, which is also responsible for enforcing the conditions that define a stakeholder pension and allow it to be registered. ☑ TPR has responsibility for employer compliance with regulatory requirements (eg. falling behind with contributions). ☑ TPR works with schemes and is engaged in the process of promoting improved standards of governance.

5. A more complete summary of the respective responsibilities in this area can be found in a joint publication of the FSA and TPR in November 2007 entitled "A guide on the regulation of workplace contract-based pensions". The section entitled "Roles in GPP regulation" explains that, where risk relates primarily to GPPs only or there are problems with the employer, then TPR is likely to take the lead; but if risks apply across a provider's whole personal pension portfolio, then the FSA is likely to take the lead. The paper also provides helpful examples of where one, both or neither regulator might get involved.

6. The overlap, as well as the similarity of issues facing different forms of DC provision, has led to calls in some quarters for a single regulator. This could help to address

the inconsistencies that can arise from the anomaly that certain forms of provision (contract-based DC and trust-based DC) which are fundamentally similar are subject to different regulatory frameworks. And at least in relation to the guide referred to above, there is still reference to an FSA approach moving more towards principles-based regulation which may point to a need to look again at how the regulators relate in the more intrusive approach expected from the Financial Conduct Authority (FCA).

7. Other factors to take into account include the following:

   - The IMA believes that some of the central challenges in ensuring good outcomes for individuals in workplace or private pension saving have little to do with regulatory structure. They have to do with governance questions, which we discuss in further detail below.

   - With the advent of flexible benefit platforms and evidence of employee interest in non-pension workplace savings (eg. workplace ISAs), the separation of regulation for certain forms of long-term saving from other parts of the market may not be optimal even in the near term. Indeed, it is given that key components of the value chain, such as investment managers and IFAs will always be FSA-/FCA-regulated even were there to be a "single" pension regulator.

<u>The governance challenges of DC pension schemes</u>

8. The IMA does not accept that contract-based schemes are inherently inferior to trust-based schemes, and that consumers are at greater risk of detriment as a result of the different delivery structure. Nor does it appear to the IMA that the FSA or TPR are currently failing in their duties towards the protection of pension savers.

9. However, there are delivery challenges in both trust-based and contract-based schemes. These challenges stem primarily from three sets of issues: combined contribution levels that are far below those of DB pensions; different views over the most appropriate investment strategy; and uneven charging levels, partly resulting from the distribution structures of the UK pensions market.

10. The question of charging levels has already partly been addressed by Government intervention to create what has become the National Employment Savings Trust (NEST). By putting scale and distribution at the heart of the debate, the proposals are likely to lead to significant change in the UK pensions market, which will ultimately benefit consumers. While an extension of charge caps beyond stakeholder pensions is likely to do little to engineer improvements, it is clear that there needs to be far greater transparency and comparability in pension fund charging structures so that both consumers and informed buyers acting on their behalf are able effectively to determine the value proposition of different product offerings.

<u>The role of the Investment Governance Group</u>

11. With respect to contribution levels and investment strategy, the work done by the Investment Governance Group (IGG) offers a way to avoid what could be a difficult regulatory process, particularly with respect to default strategy design. The IGG was

set up as part of the HM Treasury recommendations in its response in October 2008 to its consultation "Updating the Myners principles".[188] The DC IGG working party drew up a number of principles which should help to create a transparent and informed governance process.[189]

The proposed Bill

12. Whilst we have no strong views on amendments to the draft Bill in this area, the memorandum of understanding between TPR and the FSA could be recognised along with a clear statement of co-operation between the FCA and TPR.

13. We also believe that the work of the IGG is sufficiently important that it develop a permanent life, not least as a bridge between contract-based and trust-based provision.

November 2011

[188] http://webarchive.nationalarchives.gov.uk/20100407010852/http://www.hm-treasury.gov.uk/consult_myners_index.htm
[189] http://www.thepensionsregulator.gov.uk/about-us/principles-igg-dc.aspx

JP Morgan; Goldman Sachs and Deutsche Bank – oral evidence (QQ 848-914)

Transcript to be found under Goldman Sachs.

Professor John Kay, Economist; Rt Hon Alistair Darling MP; Professor Charles Goodhart CBE, Professor Emeritus of Banking and Finance, London School of Economics and Professor Eilis Ferran, Professor of Companies and Securities Law, Cambridge University – oral evidence (QQ 207-287)

Transcript to be found under Professor Eilis Ferran.

Lansons Communications LLP – written evidence

1. Introduction

1.1 This is a response to the Joint Committee's call for written evidence to aid its pre-legislative scrutiny of the draft Financial Services Bill.

1.2 Lansons Communications LLP is a public relations agency. Over 70% of its clients are in financial services. It has a dedicated regulatory consulting team that advises firms on their regulatory obligations. These are our own views based on our experience and do not reflect the views of any client.

1.3 Our response to your high level question about preventing and dealing with another financial crisis is that an over-arching body to consider and give direction on the build up of systemic risk appears to be a useful step. It should be borne in mind, however, that excessive credit extension was not a phenomenon confined to the UK and it follows that national solutions, by themselves, will only secure a modest measure of greater security. Splitting the FSA does not appear to support the stated purpose.

2. The detailed questions

2.1 These are responses to the detailed questions:

1. Is the separation of prudential and conduct regulation into a "twin peaks" system the right approach?

The approach is neither right nor wrong. Rather it does not answer the problem and is unlikely to achieve very much. The FSA could have been reformed as it was. However, both the unified and separated models can be seen to work satisfactorily in other jurisdictions, Canada and the Netherlands for example operate "twin peaks" successfully. The real issue is that during an era of heightened regulatory risk, incurring significant transaction or transformation risk (e.g. people at the FSA taking their eye off the ball while they fret about their own careers) appears unnecessary.

2. What lessons can be learnt from the approach of other countries to regulation of the financial sector?

The learning is ambiguous. Several regulatory models are in evidence though they broadly fall into unitary and twin peaks categories. None of them could prevent the financial crisis. It follows that the structure of the regulatory arrangements does not have much bearing on outcomes.

3. Is it appropriate to make such major changes to the regulatory system by way of amending legislation, rather than starting afresh?

A pristine new Bill would have been clearer for all. However, much of the present primary legislation appears serviceable and does not need repealing. Thus amending legislation appears feasible. Although beyond the Committee's remit, it might like to consider the

question of the attendant secondary legislation. Whitehall tends to forget about it once the Bill has made its way through Parliament. Financial services legislation has much secondary legislation in its slipstream. In both 1986 and 2000 this was rather overlooked and it took two further years to complete the legislative process in full. This time much of the secondary legislation also remains serviceable so the process does not begin from a standing start. Nevertheless, every line of the secondary legislation will have to be considered to ensure no amendment is required.

4. Are the accountability and governance arrangements for the Bank of England, FPC, PRA and FCA satisfactory?

The arrangements for the PRA and the FPC appear to be a significant improvement. It would be particularly valuable to have the National Audit Office conduct a full value for money programme on these bodies. The oversight of the Bank is more problematic. The Court of the Bank seems rather anachronistic and insufficient by itself to ensure a high level of performance. The Bank, and by extension the FPC, requires a modern independent board to provide constructive challenge and advice. Further, it needs to be accountable to a select committee of Parliament.

5. Are the FPC's objectives the right ones? Is the concept of financial stability adequately understood for the FPC to be able to perform against its objectives?

The nature of the problem is that the conditions for stability can never be fully foreseen. The reason for this is that the global economy is driven by factors as diverse as technological innovation and climate, such that terms of reference must be drawn very wide at the risk of becoming vague and loose. What is wanted is a pragmatic approach that can say that notwithstanding what standing orders may say or envisage, the current facts are dangerous and require decisive intervention.

6. Should the FPC be limited in the actions it can take which might affect the growth of the financial sector?

The broad answer is “No”. The size and value of the financial sector is a factor. But the FPC should be pragmatic. Society needs a successful financial sector to enable it to achieve prosperity and security. The arguments thus become rather circular. The FPC should be guided by the concept of Pareto optimality. That should lead it to the right conclusion about the trade off between the (only superficially) diverse interests of the financial sector and society broadly.

7. How will the interaction between macro-prudential and monetary policies be handled by the FPC and the MPC?

More a question for the Bank of England.

8. Has the right balance been struck between the powers of the FPC and the powers of the Treasury?

We will not know the answer to this question until the arrangements come under real stress. The Treasury will tend to reflect the personality of the Chancellor of the day tilting the power balance previously thought to exist.

9. Can Parliament take an informed decision about the proposals for the FPC without details of the macro-prudential tools at its disposal?

No. The question points to the need for dialogue between the Government, the Bank and Parliament, probably best achieved through the Treasury Committee having oversight of the FPC.

10. Does the draft Bill adequately deal with the risks posed by the shadow banking system?

By definition, (or the lack of it), shadow banking is a somewhat nebulous concept. On a narrow view, the powers are unlikely to foresee every development of the system. The solution is for future regulators to take a purposive view of the law and be much more robust than we have seen in the earlier part of the past decade. This is as much about supervisory approach as it is powers. Special purpose vehicles, conduits and sidecars were very obvious attempts to reduce the asset side of banks' balance sheets and so reduce the regulatory capital required. This was to increase yield. The regulator could have eradicated these practices with the powers at its disposal. The consideration at the time would have been that Wall Street called the shots and our banks would have been disadvantaged competitively through robust intervention at the national level. The shadow banking system is global so this answer should be read in conjunction with the high level observation above that preventing another financial crisis requires international solutions and a high level of international co-operation.

11. Are the PRA's objectives clear and appropriate?

Broadly yes. The objective of prudential regulation is relatively straightforward. The real issue is the nature of the consumer protection secured by it. There is a trade off between making services safe and making them affordable (another expression of Pareto optimality). What the PRA should seek to do is manage the trade off between how expensive financial services are and the likelihood of their failing. This is in the context of an appropriate compensation scheme able to compensate without the taxpayer subsidising it.

12. Are there any risks in the Government's proposed 'judgement-based' regulation?

Pragmatism requires good judgement. The main risks are around a capricious regulator escaping the governance and oversight arrangements and the risk of disrepute when a judgement can be seen with hindsight to be wrong. But judgement-based regulation is the way to go. It will require a bold breed of regulator able to take legal advice but not be dominated by it. It will need higher levels of market intelligence than the current regulator appears to possess. Greater emphasis should be placed on a "council of elders" type approach to guide individual decisions. This is not rocket science; for example, many practitioners warned that payment protection insurance was a scandal but the FSA was slow to react.

13. Is the Government's proposed approach to 'orderly' firm failure satisfactory?

This is unanswerable until the system comes under live testing. Although the generic causes of failure are unchanging, the specific circumstances evolve as markets evolve. We cannot foresee the next systemic event or know whether the combination of national and international regulatory arrangements will let it through.

14. Given that the PRA and the FCA will inherit FSA staff does the draft Bill do enough to ensure a new regulatory culture and a more proactive approach to regulation? Will these two new bodies have staff with the appropriate skill and expertise?

The Bill is almost silent on this subject but it may not be the appropriate place for it. There is a deep seated and long standing problem with the human resources of the FSA. The dilemma is whether working at the FSA is a long-term career option or a short-term role to enhance a curriculum vitae. They call for very different strategies. The FSA got off to a poor start because its first chairman did not value "HR" highly. Since then their solution has been to throw more people at the problem rather than raising the standard. The new regulators require fewer, much better people. However, there is a political problem. These regulators will be in the public sector. The right people will be very expensive. The public and many politicians have an aversion to paying public officials well. It is a cheap shot when politicians appeal to simple prejudices although the political imperatives are not to be under-estimated.

15. Are the FCA's primary objectives appropriate? Is significant emphasis given to the promotion of competition?

The FCA's objectives are somewhat hard to fathom because they are constructed in a rather odd way. It would appear that the Treasury may be trying to make the FCA think rather more about the balance to be struck between the risks of sharp practice and those of social exclusion. The promotion of competition sits very uncomfortably. Financial services are very diverse. The current fashion for believing the value of competition as a policy tool has been lost sight of appears to emanate from the Independent Commission on Banking's views on retail banking. One size will not fit all. The market failure conduct risk regulation is addressing is complex but essentially is to do with information asymmetry and the reluctance of many able consumers to defer spending. Under these conditions it seems doubtful that greater reliance on competition will solve anything. This is a case of policymakers failing to join up all the policies.

16. Are the responsibilities of the FCA towards the regulation of markets appropriate?

This part of the FSA's remit has worked well. Continuation would be appropriate.

17. Does the draft Bill strike the right balance between the responsibilities of consumers and firms? Are the FCA's new powers in the area of consumer protection appropriate?

This is the nub of the problem on the FCA side of the proposals. The oddly stated objectives proposed for the FCA suggest that some thought has been given to this issue. However, striking the right balance between the responsibilities of consumers and firms does not seem to be the right question. Underlying it is a more profound question about the best engagement that can be achieved between consumers and the industry to secure

the best outcome for society as a whole. Regulatory intervention in this market has to be seen in the context of wider public policy. The reason for regulatory intervention should surely have been to ensure a market that works well so that consumers' needs and wants are fully met. The difference between needs and wants appears to confuse policymakers. It certainly has profound effects on markets. The FSA has been trying to regulate a market using tools that blunder across the two. The behavioural school of economics has much to say about what public policy strategies will work under these conditions of market failure. The FSA dipped its toe in this water in commissioning its Consumer Research Paper 69. The NEST adoption of auto-enrolment is a clearer example. Until public policy broadly adopts a better understanding of consumer behaviour, market interventions are likely to be ill-judged and getting the balance of rights and obligations between consumers, firms and the State will be problematic.

18. Are the prudential regulatory responsibilities of the FCA towards FCA-only regulated firms given sufficient emphasis and detail?

In practice, they are of very little consequence. Intermediaries do not price risk on to their balance sheets so the prudential risks are modest. It is relatively straightforward to arrange for consumers to be protected from the risk of intermediary firm failure. Client money rules and the industry funded compensation scheme see to that.

19. Will the new regulatory arrangements reduce the risk and cost of dealing with miss-selling of financial products?

This is not so much about the powers as the way the regulators use them. If they manage to master the more judgemental approach the risks and hence the costs of miss-selling could fall dramatically.

20. Are the proposals for co-ordination between the PRA and FCA clear and adequate? What would be the advantages and disadvantages of having a Single Point of Contact and/or a joint rule book for dual-regulated firms?

Dual-regulated firms are likely to have a miserable time compared with the last time they were exposed to multiple regulators pre-1998. The regulators do not yet appear to know how they will undertake such common functions as authorisation, vetting approved persons and dealing with unified regulators in other jurisdictions. The goal should be to make all these touch points as streamlined as possible. In the end it is the consumer who pays for any inefficiency anywhere in the system.

21. How do the proposals in the draft Bill fit within the new European regulatory regime? What freedoms and constraints will the UK have to operate within that regime?

This depends on the nature of European Law. Increasingly, it seems likely that maximum harmonisation will become the norm and that exercising national good provisions will become less likely. Over the next decade, the European regulators may be expected to become more influential. A unitary regulator would stand more chance of fighting the UK's corner (although the FSA has tended to be too downbeat about its influence). [N.B. Formally it is the Treasury that negotiates in Brussels on financial services matters, but the

FSA has the resources and the knowledge to handle the detail so the regulator remains key to getting the best results for the UK.]

22. Does the draft Bill contain any proposals or omissions, not covered by the questions above, which cause concern?

The draft bill seems mainly to be concerned with "re-wiring" the regulatory structure rather than taking it in any new direction. However, the main issues do not appear to lie there. The main focus should have been on the effectiveness of international co-operation in regulation of banking and getting the UK regulator to use the powers it already had with greater conviction and determination. Neither of these appears to require new legislation.

August 2011

Legal and General Group – written evidence

Summary

1. We understand the Government's desire to improve the effectiveness of financial regulation. But the crisis was a failure of regulators as much as it was a failure of regulation; changes to the regulatory architecture, while necessary, will not be sufficient to deliver improved regulation.

2. The UK insurance industry manages investments of £1.5 trillion, employs more than 300,000 people in the UK and is the fourth highest contributor of corporation tax. We have limited potential systemic impact, and our overall risk of disorderly failure is materially lower than that of banks. Failure to design and execute an appropriately differentiated regime for insurers, or the compensation arrangements in the rare event of their failure, will disproportionately increase costs, reduce consumer choice and bring about undesirable transfers of risk.

3. The pace of change aims to minimise the uncertainty of transition. But far greater risks lie in the profound and long-term adverse consequences for the market and for consumers that will arise from poorly thought-through policies and hastily-drafted legislation. We need more clarity on detail to properly understand and evaluate the effectiveness and practical implications of proposed new policies.

4. European regulatory authorities are taking an increasingly dominant role in determining the content and application of financial regulation. The discretion available to UK regulators will be limited, and expectations around their exercise of judgment, or scope to gold-plate EU requirements, must be consistent with this.

5. The biggest regulatory threat to the insurance industry comes from misguided prudential regulation. The capital regime for the UK insurance industry will soon be set by the EU's Solvency II regime. Priority must be given to addressing important design flaws to avoid implementing an unstable and procylical capital regime that would substantially increase the risk profile of the insurance sector and inflate the cost of financial products for UK consumers.

6. The Government has focused more on the public disclosure of individual regulatory actions than on transparency of the regulatory strategies and policies. In a judgment-led environment, regulatory risk appetites, standards and benchmarks must be clear to all stakeholders, and hasty or injudicious regulatory disclosures must not be allowed to cause harm where no fault has been proven.

7. The risks of affording greater discretion to regulators so as to facilitate swifter interventions are insufficiently mitigated through robust due process and transparency of regulatory policy and intent. Real-time regulation is an attractive aspiration; but its practice must must be tempered by real-time checks and balances. Consultation and due process must not sacrificed as collateral damage in the pursuit of expedicious regulatory action. The draft legislation suffers substantial weaknesses in this respect, particularly when viewed in the light of the regulators' interventionist mandate.

8. Given their past track records, the regulators' ability to recruit and retain staff with the skills and experience needed to assess the business models and strategies of significant industry participants, let alone effectively second-guess the judgments of senior executives, remains questionable.

9. The authorities must be required to keep the costs to the economy and consumers of dual regulation as low as possible.

10. We fully support for the FOS in its role in resolving on a case-by-case basis any disputes that our customers may have with us. But the resolution of individual disputes must not be allowed to give rise to back-door regulatory policy-making. Conduct regulation must remain clearly and exclusively the preserve of the FCA.

Legal and General Group response to the call for evidence to the Joint Committee on the Financial Services Bill

We welcome this opportunity to give evidence to the Joint Committee.

Introduction

1. We believe that strong and effective regulation of both the prudential and conduct aspects of financial services firms' activities is in the best interests of the financial services industry and its customers. Effective regulation is essential in increasing consumer confidence, and safeguarding financial stability. It promotes the take-up of appropriate protection and savings products, with consequent wider social and economic benefits and support for economic growth. High-quality, stable and proportionate regulation not only promotes competition but is also an important condition for investment in the UK financial services industry.

2. We understand the Government's desire to improve the effectiveness of financial regulation following the crisis. But the crisis was a failure of regulators as much as it was a failure of regulation. Changes to the regulatory architecture, while necessary, will not be sufficient to deliver improved regulation.

3. We believe that a cultural step-change is now needed for both regulators and firms to create a more positive regulatory environment. It is, we suggest, essential that the Government works to bring the industry along with it throughout its reform process by acknowledging the validity of certain key concerns.

4. It is critical, therefore, that in the pursuit of robust regulation, the Government does not sacrifice as collateral damage the core principles of effective consultation, due process and provision of natural justice. To do so would risk higher consumer prices than necessary and/or render the UK financial services market unattrative to capital providers.

Appropriate regulation for insurance firms

5. To regulate the financial industry effectively, it is important that the characteristics and interests of all its sectors are well understood and catered for in the overall design of the regime. The UK insurance industry manages investments of £1.5 trillion; over 20 percent of the UK's total net worth. It employs more than 300,000 people in the UK alone and is the fourth highest contributor of corporation tax. And it is a major exporter, with one-fifth of its net premium income coming from overseas business. The

new regime, and particularly the PRA, must be designed in a way that supports the delivery of differentiated, relevant and appropriate regulation of insurers. As the financial crisis demonstrates, insurers are not banks.

Impacts of European regulation

6. The biggest regulatory threat to the insurance industry comes from misguided prudential regulation, rather than inherent business model or insurance risk. In this respect, the capital regime for the UK insurance industry will soon be set by European legislation under Solvency II. An unstable and procylical capital regime will substantially increase the risk profile of the sector. Working to avoid design flaws in the Solvency II regime should therefore be top of the list in terms of the PRA's insurance related objectives.

7. In common with others in the industry, we have consistently argued that the EU's Solvency II regulatory regime risks becoming a fundamentally flawed suite of legislation that will prove damaging to UK consumers, investment by insurers in UK corporate securities and to the UK insurance industry itself. However, it is nonetheless the primary basis for insurance prudential regulation in Europe.

8. We remain deeply concerned for the future for insurance regulation, despite the Government's acknowledgement that insurers have limited potential systemic impact, and that their overall risk of disorderly failure is materially lower than that of banks.

9. First, we are not yet confident that this recognition goes beyond lip-service. The overwhelming policy emphasis on enhancing the stability of the banking sector, and the failure to embed insurance knowledge and expertise at senior levels in the regulatory authorities, mean that we have little confidence that this key principle will be adequately reflected in the ongoing activities of the FPC and the PRA.

10. We must emphasise: failure to deliver an appropriately differentiated regime will disproportionately increase costs, reduce consumer choice and bring about undesirable transfers of risk. The UK regulatory regime must be sufficiently flexible to deliver an appropriately risk-based approach to the regulation of key sectors.

11. Our second concern is therefore more significant. It is clearly important to correct any conflicts between the UK legislation and the Level 1 Solvency II Directive – and to understand and address the reasons for those conflicts.

12. For example; the Directive text gives primacy to the objective of adequate protection of policyholders and beneficiaries, with financial stability considerations subsidiary to that objective. The draft Bill prioritises stability above policyholder protection. This inconsistency is both legally and practically unacceptable and must be eliminated. But more importantly, from our point of view, is that the underlying cause of the discrepancy needs to be addressed. In our opinion, the apparent conflict between the objectives of the UK and EU legislation simply highlights the fundamental flaws in the European approach.

13. If the PRA were to apply the capital requirements for annuities currently proposed under the Solvency II regime under PIS 5, we have estimated that the cost of annuities for UK consumers – largely pensioners – will increase by 10-20%; the effect of this for most consumers will be a reduction in the level of income they will receive in retirement.

14. The *real* challenge for the Government and the UK regulators will therefore be to ensure that the implementing regulations for this regime and those of other emerging EU legislation, give rise to proportionate and rational regulation in the UK. Otherwise, the UK legislators will be able to do little to protect the the financial wellbeing of UK consumers or the UK economy as a whole.

Proportionate compensation arrangements

15. The different risk profile of insurance firms should also be recognised in the arrangements for compensation in the event of a firm failure. The Government must make clear that pre-funding of the FSCS will not be apply to insurance firms. Pre-funding is necessary and appropriate for deposit takers. However, in the extremely rare event of a failure of an insurance company, the likely impact on customers and the compensation scheme would be far less significant than would the failure of a peer bank. To oblige insurers to cross-subsidise the costs of failure of structurally more risky institutions through a general pool creates an asymmetric and perverse transfer of risk. We have noted with growing concern that the Government has resisted our call for a reform of the FSCS to address this issue; but this must be given greater priority, as the significant financial costs of implementing a flawed system will inevitably flow through to consumers and the economy.

Fairness, objectivity and balance

16. We have welcomed the Government's acknowledgment that their judgment-led regulatory approach carries significant risks. However, in our view, the risks of real-time and judgment-led regulatory activity have been insufficiently mitigated by parallel real-time checks and balances and independent avenues of appeal.

17. There will be always be a tension between the desire for swift action and the need for depth and quality of analysis to support regulatory interventions (particularly those operating at market level). But the increasing and disproportionate emphasis placed on early intervention, when viewed together with the apparent reduction in the levels of due process that are essential to temper the exercise of regulatory powers, suggest that in reality, little value will be afforded to objectivity, fairness and balance.

18. It is essential, in the interests of maintaining confidence in the regulatory system, that these core values should not be sacrificed in the interests of speedy intervention.

19. In the light of this concern, and our knowledge of past track records, we also have little confidence that the new regime will hold the new regulators properly accountable for ensuring objectivity and fairness in their day to day supervisory activities, particularly when they have been given such an emphatic overarching mandate to interverne before any perceived detriment can arise.

20. In our detailed response, we have offered some specific suggestions as to possible improvements in this area.

Transparency

21. The 'transparency' agenda also seems to us to have lost its way. The Government has focused more on the public disclosure of individual regulatory actions than on providing transparency of the regulatory strategies and policies that will direct them. The most

important purpose of transparency is that, in a judgment-led environment, all stakeholders must have a complete understanding of regulatory risk appetites, standards and benchmarks.

22. The Government has, in placing so much emphasis on delivering judgment-led regulation, failed to address the wider consequences that will arise from poor judgment and unfettered discretion.

23. Whenever a regulator takes action, it can have substantive and pervasive policy implications; we see this already in the publication of completed enforcement actions. As regulatory activity becomes more judgment-led, and greater discretion is allowed in the exercise of regulatory powers, so the potential for individual regulatory actions to subvert the policy-making due process increases. The consequent opacity and risk of inconsistency in regulatory standards must clearly be unacceptable; in our view, it will deeply undermine the credibility of the UK regulatory regime.

24. Each authority must therefore be required to explain in advance the priorities and standards they will apply in the exercise of their judgment. They must provide explicit rationales for each of their acts, and put in place effective internal mechanisms through which the objectivity and fairness of their ongoing activities will be ensured. And they must then be held accountable for ensuring that these mechanisms operate effectively, together with putting in place appropriate "real time" check and balances and avenues of appeal.

Regulatory competence

25. Given their track records so far, however, we are also extremely sceptical of the ability of the authorities to recruit and retain staff with the skills and experience needed to assess the business models and strategies of significant industry participants, let alone effectively second-guess the judgments of senior executives.

26. We repeat – the crisis called into question the competence of regulators as much as exposing the weakness of the regulatory model.

Implementation of the reform objectives

Pace without haste

27. We note that the pace of the Government's reform programme is geared towards minimising the uncertainty of transition. But in our view, far greater risks lie in the profound and long-term adverse consequences for the market and for consumers that will arise from poorly thought-through policies and hastily-drafted legislation. The impacts on consumer choice and the costs to the industry of inefficiency and duplication must not be undersestimated.

Scrutiny of detail

28. The Government must build sufficient time into its processes to ensure that the detailed policies needed to define and implement the revised architecture are well-developed and clearly articulated. Without insight into these, it is impossible for us to comment confidently or effectively on these proposed changes.

29. There has been extensive reliance on the use of Memoranda of Understanding as a basis for providing transparency on essential operational details. We have noted within our detailed response a number of areas where further clarity and detail will be needed before we can properly understand and evaluate the practical implications of proposed new policies. We look forward to sight of the coordination memoranda, which we anticipate will provide much of the insight needed; but we regret that the intention appears to be that these will not be published for consultation. If this is correct, it seems counter-intuitive, as the industry should have the opportunity to help the authorities refine their designs, so as to minimise as far as possible the increased regulatory burden that dual regulation will inevitably bring.

FPC Strategy and Tools

30. We also note that the interim FPC has already begun to exercise regulatory powers by advising the FSA on certain policy approaches; but it has not yet carried out its remit to analyse potential macro-prudential tools and make recommendations on them to the Treasury. We believe that there must be robust analysis of the impact of macro-prudential tools to understand how they will work in practice, and provide reassurance that the FPC's activities will not impair economic growth. We also consider that it is important that the FPC's recommendations on appropriate permanent macro-economic tools should be fully reviewed and tested through public consultation.

Regulatory coordination – minimising the costs of change

31. The increased costs that will inevitably arise from dual regulation remain a continuing concern for the industry that must be addressed through exacting requirements on the authorities to keep aggregate costs across the system as low as possible. The burden of regulation on the industry already creates an unacceptable cost to the economy; these costs are often invisible, in terms of management strain and distraction. It is important that the Government should recognise that costs on our industry flow directly through to consumers and the economy, through weakened returns, reduced capital investment and lost taxation revenues.

32. We note that within the coordination requirements proposed for the authorities there are specific requirements: to avoid interference with each other's pursuit of their objectives; to share information and particular expertise; and to ensure that they each comply with the principles of regulation on proportionality and minimising the regulatory burden on firms. While these are desirable objectives, we suggest that there should also be an explicit requirement on the authorities to coordinate their activities, particularly where they each have a legitimate interest in the same matter. They must be required to minimise the aggregate regulatory burden on firms that will inevitably arise where there are distinct but overlapping regulatory interests that give rise to duplicative regulatory activity for firms.

Clarity of roles between FOS and FCA

33. We have frequently asked the Government to clarify and define the respective responsibilities of the FCA and the FOS in respect of the regulatory consequences arising from the outcomes of FOS determinations. Without greater certainty in this area, the industry will continue to see the unpredictable yet material regulatory impacts of FOS

decisions as a major barrier to innovation – for example, in relation to developing simplified advice processes to bridge the anticipated advice gap post-RDR.

34. We are unequivical in our support for the FOS in its role as a a swift, low-cost mechanism for resolving any disputes that our customers may have with us on a case-by-case basis. This is one of the strongest customer-focused features of our regulatory regime. But the resolution of individual disputes must not be allowed to give rise to back-door regulatory policy-making. Conduct regulation must remain clearly and exclusively the preserve of the FCA.

35. Clearly, the root cause of individual complaints can highlight where there is a regulatory void, or a need for change. We also accept that the basis for FOS determinations – that which is 'fair and reasonable, taking account of all the facts of the case' – is entirely appropriate for the resolution of individual complaints. However, the current arrangements create a direct link between the FOS decision and the regulatory consequence. This is inappropriate, not only because it gives rise to non-transparent and untested regulatory change, but also because there is no certainty that each firm reviewing the cases – whether because the complaint is theirs, or because the decision has been published – will extrapolate the correct regulatory approach and apply it in the same way as others do. This will lead to inconsistencies and unsatisfactory outcomes for consumers.

36. There must therefore be an independent mechanism whereby the regulatory insights that may be gleaned from individual cases can be identified and judged, and an appropriate policy response taken forward. Clearly, that activity falls within the scope, powers and comptence of the FCA; not the FOS. It is essential that this distinction is clarified and protected.

Conclusion

37. We remain supportive of the Government's underlying aims for regulatory reform. However, we believe strongly that many of the concerns that it seeks to address were already well provided for within the current regime, and that the root causes of the recent crisis were attributable as much to the failure of the regulators to apply the regime and their powers effectively.

38. The existing regime has also benefited from considerable evolutionary improvement, particularly in respect of essential checks and balances to ensure that it operates fairly and justly. These checks and balances must not be discarded in pursuit of operational expediency, particularly where no change is, in reality, required.

39. The Government must work harder to maintain a balanced approach to its reforms, changing only that which truly requires improvement and respecting the interests of all stakeholders.

Annex: response to detailed questions

Question	***Legal & General response***
1. Is the separation of prudential and conduct regulation into a "twin peaks" system the right approach?	There are advantages and disadvantages in any regulatory structure – there is no 'right' answer. We believe the most important consideration is not the structure of the regime but whether it is capable of delivering effective regulatory supervision. To be successful, the following will considerations be key: • Clarity of respective roles and responsibilities • Transparency of risk appetite and regulatory standards • Adequate accountability and checks and balances against exercise of powers • Effectiveness of communication and coordination between the authorities • Minimisation of costs and burdens of regulation • Ensuring the right outcomes in developing EU regulation
2. What lessons can be learnt from the approach of other countries to regulation of the financial sector?	No comment
3. Is it appropriate to make such major changes to the regulatory system by way of amending legislation, rather than starting afresh?	86. Financial regulation in the UK has been through a detailed evolutionary process over the past 20 years – this learning should not be dismissed. The key principles in FSMA remain valid – we see no need to do a complete re-write, particularly as that would further increase the costs of change. Instead, attention should be given to preserving, and where necessary further enhancing key elements, such as • accountability for adherence to the regulatory principles, • independent review of regulatory decisions and judgments, including decisions to publish information about individual firms;

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	• rights of challenge and appeal for firms. These measures prevent inappropriate exercise of powers and as such must be applied consistently to the new powers and duties being created under the new legislation.
4. Are the accountability and governance arrangements for the Bank of England, FPC, PRA and FCA satisfactory?	They have improved but we have some residual concerns. • It is very likely that a regulator with a single remit will pursue that objective with single-minded enthusiasm. It is therefore unlikely to take on constraints and disciplines that are not provided for in its statutory framework, given the explicit nature of other aspects of its framework. We believe it is essential that the regulatory principles that constrain each authority's pursuit of its objectives are improved, to reduce the risk of over-zealous regulatory activity. • The focus of accountability measures (reporting after the event) appears to be more on learning from mistakes rather than preventing them. • We have provided a separate paper on the important checks and balances that must be put in place to constrain the inappropriate exercise of regulatory powers. • HMT will be able to require ad hoc regulatory actions where it is 'justified in the public interest'; to understand the value of this provision, more specifics are needed as to the tests that would be applied by the Treasury. • We suggest that the Financial Stability Strategy that the FPC proposes to adopt should be subject to public consultation. • We note elsewhere that the requirement placed upon the Authorities to coordinate their activities should include a requirement to minimise so far as is compatible with their respective objectives the aggregate burden that their activities places upon regulated entities. From an accountability point of view, the actions they have taken to achieve this should then be reported on within their annual report to the Treasury (see

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	draft Schedule 1ZA of FSMA). • The legislation should explicitly require the external members of the FPC and the members of the PRA and FCA governing bodies to have sufficient breadth of knowledge and experience across all financial industry sectors, as it does in respect of the provisions for membership of the various consultative Panels. This is essential to guide and maintain the principle of proportionality across the range of industry sectors affected by regulatory decisions.
5. Are the FPC's objectives the right ones? Is the concept of financial stability adequately understood for the FPC to be able to perform against its objectives?	87. The Financial Stability Objective that is given to the Bank of England by HMT will largely drive the FPC. Early elaboration of the government's priorities and objectives in relation to financial stability, and consultation on the Bank's strategy for delivering this, would therefore be helpful in the interests of transparency. Only then will we have clarity about the definition of the concept. Whilst we consider 'resilience' in the financial system is important, it is not an end in itself, given that the measures to deliver it could have market-dampening effects. Its pursuit is desirable only to the extent that it supports the continued and stable growth of the economy. We remain concerned that there is no clear insurance expertise available in the current interim FPC membership. While the government has now acknowledged the materially lower and less direct risk posed by insurers to financial stability, it is not clear to us that the FPC (and PRA) will take sufficient account of this. We are concerned that the authorities will fail to differentiate appropriately in the way they pursue their objectives; in particular, that the FPC will fail to apply sufficient discrimination in its selection and use of macro-economic tools. We would like to see a specific requirement in new clause 9B of FSMA: that the Treasury must satisfy itself that the membership of the FPC as a whole has a sufficient breadth of knowledge or experience across the banking, insurance and investment management sectors. This is essential to enable it to understand the impact of its actions on each sector and minimise any disproportionate adverse impacts on individual sectors. We note elsewhere that the Government's approach to macro and micro-prudential regulation of insurers appears inconsistent with the requirements of the EU's Level 1 Solvency II Directive.

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6. Should the FPC be limited in the actions it can take which might affect the growth of the financial sector?	Yes – it is important to ensure that an over-cautious approach to financial stability should not be allowed to impair or restrict the ability of the financial services industry to contribute to the economy. We suggest that the relevant clause (insertion 9C(4) to FSMA) should, be expressed as a positive **-** the FPC should exercise its functions **only to the extent necessary in its opinion to sustain or enhance** the capacity of the financial sector, etc. There should also be an explicit requirement for the FPC to have regard to its impact on the international competitiveness of the UK financial services industry.
7. How will the interaction between macro-prudential and monetary policies be handled by the FPC and the MPC?	We are particularly concerned that the unsatisfactory consequences that will arise from a failure by the FPC to discriminate adequately in its approach to insurers could be further exacerbated should it use its powers to direct the PRA along similar lines.
8. Has the right balance been struck between the powers of the FPC and the powers of the Treasury?	HMT ultimately sets the FPC's agenda through the Financial Stability Objective given to the Bank, and has further influence by virtue of its ability to make recommendations to the FPC on the matters that they should regard as relevant. It would seem clear that HMT will be materially directing the FPC – and that by giving the FPC the power to direct the other authorities, is retaining strong control over the regulatory system. It is important that HMT provides transparency in relation to its exercise of these powers.
9. Can Parliament take an informed decision about the proposals for the FPC without details of the macro-prudential tools at its	We do not believe so. There has been insufficient explanation of the Government's underlying policies, and without understanding the nature and potential impact of the tools that the FPC will be able to deploy, it will not be possible to assess whether these are likely to deliver balanced regulation. 88. We also draw attention to the inconsistency between the proposed approach of the FPC and the current requirements proposed under the EU's Solvency II regime. This inconsistency is clearly a matter of some concern. However, it is far more significant that many of the principles of macro-prudential risk management

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disposal?	so far identified by the Government, such as counter-cyclicality, an appropriate balance between national discretion and EU co-ordination and an internationally level playing field, are fully relevant to the insurance sector as well as banks. While these objectives entirely appropriate, they may prove very difficult to achieve for insurers. The EU regulatory regime will allow very little, if any, discretion to the UK domestic regulator, due to the prescriptive nature of the level 2 and level 3 regulations and their application by EIOPA. If implemented as currently envisaged, the Solvency II Level 1 Directive's capital regime risks creating excessive, volatile and pro-cyclical capital requirements. In addition, it will only apply to EU insurers (thereby creating a wider international competitive distortion). As it stands, its implementation is also likely to mean that relative to banks, insurers will be subject to far more onerous treatment: a manifestly perverse result given the relative risk profiles (and recent histories) of the two sectors.
10. Does the draft Bill adequately deal with the risks posed by the shadow banking system?	We note that the scope of the PRA does not include non-bank mortgage lenders. As a small number of these lenders held a significant market share in the lead-up to the financial crisis, and therefore arguably had some systemic impacts, we question whether this is appropriate.
11. Are the PRA's objectives clear and appropriate?	To regulate the financial sector effectively, it is essential that the interests of all its sub-sectors are understood and their regulatory risks appropriately addressed. In order for the proposed authorities, and particularly the PRA, to deliver appropriate regulation of a uniformly high quality, the new model must give sufficient priority to ensuring that the prudential regulation of insurance is appropriately differentiated from that applied to banks. The PRA's assessment of the risks posed by insurers must be realistic and proportionately managed. The PRA's objectives must also be consistent with those set out in the Level 1 Solvency II Directive. In the draft legislation, the insurance objective appears subordinate to the financial stability objective. In the Solvency II Directive, the reverse applies. This inconsistency must be resolved. We also note in the PRA's published approach to insurance supervision the emphasis that is placed on ensuring

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	adequacy of reserves. The Level 1 Solvency II Directive states explicitly that capital additions should be used only as an exceptional, emergency-only and temporary measure.
12. Are there any risks in the Government's proposed 'judgement-based' regulation?	Yes – real-time regulatory activity requires similarly real-time checks and balances. While we understand the rationale behind the Government's desire for regulators to rely more on judgement, we are concerned about the potential abuse of unfettered discretion. Judgement must be exercised within an appropriate framework that delivers accountability, transparency and consultation. It is not sufficient simply to recognise that mistakes may be made under the new regulatory approach – 'a few eggs might get broken' is not an appropriate viewpoint when dealing with matters of material significance to the UK economy. Speed of action does not preclude fairness. The damage that can arise from misguided and poorly judged regulatory action can be permanent and irremediable for firms. Fairness and objectivity must be preserved by appropriate due process. We have prepared a separate paper on our thinking on this topic and have offered a number of drafting suggestions Regulators must also be held accountable for adherence to their own statements of purpose and intent of regulation – judgment and discretion must not be exploited to deliver, for example, retrospective corrections to regulatory standards. Statements of purpose and intent must form part of regulatory consultations.
13. Is the Government's proposed approach to 'orderly' firm failure satisfactory?	In the light of the low risk and incidence of insurance firm failure, and the low consumer impacts of such failures, we suggest that there is little need for an intensive recovery and resolution regime for insurers; certainly, particular attention must be paid to the analysis of costs and benefits that would arise from any detailed requirements. This is fundamentally a consumer protection point; they should not be asked to pay a disproportionate price, even indirectly, for protection against the risk of outcomes that they are extremely

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	unlikely to face.
14. Given that the PRA and the FCA will inherit FSA staff does the draft Bill do enough to ensure a new regulatory culture and a more proactive approach to regulation? Will these two new bodies have staff with the appropriate skill and expertise?	The current tone of regulatory comment does not inspire confidence in us that the FCA will adopt a professional and objective approach to their responsibilities. There is currently an over-aggressive and indiscriminate characterisation of all Financial Services firms as near criminals. This must be corrected, and the Government and regulators must their part to promote a healthy regulatory culture in the UK. Unless action is taken to bring in individuals with broader sectoral experience, the FPC and PRA will be culturally and technically over-aligned to banking. We also have concerns about the regulators' ability to recruit the right people; and given the track record of many individuals who are still in the organisation, the overall picture does not look positive. Effective judgment-led regulation requires a high level of intellectual capability, professional competence and relevant industry experience at a senior level. Without these, regulatory staff will seek to influence and direct firms in a misguided and damaging way, creating inefficiencies and harm across the financial services industry.
15. Are the FCA's primary objectives appropriate? Is significant emphasis given to the promotion of competition?	The objectives are not wrong – but they should include a requirement to ensure that access to financial products and services is not unnecessarily restricted by the FCA's regulatory activity.

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16. Are the responsibilities of the FCA towards the regulation of markets appropriate?	The Government must clarify further its intent in relation to the possible extension of FCA powers into markets, and be cognisant of the risk of an excessive retail focus being applied to wholesale market issues.
17. Does the draft Bill strike the right balance between the responsibilities of consumers and firms? Are the FCA's new powers in the area of consumer protection appropriate?	The important question will be how the balance is struck within the authorities, and we have little clarity on this. We are not convinced of need for product intervention powers. These powers give rise to a material risk of significant reduction in market innovation. This, in turn, will give rise to reductions in consumer choice. We remain concerned at the new Financial Promotions power of direction. Although a direction to withdraw a promotion may be revoked, the reputational damage and commercial loss resulting from an unnecessary ban cannot be undone. The purpose of such disclosure is presumably twofold; to allow any consumer detriment already incurred to be remedied, and to prevent further detriment arising. However, these outcomes can be readily achieved without requiring publication of the direction. Firms may be required to review and remedy any customer detriment arising from sales made on the basis of the promotion; equally, the FCA can publish general guidance to regulated firms to prevent others producing similar promotions.
18. Are the prudential regulatory responsibilities of the FCA towards FCA-only regulated firms given sufficient emphasis and detail?	No – more detail is needed to satisfy us that the regulators can and will deliver a level playing field between FCA-only firms and dual regulated, to avoid competition distortions.

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19. Will the new regulatory arrangements reduce the risk and cost of dealing with mis-selling of financial products?	The real risk is that FCA will over-regulate and reduce consumer choice. Insufficient time has been allowed for bedding-down of important changes in the current regime before contemplating deployment of excessively interventionist powers.
20. Are the proposals for co-ordination between the PRA and FCA clear and adequate? What would be the advantages and disadvantages of having a Single Point of Contact and/or a joint rule book for dual-regulated firms?	The coordination requirements should include a requirement on the authorities to work together to minimise, so far as is compatible with achievement of their respective objectives, the aggregate burden that regulatory activities place upon regulated entities. In addition, it should not be permissible for two Authorities to impose a financial penalty on a regulated or authorised person in respect of offences that are materially the same.
21. How do the proposals in the draft Bill fit within the new European regulatory regime? What freedoms and constraints will the UK have to operate within that regime?	We have commented extensively in our general response on the implications of the dependency of UK on EU policy and the need for the Government and regulators to apply resource to minimising any adverse outcomes for the UK. • UK authorities should identify and have regard to emerging EU regulation. They should be directed to avoid making regulatory changes in the UK on matters that can reasonably be expected to be addressed by forthcoming EU measures. The authorities must be held specifically accountable for any decision to risk generating unnecessary regulatory change costs by pre-empting change at an EU level. Such decisions must be driven by a clear and pressing regulatory imperative that cannot be addressed by alternative, lower cost, options.

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	• It is pointless to require a CBA for mere copy-out of EU regulation • The Government should provide clearer guidelines about the circumstances in which gold-plating of EU regulation will be considered an acceptable strategy. It should be made clear that the default approach to transposition will be pure copy-out.

22. Does the draft Bill contain any proposals or omissions, not covered by the questions above, which cause concern?	**FSCS** We believe that this reform programme is an opportunity to address the inequities of risk asymmetry in the FSCS. We are strongly favour the introduction of separate compensation schemes in order to end the current cross-subsidy between different financial institutions. In particular, we believe it would be desirable to rule out 'pre-funding' arrangements in relation to insurance or investment companies. While pre-funding is appropriate and necessary for deposit takers, given the liquidity risk and the systemic undermining of confidence if there is any 'run' on an institution, the failure of an insurance company is an entirely different matter. Insurance liabilities unwind over a period and when this is coupled with the very different capital requirements and fundamentally different leverage position it becomes apparent that there is little need for pre-funding. Similarly, in the case of investment companies, assets are generally held by a custodian and are therefore not exposed to any loss in the event of a default. To require insurance companies to provide pre-funding for deposit-takers through a general pool creates an asymmetric and unfair transfer of risk for insurers and investment companies. There is no clear rational for relying on insurers and investment companies to support compensation payments arising from other, riskier, sectors. **FOS** The reform programme also offers an opportunity to clarify and define the respective responsibilities of the FCA and the FOS in respect of the regulatory consequences arising from the outcomes of FOS determinations. It should be for the FSA to determine which of FOS' decisions should be used as a precedent, particularly where this is likely to have far-reaching consequences on a firm or firms and the way they conduct business. 89. A second suggestion would be to review the 'Issues with Wider Implications' process so that FOS is bound by the decisions of the FSA. The current IWI approach means that, for example, the issue of PPI complaints was not resolved early as agreement could not be reached with FOS. If there was alignment between the FSA and FOS such that FOS had to abide by the FSA's decision under the IWI process, this would have been avoided. **Claims Management Companies** Financial Services Claims Management Companies (CMCs) should be brought within the regulatory perimeter. and made subject to FCA conduct regulation where they are handling financial services complaints. We have identified a range of circumstances where poor competence standards and quality of advice have resulted in unsatisfactory customer outcomes. CMC complaints should also subject to FOS adjudications, and CMCs should be required to contribute to FOS fees.

Analysis: Adequate checks and balances in the proposed regulatory architecture

Introduction

Real-time regulation requires real-time checks and balances. This paper argues that insufficient emphasis has been given in the draft legislation to providing robust protections for regulated firms. Fair due process is essential in a regulatory system to offer firms some defence against the irremediable harm that can be caused by inappropriate regulatory actions.

We have identified a number of points where the draft legislation could be strengthened to ensure that it delivers a just, fair, transparent and balanced system of regulation. These fall into two broad areas:

- transparency and consultation on regulatory policies; and
- due process and natural justice for firms subject to regulatory interventions.

We have outlined below our main issues of concern. We would be very happy to discuss any of these thoughts in detail.

Consultation

Duty to consult: FPC

The Bank of England is to acquire full responsibility for protecting and enhancing financial stability, and the Court must determine a strategy for this. The proposal is that it must consult the FPC and the Treasury on this strategy. We consider this inadequate and propose that it be extended to include a wider public consultation. We can expect the strategy to reflect the FPC/Bank's risk appetite in relation to financial stability and to provide insight into how it intends to comply with s.9C(4) and with the 'have regard to' requirements of s.9E. These are matters capable of having profound impacts on the economy, markets, the financial services industry, and its consumers, and should therefore be subject to public scrutiny and comment.

The ability of the FPC to direct the regulatory activities of the PRA and FCA is not constrained by any duty to consult. This risks subverting the important consultative processes that constrain the exercise of powers by those authorities. The FPC's power of direction should therefore not be capable of binding the PRA and FCA to exercise their own powers or functions without consultation unless the conditions in new FSMA section 138M (Consultation: General Exemption) are met.

Duty to consult: PRA

PRA's general duty to consult allows it full discretion over its consultative arrangements, including the option to consult only selected persons, and unlike the FCA, is not required to establish consultative industry or consumer Panels.

This level of consultative discretion for the PRA is excessive, particularly in the light of its current bank-centric character. The PRA must be required to consult all stakeholders affected by their regulatory proposals, including consumers where it is likely that they will be

directly affected. It must also be required, rather than given the option, to establish consultative Panels under arrangements parallel to those applying to the FCA.

Feedback to consultative Panels

The current requirement for the FSA to provide a written statement to the Panels setting out where it disagrees with a view expressed, or proposal made, in the Panel's representations, has not been carried forward in relation to the FCA's Panel provisions in New FSMA section 1M. There is no rationale given for this; but we consider that it is appropriate that both the PRA and the FPC should explain and provide transparency in respect of their post-consultative decisions.

Consultation and accountability: adherence to the Regulatory Principles

It is right that the Authorities should be required to consult on the extent to which their general policies and practices are consistent with their general duties, including the duty to have regard to the regulatory principles (new FSMA s.1H/2J). This broad requirement should be explicitly underpinned by parallel 'compatibility' requirements in each of the specific consultation duty sections (eg new FSMA s.137H, 137I for the PRA). It is also unclear why the 'compatibility' requirement associated with the requirements for the authorities to consult prior to rulemaking (new FSMA s.138J/138K) is restricted to the first sub-section of their respective 'general duties' sections (new FSMA s.1B(1)/2B(1)). Instead, consistent with ss.1H and 2J, the authorities should be required to explain when rulemaking how that exercise of powers is compatible with every aspect of their general duties.

Accountability for coordination

In our main response to the Government's White Paper, we have also proposed that the requirement in new FSMA s.3D(c) for the PRA and FCA to have regard to the Regulatory Principles should, in respect of the principles in sub-sections (a) and (b) be expressed as a collective, as well as an individual, requirement. It is otherwise possible for each regulator to satisfy the requirement to use its resources efficiently at an individual level without being required to seek any efficiencies at an aggregate level that could be gained through their coordinated activity.

In addition, we have proposed that the overall duty to coordinate the exercise of functions should include a requirement on the regulators to coordinate to minimise as far as possible their *aggregate* regulatory burden on firms.

Should these proposals be accepted, they will then need to be reflected in accountability requirements across the piece, and should form part of the independent audit remit to be given to the NAO.

Consultation by the PRA and FCA – Cost benefit analysis (138J, 138K and 138M)

We are concerned at the restrictions in the requirements to provide estimated costs and benefits within the cost-benefit analyses required for consultations. If the benefits and costs of regulation cannot reasonably be estimated, we question how the PRA and FCA will be able to satisfy themselves that their exercise of functions is consistent with the regulatory principle of proportionality set out in new FSMA s.3B(1)(b).

We do not, therefore, believe that it is appropriate for the regulator to be required only to provide an explanation of why it is not practical or reasonable to provide an estimate. Where no estimate can be made the regulators should be required to set out in clearly in their consultations the basis on which they believe that their rules are proportionate.

Consultation: FCA General and Temporary Exemption (138M and 138N)

We acknowledge that the general exemption from the duty to consult where a delay would be 'prejudicial to the interests of consumers' has been carried across from the FSA to the FCA. While we accept the need for such an exemption to allow the FCA to take swift actions in extreme conditions, we do not consider that there is then a need for a further 'temporary' exemption from consultation as proposed in relation to the product intervention rules.

We are not clear why this new section is necessary given the general exemption already available and are concerned that the use of such terms such as 'expedient' and 'necessary'. One would hope that the FCA would not in any case make such rules unless they were necessary and expedient for the purposes of advancing its objectives. The additional exemption appears to allow the FCA to avoid consultation on the basis mere convenience. Instead, the general exemption given in s.138M should apply to all rules, including those for product interventions. The proposed temporary suspension of the FCA's duty to consult could – and indeed should - also be incorporated in the general exemption; even though there may be a need for immediate action, this should not result in the introduction of permanent regulatory measures without a public consultation. We would also suggest that the 'sunset' clauses (2) and (3) should be amended to require the FCA to consult as swiftly as possible after the introduction of the temporary rules, and in any case, within 12 months of their introduction.

Appropriate avenues of appeal

The FSA's internal enforcement processes have evolved over time with significant improvements resulting from the Enforcement Review conducted by David Strachan. These controls and protections should not be given up. We believe that the FSA's current enforcement process should be captured and embedded in legislation, including provision for appropriate time periods for referrals, appeals and representations, and the independent review of the Regulatory Decisions Committee, to prevent further erosion of protections that experience has shown only too clearly to be essential.

Directions to authorised persons

The BoE/FSA papers on how the PRA will supervise banks and insurers state that the PRA will use its powers to reduce the likelihood of firm failure by, for example, requiring a firm to alter its business model (for instance exiting a particular business line or not pursuing a merger) or holding greater financial resources. However, as no stand-alone provision for this appears to have been set out in the draft bill, we assume that this power is to be exercised through variations of permissions.

Decision notices arising from the exercise of powers under the new authorisation provisions (new FSMA ss.55A-Z) will, we presume, rightly be subject to the procedures that the authorities must put in place under FSMA s.395. These procedures are designed principally to ensure that no one individual or function in the authorities can propose and take a

significant regulatory decision in respect of an authorised firm or approved person without the proposed decision being subject to independent scrutiny and challenge.

We are, therefore, deeply concerned at the extent of discretion given to the authorities to avoid the involvement of independent challenge in their decision processes in cases where they consider necessary in order to advance their objectives. Since 'advancing their objectives' is arguably equivalent to 'doing their jobs', it is hard for us to see this exemption as anything other than a gaping loophole in essential protections.

Independent challenge of the executive is expected of every regulated firm. We consider that the same should apply within the authorities, particularly when the potential consequences on firms of faulty decisions can be so severe. It has already been acknowledged by key individuals in the FSA that in some instances, the authorities may, in acting on judgments, 'get it wrong'. The procedures to prevent this happening must therefore be rigorous and robust, particularly when the authorities are relatively new and are still settling in their revised regulatory culture. Speed of action cannot be the issue here; the procedures may make provision for fast-track reviews, but the authorities must not be allowed to avoid them completely.

Publication of Warning Notices (s391)

The pre-emptive publication of warning notices before an investigation has taken place flies in the face of the notion of natural justice that requires each party to be given the opportunity to ask questions and challenge the evidence of the opposing party. Although firms will be consulted before the publication of a Warning Notice, it will be difficult, if not impossible for them to contradict the regulator's judgments effectively. We can expect little objective evidence to have been produced at that stage; it will emerge in the course of a full regulatory investigation process. Firms will be forced to challenge opinions, and powerless to prevent ill-judged actions being taken against them

The period for a firm to make representations to the PRA/FCA before it issues (and now publishes) a warning notice has been reduced from a minimum of 28 days to 14. There is no clear rationale for this reduction in time and it raises further concerns that firms will not have an appropriate opportunity to fully review and challenge the evidence or other considerations on which the regulator's view is based.

It is also unconscionable that decisions to publish cannot be stayed and examined by reference to the Tribunal. The over-hasty and ill-judged publication of warning notices may give rise to significant reputational damage and loss to a firm, exposing them to public censure without the benefit of proper process. We fundamentally dispute the need for the regulator to enjoy such an unfettered power to damage the firms it regulates.

The damage which may be caused by the publication of a warning notice that proves to be ill-founded will often far exceed the possible benefit of publication prior to the conclusion of a full and fair investigation. If the Government insists on carrying its 'transparency' policy forward, it must put in place appropriate protections in order to avoid significant and unwarranted harm being caused.

We see no material difference in significance between a decision to publish a Warning Notice or other information about a firm, and any other decision to exercise regulatory

functions. Decisions to publish Warning Notices must therefore also be made subject to the regulators' internal independent challenge procedures set up under FSMA s.395.

Publication of directions in relation to Financial Promotions (s137P)

We are similarly concerned about the proposals regarding the publication of directions to firms in relation to financial promotions, particularly where such a direction may later be revoked. Publication of directions relating to financial promotions is arguably 'public censure' without the appropriate and necessary safeguards.

References to the Upper Tribunal (s133, 133A)

As a reference to the Upper Tribunal is one of the few 'real time' checks on the judgement led decisions of the PRA/FCA, it is imperative that it is empowered to operate effectively and efficiently. The new powers given to the regulators will need to be tested and full rights of appeal by firms are therefore essential. Effective review by a third party of disputed decisions must be put in place consistently to the worst consequences of inappropriate, unfair or poorly judged regulatory action.

The restriction on the action that the Tribunal can take in relation to some decisions by the regulators is unjustified – instead, the Government should ensure that their powers are not reduced and are extended to cover any new powers granted to the regulators. One of the key drivers to ensure that regulatory decisions and analysis are robust is the regulators' understanding that those decisions are subject to external review and, ultimately, published comment. It has been shown that an independent review can identify flaws and poor practices and prompt change – the criticism of the Upper Tribunal of the poor practices of the FSA following the Legal & General case is a good example of this. We do not believe that the restricted appeals process delivers this.

Suspension of regulatory action pending Tribunal determination

Under the current regime, the enforcement process provides for firms with 28 days to refer the matter to the Tribunal; the decision notice may not then be issued until after the Tribunal has made its determination.

As currently drafted, section 133(4) only prevents the regulators from taking the actions specified in a 'decision notice' where it is subject to a referral to the Tribunal. This suggests that substantive actions taken under other powers, including the power to publish written notices, are not automatically stayed by a referral to the Tribunal but are instead dependent on the discretion of the Tribunal (s133(3)). We see no persuasive rationale for drawing this distinction between decision notices and other definitive regulatory decisions and acts that have impacts on firms.

In addition, there are some circumstances where the right to refer matters to the Tribunal only takes effect *after* the substantive regulatory action. For example, under sections 55L and 55M, the regulators can issue a 'written notice' imposing, with immediate effect, a requirement on an authorised person. There is nothing in the proposed legislation or any of the documents so far published that gives us comfort that the right to refer a matter to the Tribunal in these circumstances offers anything more than an opportunity to shut a stable door after a reckless horse has bolted. This should be corrected.

Analysis: the Financial Ombudsman Service

We fully support the role of the Financial Ombudsman Service in providing an effective, independent, quick and free service to resolve disputes between individual consumers and firms on a case-by-case basis.

However, the uncertainties that arise from the impact that FOS decisions currently have on regulatory policy cannot be overstated. It has blighted firms' appetite for innovation and prevented the development of solutions to important issues such as the advice gap that will arise from the Retail Distribution Review.

The current regulatory reform programme offers an important opportunity to support growth and innovation in financial services by clarifying the role of the FOS in respect of individual complaints and differentiating it from that of the FCA, as regulatory policymaker. An explicit objective should be drawn up for the FOS, together with a suite of principles to inform and direct the actions they take in pursuit of their objective.

The bodies should not be permitted to make their own rules.

The role of the FOS in relation to matters of regulation and law

We welcome the Government's wish to provide greater clarity in relation to the respective roles of the FCA and FOS in respect of potential causes of mass detriment. However, we suggest that the basis for proposing these measures would in fact support a wider scope to include all cases where there is a regulatory concern arising from complaints adjudicated by the FOS.

It is essential that the legislation should specify that individual FOS decisions cannot be taken as creating or modifying regulatory requirements.

Although decisions by FOS are made on an individual case basis and its findings are therefore specific to the particular circumstances of each case, the current requirement on firms to take account of the decisions of FOS means that individual decisions can generate wider precedents for firms.

This is, of course, not inappropriate where complaints clearly share a common root cause within a firm, and the findings are consistent with applicable law and regulation. Firms should rightly learn any lessons to be taken from such decisions and apply them to the benefit of their other customers.

However, difficulties arise where the Ombudsman's decision implies a higher standard than that set by current law or regulation, sets a standard of conduct that has not been captured in law or regulation, varies an existing legal or regulatory standard or requirement, or applies one retrospectively. In these circumstances, the FOS is, in fact, generating regulatory policy, but is doing so without the protections that apply to the regulators when they propose new or changed measures.

We believe that it is necessary to clarify in statute that FOS decisions are relevant only to the case in point, and that no FOS determination may be taken to introduce new legal or regulatory requirements or vary those applicable at any given the time.

Resolution of regulatory issues by FCA

There should be a right to refer to the FCA any regulatory concerns arising from a complaint or from an ombudsman decision. This right should not, as is proposed in respect

of issues giving rise to mass detriment, be limited to nominated parties, but should extend to any interested party.

FCA decisions on such referrals must be binding on the FOS, as is currently the position under section 404 FSMA and consumer redress schemes.

Resolution of novel points of law

90. Firms may currently request that ombudsman decisions that turn on a novel or disputed point of law be referred to courts as test cases. This process should continue; however, it should not be for the FOS to decide such requests, as it is clearly conflicted. A competent and independent third party, established for the purpose, should determine the validity of the request.

FOS Discretion

FOS is empowered to determine complaints based on what is 'fair and reasonable in all the circumstances of the case'. This means that FOS decisions are not constrained by a pure reading of the law or regulations. The wide discretion particularly allows the FOS to examine all matters relevant to a complaint, such as delays or maladministration, which would otherwise fall outside regulatory or legal consideration.

In the Court of Appeal case *R (on application of Heather Moor v Edgecomb Ltd) v Financial Ombudsman Service* [2008], the Court considered this extensive discretion, and found that, absent an 'exception factor', firms which comply with regulatory requirements should not be held liable. The Court's approach clearly took account of the evolution in the regulatory regime; the high operational standards now expected of firms to meet customer fairness requirements would be sufficient to address most customer problems.

We do not advocate full removal of FOS' wide discretion, as it is appropriate to the resolution of individual disputes. However, we do suggest that for the purposes of clarity and certainty for firms, the basis for its decisions must be more reasonably constrained by due regard for the legal and regulatory requirements that apply to firms.

In determining what is fair and reasonable, therefore, we suggest that the Ombudsman be required to have regard to the extent to which a firm's actions were compliant with rules and regulations in existence at the time of the complaint. Determination of a complaint based on matters that were not a requirement of either regulation or law should only be made as an exception.

Identification of further grounds for complaint

Should the Ombudsman identify in the course of his deliberations a new ground for complaint that has not yet been raised by the consumer, the Service currently creates a new complaint case and charges the firm concerned a further case fee. This 'additional' complaint will also be added to FOS complaint statistics against the firm. In our view, the FOS should instead be required to refer the matter back to the respondent firm to address under their normal processes. Otherwise, firms are exposed to multiple ombudsman decisions (and fees) without having had the opportunity to resolve them satisfactorily themselves and obviating the need for further FOS intervention.

Publication of determinations

The FOS has been given a clear remit to publish individual decisions, so as to inform firms and consumers of the basis on which FOS is determining complaints. We have dealt else where with the need to make clear that individual complaint decisions, whether published or not, cannot create regulatory precedent. Nonetheless, there may be decisions that rely on other factors, and there may be some benefit from publication. However, rather than the 'publish all' approach proposed, the FOS should be required to publish only those decisions that are likely to inform firms about general principles being applied by the FOS, where they do not relate to matters of regulation, and pending their adoption into the FOS's canon of technical standards.

Such decisions should be anonymised before publication so that neither the respondent firm nor the complainant can be identified. It would be unreasonable for those reviewing the decision, in particular, consumers, to draw inferences about a firm's general behaviour on the basis of an individual complaint.

Inappropriate Compensation Awards

Current FOS arrangements allow the quantum and basis for compensation can reward consumers beyond reasonable expectations. For example, requiring a full refund of premiums on upholding a mis-selling complaint when a claim under the policy complained of has been paid out. In such circumstances the policyholder has benefited from free insurance cover, and has therefore been unjustly enriched.

The first objective of redress should be to return the policyholder to the position they would have been in should the cause of the dispute not have arisen. Therefore, in our example, any refund of premiums arising from a determination that the product was missold should take into account any monies that have already been paid out under a claim.

Accountability and Oversight

The legislation currently requires little in the way of accountability and oversight over the FOS.

Operational Conflicts of Interest

FOS is continually placed under operational pressures by the high volumes of complaints it receives. This pressure gives rise to a conflict of interest within the FOS. The pressure to reduce strains on budgets could compromise objectivity or create perverse incentives for the FOS to find more cases in favour of customers (this effectively forces firms to apply a potentially contentious approach to complaints before they are referred). Equally, the FOS could be tempted to apply a bulk process to clear complaint numbers, that could lead to reliance on a single perceived point of failure rather than by reference to the individual circumstances of each case.

We believe that the FOS Board should be explicitly accountable for managing internal conflicts of interest such as these.

September 2011

Mr Paul Lewis; Financial Services Compensation Scheme; Financial Ombudsman Service; Money Advice Service; Reserve Bank of Australia; Consumer Focus; Which?; Citizens Advice Bureau and moneysavingexpert.com – oral evidence (QQ 99-206)

Transcript to be found under Consumer Focus

Listing Authority Advisory Committee – written evidence

Thank you for the opportunity to provide written evidence to the Joint Committee on the Draft Financial Services Bill and apologies for the lateness of this response.
I am pleased to respond on behalf of the Listing Authority Advisory Committee ("LAAC"), an independent advisory committee to the FSA Board comprised of experienced users of the financial markets, including issuers, investors and financial intermediaries. The attached memorandum provides our evidence on questions 15, 16 and 17 of the Committee's call for evidence.

In answer to your general question about whether the draft legislation will or could better prevent another financial crisis, we believe that an equity market perspective might be salient. In 2009, as a response to the corporate balance sheet problems exposed by a combination of over-gearing and sharply reduced debt liquidity, UK equity investors were called on to subscribe to new issues of equity via rights issues, open offers and placings totalling £110bn. The regulatory processes required for this issuance (prospectus production and oversight by the UKLA, in particular) were seen by participants as contributory to the success of the equity-raising process, rather than as an impediment to it.

We would point out that whilst some may perceive the formation of the FCA to be founded on the failure of the tripartite regime which preceded it, the UKLA's success throughout 2009 and beyond would suggest that the more appropriate question may be not how to prevent another failure, but how to ensure another success?

I hope that the answers to the questions as attached will assist in providing a regulatory framework to that end, and would be more than happy to give oral evidence if the Committee would find that helpful.

Introduction to the Listing Authority Advisory Committee

The Listing Authority Advisory Committee is composed of persons appointed by the Board, whose membership includes those chosen to represent the interests of practitioners and listed companies. Currently there are sixteen members representing issuers, investors, corporate finance, professionals and the London Stock Exchange. It meets three times a year and holds a number of sub-group meetings to discuss in detail specific issues that are either raised at a previous meeting or that the UKLA request input on.
The Committee is independent of the Board and reports half yearly on its activities, in addition to bringing to the attention of the Board anything it believes is relevant for consideration.

Its function is to advise the Board:
· on major policy issues relevant to the Board which affect issuers of securities; and on proposals for the regulation carried out by and the policies and operation of the Authority's listing function.

Question 15

**15. Are the FCA's primary objectives appropriate? Is significant emphasis given to
the promotion of competition?**

FCA Approach and Objectives

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

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

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

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

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

Promotion of Competition

15.6. We believe that a broader interpretation of the question of the promotion of competition also requires us to address the issue of international competitiveness.

15.7. We note that maintaining the international competitiveness of the UK's financial markets is not proposed to be a self-standing objective of the FCA. However, we believe that the FCA, and the listing authority in particular, need to ensure that the

UK's financial markets do continue to attract a diverse range of issuers and financial products, both domestic and international, and that the UK should actively seek to maintain its position as one of the world's most important financial centres. In the absence of restrictions on international movements of capital, UK investors will be able to buy investments wherever they are issued and whoever approves the prospectus. And they will do so, particularly if the UK approved market becomes limited in scope in the interests of protecting consumers and the only way to find higher returns on investment (usually involving higher risk) is to look to other markets.

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

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

16. Are the responsibilities of the FCA towards the regulation of markets appropriate? And 17. Does the draft Bill strike the right balance between the responsibilities of consumers and firms? Are the FCA's new powers in the area of consumer protection appropriate?

17.1 As regards the appropriate regulation of markets, the FCA needs to be mindful of the distinction between consumer and investor protection, and between wholesale and retail markets.

17.2 We think that the Treasury Select Committee is right when it says "financial markets are primarily about the management and pricing of risk, not its removal"1. In the context of the listing authority, this translates into ensuring that proper disclosure is made in prospectuses, within the limits prescribed by the prospectus directive regime, not refusing admission to products that are deemed to be too risky for certain investors2.

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

17.4 The focus of legislation therefore should be to reinforce disclosure requirements

for the fullest possible range of products admitted to the UK's markets, but with graded conduct of business rules designed to protect the most vulnerable (for example, by imposing suitability or appropriateness duties on the intermediaries that sell products to them or even, in some extreme cases, banning sales of particular products to them altogether). But those rules should allow the more experienced investors to judge the investment opportunities for themselves and take whatever risks they make think appropriate. This needs to be made clear in the legislation to avoid misunderstanding and a possible regulatory creep towards risk aversion in the future.

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

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

September 2011

Lloyds Banking Group – written evidence

Lloyds Banking Group ('the Group') welcomes the opportunity to respond to the Call for Evidence from the Joint Committee on the Draft Financial Services Bill. We have been closely engaged throughout the Government's development of its regulatory reform proposals, contributing responses to formal consultations and participating in industry roundtables.

In common with many stakeholders, the Group supports the development of a robust, fit-for-purpose supervisory regime which balances financial stability concerns, the fair treatment of customers and sustainable economic growth. Given the importance of these reforms to the financial services sector and the public in general, we are pleased that the Draft Bill will be undergoing detailed pre-legislative scrutiny by the Joint Committee.

The Group has contributed to the BBA, ABI and the CBI responses. The purpose of this letter is to highlight areas of specific concern and / or interest. For ease, we have selected appropriate questions from the Committee's list under which to make our comments.

3. Is it appropriate to make such major changes to the regulatory system by way of amending legislation, rather than starting afresh?

Given the short timescales for delivering the new regime, it appears impractical to start afresh.

4. Are the accountability and governance arrangements for the Bank of England, FPC, PRA and FCA satisfactory?

We remain concerned about the coordination between the regulatory bodies, particularly given that the differing objectives of the PRA and FCA may create situations where a particular product or business area is subject to conflicting policies, e.g., changes in prudential treatment and conduct of business requirements. We look forward to seeing more details on how policy and intervention will be coordinated.

12. Are there any risks in the Government's proposed 'judgement-based' regulation?

Yes. The main three areas of concern are as follows:

- **Judge and Jury:** HM Treasury proposes changes which will allow an individual who has been directly involved in establishing the evidence in a supervisory or enforcement investigation to also be involved in the decision to issue a supervisory notice (amending existing sections 395(2) of the Financial Services and Markets Act). This means that an individual charged with investigating a matter can also determine the penalty to be imposed. It is unclear why this change is necessary when previously emphasis was placed on separating the act of investigation from the decision on penalties. If the Government is minded to proceed, appropriate safeguards will be necessary to ensure the decisions taken are fair.

- **The responsible application of new powers:** the FCA has been granted new powers in three key areas: product intervention, the amendment/withdrawal of financial promotions, and (along with the PRA) the publication of supervisory notices. Regulators should publish guidance on how and when the powers will be used. Equally, safeguards are needed to ensure that the use of these tools must be preceded by supervisory engagement with the firm(s) to resolve the issue.

- **Judgement-based regulation:** the PRA and FCA need to be transparent about the work they do and continue with the early and ongoing dialogue with firms, particularly if there is less scope for appeal.

15. Are the FCA's primary objectives appropriate? Is [sufficient] emphasis given to the promotion of competition?

We see potential risks with how the FCA interprets and operationalises its objectives. Too great a focus on transparency and on price may drive product providers towards 'lowest common denominator' offerings, the stifling of competition, and disincentives to innovate.

There needs to be coordination across the competition regulatory architecture. Any new proposals regarding competition powers for industry regulators such as the FCA should await the policy outcomes of the Government's proposals for reform of the current competition regime.

17. Does the draft Bill strike the right balance between the responsibilities of consumers and firms? Are the FCA's new powers in the area of consumer protection appropriate?

Broadly, as we acknowledge that high standards of conduct are important to enhancing confidence in the UK financial system.

However, it is important that the degree of regulatory protection afforded should be tailored to the type of consumer. The term "consumer" as defined in the draft Bill covers a broad spectrum, from private individuals purchasing long term retail products (e.g., life insurance, pensions) or using their bank accounts on a day-to-day basis to investment banks engaging in financially sophisticated transactions to small companies borrowing directly from banks. This broad definition means that it is essential that the Bill includes reasonable provisions to ensure that regulatory approaches, (whether in terms of policymaking, enforcement or day-to-day supervision) are be proportionate to the customer, the nature of the transaction and the product type.

We would be happy to discuss any of the issues raised in the White Paper with Committee members and look forward to working with you as the Bill develops.

September 2011

Lloyds Banking Group – supplementary written evidence

Lloyds Banking Group has been closely engaged throughout the Government's development of its regulatory reform proposals, contributing to formal consultations and participating in industry roundtables. We submitted a response to the Joint Committee's recent call for evidence and worked closely with the BBA on its industry level response. The following paper is our response to the questions which were circulated by the Clerks to the Joint Committee on 27 October 2011.

Questions on the role of the FPC

1. **The draft Bill states that the FPC should not exercise its functions in a way that might have a significant adverse effect on the capacity of the financial sector to contribute to medium and long term economic growth. Is this sufficient to ensure that impacts on economic growth are taken into account?**

- We are ultimately more concerned with how the FPC approaches and executes its responsibilities in practice.
- The ability of the Treasury to make recommendations to the Committee is an important element of the structure; it will help to ensure that the Committee can reflect on national policy concerns in its deliberations.

  - **Would you prefer a positive requirement for the FPC to support growth rather than a direction not to significantly harm it?**

- In terms of practical application on a day-to-day basis, there may not be much difference between the two ways of articulating the objective. However, a requirement to 'support growth' is likely to be interpreted more restrictively than a direction not to harm growth.
- The Treasury's ability to make recommendations to the FPC should help to ensure that the FPC's actions reflect, for example, a need to support the UK growth agenda.

2. **Should the FPC have regard to other objectives or issues?**
   - **Could this dilute its focus on the main objective?**
   - **Are there additional measures that should be included in the draft Bill to ensure that the FPC takes into account relevant perspectives from consumers and industry?**

- The process for the Treasury to make recommendations to the FPC should help to ensure that the FPC gives due consideration to economic, social and / or other issues as these come to the fore.
- It is important not to second-guess what may be required at some point in the future.

3. **[To Barclays and HSBC]: You have suggested that the financial stability objective should be changed to maintaining a sustainable supply of credit. In a recent oral evidence session with a panel of academics, two concerns**

- We think that the current Bill text achieves a difficult balance.

4. **The supply of finance, including bank credit to business, has been a prominent issue since the crisis. Should the FPC be given an explicit responsibility for making recommendations on such issues? Or should it be the responsibility (as it is now) of HMT and the Department for Business Innovation and Skills?**

- This should continue to be the responsibility of the Government, which can balance economic and social policy according to prevailing conditions.

Questions on macro prudential tools

5. **Are the arrangements for the Treasury to introduce macroprudential tools satisfactory? Should there be additional requirements for example, consultation with the industry to avoid unintended consequences?**

- We believe that industry consultation may not be needed where proposals are in line with EU minimum standards. But industry consultation to identify unintended consequences is highly desirable where the UK is proposing to be super-equivalent.
- The draft Bill enables the Treasury to create new tools and suggest other factors the FPC might consider in the exercise of its function. There is a need for clear triggers and checks and balances.
- The FPC's toolkit should be developed in alignment with international consensus to avoid the UK becoming an outlier or competitively disadvantaged.

6. **Would you prefer the application of macroprudential tools to be governed by predictable rules, e.g. on loan loss reserving or capital requirements, rather than left to discretionary actions by the FPC?**

- Certainty and predictability has, by and large, been a key feature of UK financial services legislation in recent years. The aim should be for this tradition to continue rather than leaving too much to the discretion of the FPC.
- Banks require certainty to manage their business and to provide the best service to customers.

Questions on accountability and governance of the Bank

7. **Do you agree with concerns that draft Bill places too much power within the Bank of England? If so which powers/duties would you take away from the Bank and where would you put them?**
   - **Do you have any concerns about the prudential regulator being part of the central bank?**

- **Is the Bank's governance structure suitable to support such powers?**

- It is important that the Bank of England is accountable to Ministers and Parliament.

Questions on membership and accountability of the FPC

8. **What is your view on the accountability arrangements and balance of membership of the FPC? Would you suggest any specific changes to the draft Bill?**

- The balance of Bank versus non-Bank staff on the FPC is equivalent to arrangements for the MPC. This appears consistent.

9. **What are the pros and cons of the proposal that the FPC should be a committee of the Court?**

- The different status of the Financial Policy Committee and the Monetary Policy Committee simply reflects the existing statutory position: the Court is required to determine and review the Bank of England's strategy in relation to the financial stability objective; but it does not have a remit for the formulation of monetary policy. More important are the similarities between the FPC and the MPC in relation to the appointments process to the two committees and in particular the expectations of transparency.

10. **Are the proposed arrangements for keeping the Chancellor informed of potential financial stability problems sufficient? Is there a case for requiring the Bank to inform the Chancellor before the SRR is triggered?**

- Yes, the arrangements appear sufficient.
- The Governor must notify the Chancellor whenever there is a potential for a call on public funds. Triggering the Special Resolution Regime (SRR) is likely to meet that test of 'potentially' calling on public funds. In practice and because of the naturally prudent character of the role of the Governor of the Bank of England, we expect that the Governor will notify the Chancellor before the SRR is triggered.

Questions on the FCA's objectives

11. **Concerns have been raised about the FCA's strategic objective to promote and enhance confidence. What is your view on alternative suggestions such as ensuring a fair and transparent market or promoting fair, efficient and sustainable markets that work well for consumers and users of financial services?**

- More important for practitioners and consumers is how the organisation approaches its work and whether it has the ability and resources to do its job properly.

12. **Would you agree with the ICB recommendation to replace the FCA's efficiency and choice objective with one to 'promote effective competition'?**

- The TSC and the ICB have argued for competition to be a 'Primary Objective' for the FCA while the current HMG proposals are for a 'Primary Duty';
- We support the current formulation contained in HMG draft legislation which grants the FCA a primary duty to promote competition; this is sufficient to ensure that the FCA takes account of competition
- We do not believe that the FCA should have concurrent powers with the OFT to enforce general competition law.
- We would be concerned at any suggestion that the exercise of the FCA's powers would be less susceptible to legal challenge – this would deny those subject to regulation their fundamental rights of defence.

13. [To HSBC] What are your reasons for suggesting competitiveness of the UK as an additional objective for the FCA, but not the PRA?

Questions on consumer protection

14. Consumer groups have told us that in other sectors, regulators (such as Ofgem, ASA and Ofcom) are more open about firms that they are investigating. Why do you think that the risks of increasing the transparency of investigations are more problematic in the financial sector?

- Banks are not utilities. They are very different organisations to those regulated by regulators such as Ofgem or Ofcom.
- A key difference in financial services is the existence of 'approved persons'. Whereas investigations into e.g. the propriety of an advertisement, or service quality in a gas or telecommunications company, impact on the corporation concerned, the simple fact of an investigation in an area where there are 'approved persons' could jeopardise an individual's reputation without due cause.
- It also depends on the nature of the information which is to be disclosed. It is already recognised that there is a need for safeguards around disclosure when operating the SRR given the potential for extreme market reaction and contagion.
- In terms of investigations prompted, for example, by potential mis-selling, we would point out that the new regulators will have strong product intervention powers which will enable them to stem the flow of such products to consumers; this mitigates against disclosure being used where the purpose of such disclosure would be to prevent further consumer detriment by warning consumers against buying particular products.
- The financial crises have demonstrated that financial markets are extremely confidence sensitive – from the queues outside of Northern Rock to the spreads on some EU member states' debt.
- These markets are critically and inextricably linked to the wider economy, and where information is disclosed it can cause severe disruption to the normal operation of the financial markets on which the economy depends.

Questions on consumer responsibility

15. The FSA Consumer Panel has put forward the proposal that firms should have a fiduciary duty to complement the consumer responsibility principle. What is your view on this and on the general proposition that the consumer responsibility principle be complemented by a similar principle for firms?

- We understand that the Consumer Panel is seeking to require 'a stricter standard of behaviour than the comparable duty of care at common law'. The Panel proposed an amendment of the regulatory principles to state that 'where appropriate, authorised persons should have a fiduciary duty towards the consumers who are their clients'.
- Currently, FSA rulebooks and legislation set out the duties of firms to consumers in particular circumstances; in many cases, these duties are derived from EU legislation or are the result of consultation at a national level. For example, there are specific duties which a firm has where it is providing investment advice to a retail customer. This approach, which is tailored for specific types of activity, is more appropriate to protecting the interests of customers than an overarching statement.
- Given the broad definition of consumer in the Bill, its inclusion in an overarching statement could have unsuitable impacts on for example counterparty interactions, removing responsibility for counterparties of equal knowledge or status for their own decisions and actions.

16. Should the Bill define different types of consumer?

- 'Consumer' is generally interpreted in a retail, private individual context, whereas the Bill uses it to cover all users of financial services. We recommend the term 'user' which would encompass all relationships, but not have the same connotations as 'consumer'.
- An attempt to set out different types of consumer in the Bill may add an additional layer of complexity. EU legislation uses a range of terminology to describe client relationships. For example, MiFID sets out client categorisations of private clients, professional clients and eligible counterparties, whereas the Payment Services Directive uses the term 'consumer' to apply to "a natural person who, in payment service contracts covered by this Directive, is acting for purposes other than his trade, business or profession."
- Differentiating between types of consumers is best accomplished within regulation, i.e., within the regulator's Handbooks.
- The regulator should have the ability to treat business lending discretely from retail consumer credit within its Handbook, and thereby ensure that the regulatory regime is tailored to this type of activity.

Questions on the PRA's objectives

17. [To Barclays] Why do you think that the PRA should have regard to economic growth?
   - **The FPC will need to take into account impacts on medium and long-run growth. Why is this not sufficient to ensure that prudential regulation makes the right trade-off between stability and growth?**

- We do not have a strong view on Barclays' proposal.

- The FPC will have the ability to direct the PRA, and may do so in a way which reflects the need to support economic growth, particularly if the Treasury has made recommendations to the FPC in this respect.

18. **[To RBS] Why do you think the PRA should take into account impacts on competitiveness and innovation?**
    - **Is there a risk of creating an insufficiently focused remit?**

- Again, we have not taken a strong view on this but would assume that the rationale for including competitiveness and innovation in the objectives is to ensure the regulators are focused on fostering UK economic growth.

19. **[To all] In our evidence session with Sir John Vickers, he thought it important that the PRA should have regard to competition, although did not specify how or whether this should be reflected in legislation. Consumer groups have suggested that the PRA should take into account effects on competition and consumers. Do you think that the PRA should have regard to effects on competition and consumers?**
    - **Do you think the PRA's veto power over the FCA is appropriate?**

- The PRA should take into account the effects of its interventions on competition and consumers.
- It makes sense for all of these bodies to be as consistent in their actions as possible.
- The issue of a veto is one for the authorities; but we would observe that *in extremis* there may be occasions where prudential considerations must over-rule conduct of business considerations. But the grounds on which the veto could be used should be made clear; as should the expectation that the power would be exercised very sparingly.

Questions on coordination between the PRA and FCA

20. **Are you satisfied for the PRA and FCA to set the detailed coordination arrangements, or do you think specific provisions should be included in the Bill?**
    - **If provisions should be included in the Bill, which specific provisions, and why?**

- We remain concerned about the coordination between the regulatory bodies, particularly given that the differing objectives of the PRA and FCA may create situations where a particular product or business area is subject to conflicting policies, e.g. changes in prudential treatment and conduct of business requirements. We look forward to seeing more details on how policy and intervention will be coordinated.

Questions on coordination with Europe and the impact of CRD IV

21. **What is your view on the idea of an international team drawn from both the FCA and PRA to negotiate for the UK in the EU and other international rule setting bodies?**

- We support this proposal. It is crucial there is consistency across the complex global regulatory political landscape.

22. Given the limits placed on national regulators by CRD IV, do you think the UK will have sufficient flexibility in implementing prudential policy?

- This is a question for HMT/Bank/PRA. Pillar 2 of the Basel Accord provides flexibility today. We remain concerned about the impacts of super-equivalence, the costs to the industry and the wider economy and the barriers to competition from other EU banks that arise from it.

Questions on the judgement-based approach

23. There have been concerns about whether there will be sufficient safeguards to ensure that regulation does not become inconsistent under the judgement-based approach. Do you think any further safeguards need to be written into the Bill?

- We support the move to judgement-led regulation. It is important that decisions the PRA makes are in line with the individual circumstances of the firm, its position in the relevant markets and the economic conditions at the time. This will enable the PRA to have sufficient flexibility to make decisions based on the specificities of each case, rather than being hampered by a preset formula.
- The HMT blueprint acknowledges that the quality of the PRA staff will be particularly important, and that judgement-led decision-making will be rigorously evidenced based. It is vital that these two principles are applied subject to a high standard and level of scrutiny in order for the PRA to make successful judgement-lead decisions.
- The Bill needs to ensure that the PRA and FCA are transparent about the work they do and that they continue with early and ongoing dialogue with firms.
- The most important and, in our view necessary, safeguard would be the maintenance of a full appeal on the merits review by either the Tribunal or the courts.

Questions on holding regulators to account

24. Will there be sufficient accountability in the new system? For example, do you feel that regulators will be adequately held to account for mistakes?

- To ensure that the new system gains the respect and credibility of consumers, practitioners and the wider market, a robust system of accountability is needed to ensure that high standards are maintained.

25. It could be argued that giving the Tribunal powers to substitute its own judgement for that of the regulator could undermine the judgement-based approach. In addition, it is not clear that the Tribunal rather than the regulator is best placed to make decisions about regulatory action. What is your view on this?

- Most regulation involves elements of judgement, sometimes to a high degree. In other areas, such as competition regulation, there is ‘appeal on the merits’ where the Competition Appeals Tribunal and the higher courts can overturn a regulator’s judgement, as well as requiring the regulator to reconsider their judgement, reasoning and evidence. This provides an important safeguard both to the consumer and to regulated bodies.
- There remain significant concerns about the appeals mechanism on supervisory decisions given that (when called upon) the Tribunal would no longer be able to substitute its own opinion for that of the regulator, leading to a potentially toothless review process. This would represent a serious erosion of firms’ rights to an independent review of contested decisions and we believe that it is right for the Tribunal (and/or the courts) to retain the authority to overturn decisions with which it disagrees.

Questions on the ring-fencing proposal

26. What are your views on the costs and benefits of a retail ring-fence?

- The final ICB report was well balanced and thoughtful. We believe its recommendations will help enhance the financial stability and reduce probability of reliance on taxpayer in any future systemic crisis.
- The changes are part of a holistic package of reforms. Four Pillars: more liquidity; more and better quality capital; effective macro and micro supervision; recovery and resolution.

Costs and benefits

- There will be some costs, in terms of pricing/availability of credit to wider economy, for the enhanced financial stability the ICB’s recommendations will create. There is a need for a credible cost benefit analysis.
- The ICB proposal for a ring-fence captures the claimed stability benefits of Glass-Steagall but also retains some diversification and management synergies.
- We welcome flexibility on the width of the retail ring-fence. It is necessary to sustain the flow of credit to business of all sizes.
- The ICB has been adamant that ring fencing would curtail any implicit government guarantees present in the system, and in particular that the (Ring-Fenced Bank) RFB would not enjoy any implicit support.
- Improved regulation, higher capital and liquidity requirements as in Basel III, plus R&R plans all help to ensure that banks are not only much less likely to fail but also much less likely to need government support if they do still fail.
- The RFB in particular would be an exceedingly safe entity - simpler, less interconnected and more highly capitalised - and should thus have no need for taxpayer support.
- We welcome the ICB’s focus on loss absorbing capital. It is important that regulation and legislation retains this loss-absorbing aspect: if the ICB proposed levels became a hard regulatory requirement, then banks’ managements would have to hold significantly larger capital reserves.
- Further and careful consideration is needed on bail-in-ability and depositor preference proposals for their implication for senior unsecured markets.

- The best outcome for the markets is early clarity of Government intention on the ICB, careful and considered legislation to implement intentions and realistic timescales for the banks to make the necessary changes. It is important to avoid rushing legislation for the Financial Services Bill simply because it exists as a vehicle.

  - **Do you envisage that in practical terms, we are likely to see banks deciding to structurally separate their businesses rather than operate a ring-fence?**

- The ICB's recommendations allow banks considerable flexibility in how they organise their businesses.
- We cannot predict how individuals and businesses may assess the risk/reward trade-off of the RFB vs. the non-RFB.
- One could imagine that in a crisis situation, customers' perceptions of the relative riskiness of the different institutions might change. This could be de-stabilising for the non-RFB.
- Transparency as to what services each bank is offering inside or outside the ring-fence will be important in enabling customers to make this choice.

Questions on the effect of ring-fencing on resolution

27. **How confident are you that the Independent Commission on Banking's proposals, taken with other reforms, will protect the taxpayer from having to bail out a bank in the future?**

- It is important to remember that a ring-fenced bank would be a much safer entity and so would be much less likely to need to be resolved. It will be insulated from the greater interconnectedness of I-banking activities. Applying the ICB's proposed enhancements to the Basel III capital and liquidity standards to such a subsidiary would create an especially well-capitalised and well-funded entity, contributing to, and benefiting from, economic stability.
- In the unlikely event that the RFB needed to be resolved, it would be simpler by virtue of being less interconnected. The Special Resolution Regime already provides for a number of resolution options, including use of a bridge bank and Temporary Public Ownership (TPO).

Questions on measuring risk

28. **It is now clear that in the run-up to the last crisis, risk was under-estimated and mis-priced. How successful do you think prudential requirements based on risk-weighted assets will be in the future?**

  - **Is there more that we should, or could do to ensure that the risks that banks take are more transparent?**

- The financial crisis identified areas where the amount of capital set aside for losses proved to be insufficient, most notably, market risk and counterparty credit risk. Changes will soon be introduced in banking regulation that substantially increase the amount of capital required for such exposures.

- In addition Basel III is introducing changes from 2013 to increase the quantity and quality of loss absorbing capital in banks and we believe this will significantly improve stability in the financial sector. This is the most significant element of the package of changes.
- However, this will not deliver a "zero failure" regime. A BoE study (Professor Miles, Jan 2011) concluded that banks would have needed a core tier 1 ratio of 50% if they were to survive every recent economic crisis. Clearly if Core Tier 1 ratios were to rise to 50% then it would be massively detrimental to the economy and the cost of credit.
- Capital alone is not the only answer. It is also important to improve the measurement of risk, building up loss absorbing capital in banks (e.g. new EU requirements for a 9% CT1), improving liquidity, funding arrangements, Recovery and Resolution/Living Wills, management and supervision of banks. Transparency (disclosure) is also important
- The level of public disclosure we have is already significant and in our view about right to enable rating agencies, market analysts and commentators to understand the risks that banks have. This has changed dramatically since 2009.
- We accept that it is sometimes difficult for the public to interpret some information. They rely on bank's management, regulators, market commentators and rating agencies to identify risks to them. We think this is the right approach.

November 2011

London Stock Exchange Group – written evidence

Executive Summary

The London Stock Exchange Group (LSEG) welcomes the opportunity to engage with the Joint Committee on the draft Financial Services Bill. In consultation on the Bill so far, we have worked with policy makers and are pleased to note that many of our proposals have been included in the draft Bill.

Following on from the progress made to date, the Joint Committee has important opportunities to further strengthen the UK's financial services regulatory regime through this Bill. There are three guiding principles which we would encourage the Committee to consider when making their recommendations on the Bill: (1) The importance of the UK's **international competitiveness** for our economy; (2) The need for **regulatory proportionality**; and (3) Effective **interaction with Europe**.

With these principles in mind, we make the following points:

1. **Retain the regulatory principle for the PRA and the FCA to consider the UK's international competitiveness.** Currently, financial services regulators must consider the international competitiveness of the UK's capital markets when regulating. But in the draft Bill, this requirement has been lost. Retaining this requirement will help to maintain the UK's ability to attract international businesses, which is a major asset to our economy in terms of generating tax revenues, providing a hub of expertise and increasing the UK's diplomatic weight on the international stage. It also has a knock-on effect on the ability of companies, both in the UK and abroad, to create jobs and growth. There is no need to see this as requiring a trade-off between regulation and a healthy business environment. In fact, effective regulation provides a stable environment in which businesses can operate effectively. This requirement is particularly important to the UK Listing Authority – the UKLA should retain its separate objectives under Part 6 of the Act.

2. **Regulation must be proportionate and fair.** The Joint Committee should ensure that the new financial services regulatory regime is effective and also proportionate, not unduly burdensome to companies. For instance, we are concerned that the new proposals to allow the FCA to commission a skilled person report contained in the draft Bill could be such an undue burden on SMEs because of their potentially high cost, and could run counter to the Government's own growth agenda to make the UK the best place in Europe to start, finance and run a business.

3. **The new regulatory bodies should adhere to high standards of corporate governance and observe the UK Corporate Governance Code.** In particular, appointments to the governing bodies of the PRA and the FCA should be based on merit, expertise and experience and, where possible, the bodies should be comprised of a majority of independent members.
4. **Coordination between the UK's regulatory bodies is crucial in ensuring that the UK has a strong voice in Europe.** Given the importance of European legislation to the UK, it is essential that a culture of co-operation and co-ordination is embedded within and applied across the various regulators and Government departments. This will

help to ensure that the UK has a coherent approach and can speak with a powerful voice both in Europe and internationally. In addition, the regulatory bodies should be required to consult fully with practitioners, consumers and other stakeholders.

5. **Given the importance of the RIEs in providing fair and orderly markets for trading, any new powers proposed under Part XVIII must be exercised fairly, responsibly and transparently.** For instance, participants and other relevant stakeholders should be able to make representations to regulators when they give notice that they intend to make a direction.

PART B – RESPONSES TO INDIVIDUAL QUESTIONS

Question 1 – Is the separation of prudential and conduct regulation into a "twin peaks" system the right approach?

We provide no answer to this question

Question 2 – What lessons can be learnt from the approach of other countries to regulation of the financial sector?

We provide no answer to this question

Question 3 – Is it appropriate to make such major changes to the regulatory system by way of amending legislation, rather than starting afresh?

The ability of the UK's financial services industry to drive our economy is critical to our future growth. In 2010, the industry contributed more than 11 per cent of the Exchequer's revenues and employed more than one million people throughout the country.[190] The financial services sector also plays a vital role in taking money from where it is, to power the businesses around the UK – both large and small – to where it is needed.

When considering changes to the existing regulations which govern the financial services industry, the most important thing is not the method by which the legislation is changed, but ensuring that the changes have a positive effect, minimising the disruption to the ability of the financial services industry to drive the UK economy and create jobs.

Question 4 – Are the accountability and governance arrangements for the Bank of England, FPC, PRA and FCA satisfactory?

1. PRA and the FCA

2.1. Governance

We suggest that the PRA and the FCA observe the relevant parts of the UK Corporate Governance Code where they are able to do so in order to ensure effective governance and accountability.

[190] The Total Tax Contribution of UK Financial Services, Third Edition, *City of London, prepared by PWC*, December 2010

We welcome that the governing bodies of the PRA and the FCA will be comprised of a majority of independent members. Appointments to these bodies should be made with consideration to the principles of the UK Corporate Governance Code to ensure that appointments are based on merit, assessed against objective criteria, and is given due regard to diversity.[191]

We also suggest that to ensure effective governance and accountability, the Chairman of each body should be independent.

2.2. Requirement to consult

We welcome that the FCA will be required to consult with the statutory bodies representing those persons subject to the FCA's decisions. Given the role and scope of the PRA, we feel that an equivalent approach might be beneficial in supporting the rule making process of the PRA.

Question 5 – Are the FPC's objectives the right ones? Is the concept of financial stability adequately understood for the FPC to be able to perform against its objectives?

We agree that the first objective of the FPC should be to maintain financial stability.

However we question whether the concept of financial stability is adequately understood or defined for the FPC to be able to perform against this objective. Without a clear definition of financial stability, it is impossible to hold the FPC accountable for its success in achieving financial stability. We suggest that further consultation is required to find a definition of financial stability which can be used to measure the performance of the FPC.

Question 6 – Should the FPC be limited in the actions it can take which might affect the growth of the financial sector?

Whilst we agree that the first objective of the FPC should be to maintain financial stability, **we suggest that the FPC is given a second objective: to support the economic policies of the government:**

- **The responsibility for balancing financial stability and economic growth should belong to the government.** Financial stability is clearly linked to economic policy. As the House of Commons Treasury Select Committee has noted, financial stability is not a free good and there is a necessary trade-off between financial stability and economic growth.[192] For example, there can be perfect stability if the banks stop lending, but that would result in either sluggish or no growth. This decision on how to balance financial stability and economic policy should be a matter for the government.

- **As a precedent, the Monetary Policy Committee (MPC), the sister body to the FPC, already has this objective**.[193] By being able to support the economic policy of the government, including its objectives for growth and employment, as well as having

[191] Principle B.2
[192] "Financial Regulation: a preliminary consideration of the Government's proposals, Volume 1", 3rd February 2011
[193] Bank of England Act 1998 S11 (a) (b)

a clear target for price stability (achieving a target inflation rate of two per cent, for example), the MPC is clearly accountable to the Chancellor and its objectives are clear.

- **In order to fulfill this objective, the FPC should be clearly accountable to the Treasury and also to Parliament**. Currently there is little detail about how the FPC will be held accountable. In light of our recommendation for the FPC to support the economic policies of government, we recommend that clear lines of accountability are established between the FPC, the Treasury, and Parliament.

It would also be helpful to understand **how the FPC will account for international developments in prudential regulation, and global economic conditions**. Whilst the importance of international developments, particularly in Europe, has been acknowledged by the FSA and the Bank in relation to the workings of the PRA and the FCA,[194] it is important that the FPC gives them due regard too. The UK's financial services sector is one of the most international in the world. Narrow consideration, focused exclusively on UK economic conditions, could result in the use of macro-prudential tools that are ineffective when set against international developments.

Question 7 – How will the interaction between macro-prudential and monetary policies be handled by the FPC and the MPC?

We provide no answer to this question

Question 8 – Has the right balance been struck between the powers of the FPC and the powers of the Treasury?

Please see our answer to question 6

Question 9 – Can Parliament take an informed decision about the proposals for the FPC without details of the macro-prudential tools at its disposal?

We provide no answer to this question

Question 10 – Does the draft Bill adequately deal with the risks posed by the shadow banking system?

We provide no answer to this question

Question 11 – Are the PRA's objectives clear and appropriate?

The general objective of the PRA to promote the safety and soundness of PRA authorised persons is appropriate, and we agree that the PRA will not be responsible for the successful financial management of firms, but instead will look to ensure that the unwinding of a firm does not have systemic consequences.

[194] Our Approach to banking supervision, The Bank of England, Prudential Regulation Authority, May 2011, and Approach to Regulation, FSA, June 2011

However, we believe that it is important that the PRA and other regulators should have appropriate regard for the international character of financial services and the desirability of maintaining the competitive position of the UK.

Question 12 – Are there any risks in the Government's proposed 'judgment-based' regulation?

Question 14 – Given that the PRA and the FCA will inherit FSA staff does the draft Bill do enough to ensure a new regulatory culture and a more proactive approach to regulation? Will these two new bodies have staff with the appropriate skill and expertise?

We provide a grouped answer to questions 12 and 14.

Whilst we support a more judgment based approach to regulation, we believe that the following issues need to be considered:

- It will be important for the regulators to fully set out how they intend to exercise a judgment based approach, and the expectations on authorised firms. This is necessary to ensure that the actions regulators take are transparent, consistent and proportionate.

- Focusing on the recruitment and retention of suitably experienced staff with expert knowledge will be critical. In order to exercise high quality judgment, the quality of staff, and of the information, resources and analysis available to staff, will be essential.

Question 13 – Is the Government's proposed approach to 'orderly' firm failure satisfactory?

We provide no views to this question

Question 15 – Are the FCA's primary objectives appropriate? Is significant emphasis given to the promotion of competition?

1. Objectives and regulatory principles

- **We support the FCA's primary objective of protecting and enhancing confidence in the UK financial system.** We also support the six regulatory principles to which the FCA will need to have regard when conducting its regulatory responsibilities, especially that a burden or restriction imposed on a person should be proportionate.

- **Need for emphasis on proportionality and fairness.** It is important that the FCA ensures that burdens placed upon persons are proportionate and fair. Based on the FSA's discussion document on the FCA's approach to regulation, we suggest more emphasis should be given to the proportionality of burdens and restrictions, as stressed by the Government in its earlier consultation document.

- **Need to retain regulatory regard for the UK's international competitiveness and attractiveness.** We believe that it is important that regulators should have

appropriate regard for the international character of financial services and the desirability of maintaining the competitive position of the UK.

In our view, there is no need to see this as requiring a trade-off between effective regulation and ensuring that the UK remains internationally competitive. On the contrary, it is the way these two elements work together that is so effective. For instance, one of the reasons why the UK attracts international companies to list and trade on our markets here is because our strong system of proportionate regulation provides them with the confidence and certainty of a stable environment within which to operate.

It is vital for our economy that international firms continue to be drawn to the UK. The UK's continued economic competitiveness is a major asset to the UK in terms of generating tax revenues, providing a hub of expertise and increasing the UK's diplomatic weight on the international stage. Our ability to win listings at a global level also has a knock-on effect on the ability of companies, both in the UK and abroad to create jobs and growth.

We would support an approach where such a consideration is delivered either by way of a need to have specific regard to international "competitiveness" or "attractiveness", or by a requirement that regulation should be applied in a way that is "proportionate, having regard to the interests of stakeholders, including the attractiveness of UK markets".

2. Competition

We believe that an appropriate emphasis is given to competition, and welcome that the FCA should promote competition in a way that is compatible with its strategic and operational objectives, and not as an objective in its own right. Competition is important for driving innovation, best practice and helps to ensure a better outcome for consumers.

However, the FCA should not be an economic regulator, and we welcome that the Government does not propose to give specific additional competition regulation powers to the regulator. The financial services sector is materially different to those sectors regulated by authorities that possess competition regulation powers, such as the water and electricity utility sectors, which have traditionally been dominated by a small number of large entities.

Question 16 – Are the responsibilities of the FCA towards the regulation of markets appropriate?

We focus our answer on changes to the listing regime (Part 6 of FSMA), and changes to the regime in Part 18 regarding Recognised Investment Exchanges (RIEs).

1. Listing

1.1. Objectives

We welcome the Government's decision to retain the listing function within the FCA. This is important to ensure that the regulation and supervision of markets remains coherent and that UK primary markets interests are properly and fully represented in Europe.

However the UK Listing Authority (UKLA) must retain its ability to consider the UK's international competitiveness. Currently, the UKLA must consider "the

international character of capital markets and the desirability of maintaining the competitive position of the United Kingdom" (73 (1) (d)). In other words, it must consider how its regulation affects the competitiveness of the UK's capital markets. In its current form, the Government's proposal in the draft Bill to bring the functions of the Listing Authority under the general framework of the FCA would result in the Authority losing its ability to have regard for the international competitiveness of the UK.

This matters because London's continued economic competitiveness is a major asset to the UK in terms of generating tax revenues, providing a hub of expertise and increasing the UK's diplomatic weight on the international stage. Our ability to win listings at a global level also has a knock-on effect on the ability of companies, both in the UK and abroad, to create jobs and growth.

1.2. Skilled Person Report

In its White Paper, the Government acknowledged that a number of bodies have expressed concern about the proposal to allow the FCA to require a 'skilled person' report from listed issuers and primary information providers. Despite these concerns, the proposal has been retained. There are two problems with these reports:

- **Potential disproportionate impact on SMEs which runs counter to the Government's growth agenda.** Such a requirement could be unduly burdensome and costly for issuers, especially for SMEs. SMEs are the backbone of our economy – indeed SMEs admitted to our growth market AIM contributed in excess of £20 billion to the economy in 2009.[195] As the cost of such reports may be high, their introduction could have a disproportionate impact on smaller listed companies. This runs counter to the Government's stated aim to drive growth and "make the UK the best place in Europe to start, finance and grow a business".[196]

- **No clear cost benefit analysis.** It is unclear what market failure this proposal has been designed to address in relation to listed companies, nor its relationship with the BIS Inspectors Reports already available to regulators under the Companies Act, and does not appear to have been fully analysed from a cost benefit perspective. Such measures could represent a significant cost to issuers, potentially deterring enterprises from seeking a listing in London, and therefore reducing the liquidity of markets, with a consequent rise in the cost of capital.

2. Recognised Investment Exchanges

Several "technical changes" have been proposed to Part 18 of FSMA, including simplifying the process by which directions are given to RIEs, the use of financial penalties and public censure, and the use of skilled person reports.

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[195] Both directly and through Gross Value Add - Economic Impact of AIM and the Role of Fiscal Incentives, *Grant Thornton and LSE*, September 2010

[196] Paragraph 1.70, Budget 2011, *HM Treasury,* March 2011

We remain to be convinced of the necessity of these changes, and the failures that they are designed to rectify. During the financial crisis, there was no failure of market infrastructure, and equity markets remained open for business whilst other parts of the financial sector ceased working.

RIEs have an important role to play in maintaining fair and orderly markets, and facilitating the capital raising activities of companies. These are of significant importance to the economy, and ensuring the provision of jobs and maintaining growth. It is essential that any changes do not undermine the value that RIEs bring to the economy.

2.1. Power of direction

The Government proposes that that FCA will, under Section 296, have simplified powers of direction over RIEs. We note that:

- Notice of a direction will only be made to the RIE concerned, and representations may only be made to the regulator by the RIE, and no longer by its members, or other persons likely to be affected by the direction;[197] and

- The procedure by which a direction is given may be truncated if the regulator concerned "reasonably considers it necessary",[198] rather than "considers it essential to do so" as at present.

We do not believe the reduction of notice proposed in (a) to be in the best interests of the market. Further, proposal (b) would need to be employed with significant safeguards to ensure that the FCA's discretion is exercised reasonably and does not adversely affect market stability.

RIEs, as front line regulators, have an important role to play in ensuring that markets remain orderly, fair and efficient. It is likely that a direction placed on an RIE would have far ranging consequences on the market participants that it regulates and on issuers admitted to its markets.

It is essential that, in order to ensure that the UK's markets remain attractive to issuers and investors, whether domestic or international, **that member firms and other concerned stakeholders continue to be able to make representations where it is apparent that a direction to an RIE is likely to have an impact on them**.

2.2. Financial Penalties and Public Censure

Notwithstanding our view that no market failures have been shown to necessitate such an increase in power, we feel that it is important that there are appropriate safeguards if such powers are introduced. In particular:

- The disciplinary measures proposed under Part 18 must be equivalent to those measures employed for authorised persons under Part 4.

[197] Section 298 (1) and (3)
[198] Section 298 (7)

- The procedure by which penalties are imposed may not be truncated.

- The RIEs must be consulted before any such decisions are made and can make representations to the regulator.

It is likely that public censure of an RIE will have an adverse impact on the markets that they operate. The regulator must consider this carefully before taking any actions that may undermine market stability or confidence.

Question 17 – Does the draft Bill strike the right balance between the responsibilities of consumers and firms? Are the FCA's new powers in the area of consumer protection appropriate?

We welcome that one of the regulatory principles applied to both regulators will be that consumers should take responsibility for their own decisions. We accept that certain consumers will require a greater level of protection than others, in particular retail clients and we note that in order to achieve this balance, the FCA will have new preventative and intervention powers for financial products and services. These powers will include new powers of product intervention, powers to require firms to withdraw or amend misleading financial promotions and early publication of a disciplinary matter.

We have the following comments to make regarding product intervention powers, and the early notification of disciplinary action:

1. Product intervention powers

- **Purpose should be to prevent significant consumer detriment**. These powers should only be exercised when there is a clear and demonstrable risk of significant consumer detriment representing large scale loss or damage. These powers should not be used to approve new financial products or guarantee returns.

- **This power should not be used to prevent financial markets from undertaking their key purpose of managing risk and providing choice.** The right balance must be struck between preventing significant consumer detriment on the one hand, and limiting choice and quashing innovation on the other.

- **Powers should be limited to retail consumers only.** Product intervention powers are unlikely to be effective or appropriate where consumers are either professional or eligible counterparties, and should be restricted to retail only. A key principle of financial regulation is that professional clients and eligible counterparties have the knowledge and ability to accurately assess the risk that they are exposed to – it is not for the regulators to determine this.

- **Need for clear guidelines on utilisation of powers.** There must be clear and transparent guidelines defining the circumstances and method for utilising these powers. This will provide the market with a solid framework within which to operate when designing new financial products.

2. Early notification of disciplinary action

We support and provide transparent financial markets and believe it is essential that market participants are presented with the fullest possible information to make informed decisions, and to ensure stable and fair markets.

However, the FCA's proposed power to disclose disciplinary action early may not have the beneficial effect intended and have wide ranging and adverse impacts on the UK's financial markets. Whilst alerting the markets/investors to action being proposed by the FCA, it would not provide specific details or analysis of the likely outcome. This in turn could cause significant market uncertainty, threaten market stability, and the reputation and viability of issuers and investment firms.

We welcome the proposal that exercise of early disclosure will be discretionary, and that the power will be subject to safeguards. In particular, we would suggest that regulators consider the potential impact on market stability and market participants/investors/issuers of such an announcement, and the potential reputational damage that may occur, balanced against the likelihood of a penalty being imposed.

Question 18 – Are the prudential regulatory responsibilities of the FCA towards FCA-only regulated firms given sufficient emphasis and detail?

We provide no answer to this question

Question 19 – Will the new regulatory arrangements reduce the risk and cost of dealing with miss-selling of financial products?

We provide no answer to this question

Question 21 – Are the proposals for co-ordination between the PRA and FCA clear and adequate? What would be the advantages and disadvantages of having a Single Point of Contact and/or a joint rule book for dual-regulated firms?

We provide no answer to this question

Question 22 – How do the proposals in the draft Bill fit within the new European regulatory regime? What freedoms and constraints will the UK have to operate within that regime?

Many of the financial services regulations which affect the ability of the UK's financial markets to contribute to our economy come from Europe rather than the UK. Currently major pieces of European legislation include the Markets in Financial Instruments Directive (MiFID), the European Market Infrastructure Regulation (EMIR), the short selling regulation, and the Basel Accords.

As events in Europe have a substantial impact on the UK's financial services industry, it is vital that the UK industry is well represented in Europe.

We welcome the intention to establish a Memorandum of Understanding between the Treasury, the Bank of England, the PRA and the FCA on overall international co-ordination to achieve the best outcome for the UK in Europe, we would like to emphasise to the Joint Committee the importance of developing a **culture of co-ordination and co-operation** between these institutions to ensure that effective working relationships are established and that there is a clear lines of representation.

Question 23 – Does the draft Bill contain any proposals or omissions, not covered by the questions above, which cause concern?

Whilst much has been written about the way in which the PRA and the FCA will co-ordinate their activities, little has been written about how co-ordination will be achieved between the Bank and the FCA.

This is important for the Joint Committee to address, most notably because of the existing confusion over how clearing services (the services which process all public trades in the UK market) will be regulated. Currently, Recognised Clearing Houses (RCHs) and Settlement Systems will be regulated by the Bank of England, but will be represented in Europe by the FCA at ESMA.

We suggest there will need to be a mechanism for co-ordination between the organisation regulating RCHs (the Bank), and the organisation representing them in Europe (the FCA).

September 2011

Professor Niamh Moloney, London School of Economics – written evidence

This written evidence addresses the consumer protection aspects of the Financial Services Bill, and in particular the new product intervention powers under Clauses 137C and 138N.

1. A new form of intervention

I strongly support the introduction of statutory product intervention powers in the Draft Financial Services Bill, clauses 137C and 138N

Clause 137C implies that the Financial Conduct Authority (FCA) will be empowered to adopt product intervention rules, allowing it to prohibit the sale of particular products, where 'necessary or expedient' for the purposes of advancing the consumer protection and the efficiency and choice objectives, or, in certain circumstances, the market integrity objective. Clause 138N will empower the FCA to adopt temporary product intervention rules (exempt from consultation obligations) where it is 'necessary or expedient' not to comply with the consultation rules for the purposes of the consumer protection and efficiency and choice objectives, or, in certain circumstances, the market integrity objective.

This power, new to UK retail market regulation, reflects the FSA's January 2011 consultation on a menu of 'product intervention' powers,[199] and the June 2011 publication by the FCA of its more intrusive approach to the retail markets.[200] In January 2011 the FSA launched a 'new and more intrusive approach' to the retail markets in the form of a new 'product intervention' regime.[201] It reflected the FSA's post-crisis adoption of a more intrusive, outcomes-based, and pre-emptive approach to conduct regulation generally, and the adoption over 2010-2011 of a more interventionist approach to consumer detriment, in order to engage properly with the UK's experience of repeated cycles of mis-selling and of related ex-post reform and redress. This product intervention strategy was designed to re-orient the retail markets regime from the distribution (selling) stage, to change the prevailing philosophy that most retail products were useful to some investors, and to use rules and regulatory oversight to intervene early in the product 'value chain.' It signalled a 'decisive shift in [the FSA's] tolerance for the amount of actual harm or detriment we are prepared to allow happen'. The new model did not propose general ex-ante licensing of retail market products, but was 'pitched between a strategy that relies on point-of-sale interventions and one that relies on product pre-approval.' It had two elements: (1) a 'product governance' regime based on regulatory oversight of the product design process; and (2) a range of product intervention techniques on an intensifying spectrum, including, as a last resort, pre-approval and prohibition techniques for specific products. This products strategy was adopted by the new FCA in its June 2011 document setting out its approach to regulation.

Clauses 137C and 138N therefore provide 'last resort' prohibition powers, in support of the suite of more general product intervention powers - which are largely focused on oversight of the product design process and on 'early detection' - which the FCA will develop.

2. Product Prohibition Powers: new powers

[199] FSA, DP 11/1, Product Intervention (2011), 3.
[200] FCA, Approach to Regulation. June 2011.
[201] FSA, DP 11/1, Product Intervention (2011), 3.

Product intervention powers are typically associated with (1) ex-ante product design/approval rules and/or (2) ex-post product prohibition powers, internationally and in the related literature. Retail market regulation internationally, however, has been dominated by firm-facing distribution (selling) and investor-facing disclosure rules in recent years. Design/approval, and/or prohibition powers are regarded as the most interventionist form of retail market powers, and are rarely given to or deployed by retail regulators internationally.

Marketing/selling restrictions on the types of products which can be marketed to retail investors are, however, common, including in the UK (they commonly relate to hedge-fund related products), and the practical impact of these rules can be similar to design and prohibition rules in practice.

Detailed product design/authorization rules do apply to the 'UCITS' mutual fund product – the dominant form of regulated mutual fund in the EU. The UCITS regime, however, is more a function of liberalization and the extension of the UCITS market, and the demands of the UCITS product provider sector, than of retail investor protection policy. This is clear from the extension of the UCITS product. Following the liberalization-driven 'UCITS III' reforms, it now includes complex and often hedge-fund-like structured products. The related 'stretching' of the UCITS label as a 'gold standard' retail product, and its troublesome fit within the UK and EU's distribution regime for 'execution-only' sales (governed by the 2004 MiFID Directive which permits all UCITS products to be sold execution-only, or without advice), raises significant retail market risks and is currently the subject of debate in the EU.

But UCITS-aside, retail market regulation pre-crisis in the UK and in the EU has largely been a function of disclosure and distribution regulation (and, of course, ex ante enforcement and remedies).

3. The need for a rethink

The academic and policy literature underlines the significant risks associated with product regulation, and particularly ex-ante product design/approval and ex-post product prohibition powers, certainly in the investment markets. Stronger arguments can be made in relation to the consumer finance markets (credit cards; bank accounts; basic insurance policies) given the ubiquity and necessity of basic banking and credit products, as Professor Elizabeth Warren has long argued in the US and in the context of the new, post Dodd-Frank Act Bureau of Consumer Financial Protection.

The risks include regulatory arbitrage, as arbitrage risks are high, particularly where design/approval rules apply to a particular class of product, and not to others. This risk has been sharply exposed in the EU by the differential treatment of UCITS products (heavily regulated) and, for example, structured and unit-linked investment products in the EU, which are not subject to harmonized EU authorization and design rules. Product intervention, whether design- or prohibition-based, is also associated with damage to innovation and with limiting investor choice. Rules of this nature are also associated with related reputational and resource risk to the regulator, given the more intense intervention in the market, and the related danger of error, and of investor and market confusion. Moral hazard – the risk that investors take less care, assuming that the regulator has somehow 'signed-off' on a product or will intervene in the future - is also commonly associated with product intervention. The association between product intervention and 'over-regulation' generally is also considerable, as the lively US debate on the appropriateness of product intervention in the context of the Dodd-Frank Act underlines.

On the other hand, the dominant 'disclosure and distribution' form of regulation has not been successful in preventing retail detriment, as the crisis has made clear. The financial

crisis exposed the mis-selling in the UK, many Member States, and the US, for example, of complex retail structured products which had enjoyed a surge in popularity pre-crisis. Pre-crisis, years of experience in the UK with distribution rules, and strenuous efforts by the FSA, including recently the innovative 'Treating Customers Fairly' supervisory initiative, have not prevented repeated cycles of mis-selling. A combination of very limited investor ability to decode complex and detailed disclosures and to assess conflict of interest risk, largely unrestricted product development and duplication, and significant conflict of interest risk in the structure of the commission-based distribution sector, make the investor vulnerable to mis-selling.

In this environment, and combined with the state's withdrawal from welfare provision, the notion of consumers being able 'to take responsibility for their decisions' (Bill, clause 3B(c)) must be treated as a very limited concept. The state owes households very significant responsibility to ensure that their 'decisions' are made in an environment in which significant efforts are made by the regulator to make the investment environment as free of structural failures as possible. Much remains to be done on this front.

With respect to distribution, the Retail Distribution Review, which aims to restructure the UK investment advice industry and remove commission risk may, finally, address the deep-rooted structural weaknesses in the distribution industry which have proved very difficult to address through traditional distribution and disclosure regulation. But it not the only solution required; years of focus on distribution-related regulation suggest that attention must be paid to other and supporting techniques. It is also well past time that regulatory policy began to regard disclosure and education-related techniques as simply educational, and as having a very long-term horizon. Disclosure and literacy strategies are important in developing a cohort of informed investors, but, as a wealth of empirical studies suggest, they cannot carry out the heavy-lifting required to protect investors in highly complex, confusing, and conflict of interest prone investment markets, and they must not be regarded as a panacea. Great care should be taken to ensure that disclosure and, in particular given their current prominence, education tools do not obscure the primary importance of robust intervention by regulators. In this respect, the new Money Advice Service, while welcome, in no way takes the pressure of regulatory intervention.

Product intervention, therefore, must be deployed if a serious attempt is to be made to reduce consumer detriment as financial regulation is being restructured post-crisis. The 'new thinking' associated with the financial crisis must also be used in the often overlooked retail sector. The financial crisis affords an opportunity to rethink more generally the range of tools which are used in the retail markets and to address, finally, years of failure. This rethink is all the more important as the retail markets have tended to lag the wholesale markets in terms of innovation in regulatory design. The Bill's proposal that statutory prohibition powers be adopted is, when allied to the more general design oversight powers under development by the FCA, an important and positive development.

4. The current 'direction of travel' in the EU and the Bill.

The extent to which the EU now controls the 'rule-book' for Member State financial markets suggests that the 'fit' between the Bill and emerging EU policy is an important consideration. This is particularly the case given the current MiFID Review (a proposal is expected imminently) as the Bill must fit with the new MiFID Directive (MiFID governs the distribution of investment products in the EU).

It is also the case that national approaches can shape emerging EU policy. There is considerable evidence that the EU is now moving in the direction of a product intervention policy, with a particular focus on oversight of the design process, but also with some focus

on clauses 137C/138N-style powers. Therefore the statutory powers under consideration may become something of a template for future harmonized measures, and allow the UK to lead the debate and shape its outcomes.

The more towards product prohibition in the Bill (and the related FCA policies) reflects a clear 'direction of travel' in the EU at present.

At Member State level, the extent to which domestic regulators across the EU are now turning to product-related techniques in the retail markets, and in particular addressing perceived complexity risks, is striking. In August 2011 the Italian regulator, CONSOB, presented proposals to encourage credit institutions to raise finance through euro-denominated 'simple bonds', which would guarantee repayment, be highly liquid, not rely on derivatives, provide simple and accessible disclosures and be easy to understand; incentives were provided in the form of a streamlined approval process. In June 2011, the Belgian regulator (the FSMA) called for the voluntary suspension by the industry of retail distribution of complex structured products which it deemed to be 'needlessly complex'; a binding prohibition is expected to follow. In France, the AMF has targeted the distribution of 'complex' products (mainly structured products and complex debt securities) to retail investors. In an October 2010 'position' the AMF in effect prohibited the marketing of complex structured products to investors; complex products can only be marketed (including through investment advice) where they carry a warning that the AMF has determined them too complex for retail marketing. France has also lobbied for the EU's upcoming 'Packaged Retail Investment Products' ('PRIPs') disclosure and distribution reforms (noted below) to include rules governing the prohibitions on distribution. The French AMF is also in the vanguard of current efforts to reshape the UCITS regime to distinguish between 'complex' and 'non-complex' UCITS. More generally, June 2011 saw the Dutch government announce proposals, following a request from the Dutch AFM, for the AFM to supervise the development of new financial products through design-related techniques

In terms of harmonized regulation, a similar direction of travel is emerging at EU level. The 'Packaged Retail Investment Products' initiative (the 'PRIPs' policy) was launched in 2008, and a formal proposal has yet to appear, although it is expected and forms part of the crisis-era agenda. Its focus is on the arbitrage risks which follow from the distinctions in the EU harmonized regime between different types of products, particularly unit-linked investment products, deposit-based investments, and the UCITS products. Its focus, however, is on levelling the playing field with respect to disclosure (particularly summary prospectus rules) and distribution (particularly conflict of interest rules), rather than on product-related rules. But in December 2010, the Commission proposed a new product design oversight model, similar to model under development by the FCA, under the MiFID Review. It suggested that the organizational and risk management requirements which apply to MiFID-scope product providers be enhanced and extended to capture the particular risks raised by product design. But there are also indications of a more interventionist approach, similar to the clauses 137C/138N powers. The Commission has proposed that it be conferred with powers to ban products or their distribution where significant and sustained investor protection concerns arise, or where a product or activity threatens the orderly functioning and integrity of financial markets or the stability of the whole or part of the financial system. It has also suggested that all national regulators (such as the FCA) be given the power to temporarily ban or restrict the trading or distribution where a serious threat to financial stability or market confidence in the EU or in a Member State.

There is also emerging evidence that the new EU markets regulator, the European Securities and Markets Authority (ESMA), may be conferred with product prohibition powers, at some stage. Under the MiFID Review, the Commission suggested that where a national authority had not taken measures to address a product-related threat to the

orderly functioning and integrity of financial markets or the stability of the whole or part of the financial system, or the measures taken have not been sufficiently effective, ESMA be empowered to ban, temporarily, the distribution of the product. The ESMA Regulation, under Article 9, also empowers ESMA temporarily to prohibit or restrict certain financial activities that threaten the orderly functioning and integrity of financial markets or the stability of the whole or part of the Union, but only as specified in relevant EU legislation; these powers have not, as yet, been conferred with respect to retail market product distribution.

The institutional enthusiasm in the EU for an EU product-related regime seems considerable. The European Parliament championed the addition of ESMA's Article 9 powers. ESMA also appears ready to embrace these powers; the initial, agenda-setting statements by ESMA's newly-appointed Chairman in early 2011 suggested that Article 9 was a priority power for ESMA, and that ESMA would be willing to take action against high commission products where negative outcomes were likely for investors.[202] It is also of some significance that exchange-traded funds (ETFs) and structured UCITS were the subject of one of ESMA's first sets of Guidance over summer 2011,[203] after its January 2011 establishment. Although the proposed Guidance is primarily disclosure-based, ESMA highlighted that it may in the future issue warnings and apply for product-prohibition powers, given the potential risk of consumer detriment.

Particular, harmonised product-related initiatives are also in train with respect to complex 'UCITS III' structured products. The new summary disclosure regime for UCITS (the 'Key Investor Information Document') - which came into force in 2010 - contains distinct requirements for 'structured UCITS', while the MiFID Review has suggested that MiFID-scope firms be required to provide additional disclosures concerning complex products, including structured products. Structured UCITS are also addressed by ESMA's proposed 2011 Guidance on Exchange-Traded Funds (noted above) which highlights the need for such funds to comply with the diversification and risk management rules which apply to UCITS generally. But more interventionist, product-related measures also look set to follow. MiFID's execution-only regime, which requires that only 'non-complex' products can be sold without a suitability assessment, includes all UCITS as eligible non-complex investments. The MiFID Review has queried whether the execution-only regime should be abolished, or whether it should be retained, but with the exclusion of particular UCITS which employ more complex portfolio management techniques. The issues raised by any change to the designation of UCITS as 'non-complex' are many and complex but the ongoing debate underlines the change in the regulatory direction of travel.

The emerging EU agenda for exchange-traded funds (ETFs) also illustrates the growing importance of product-related regulation. ETFs are open-ended UCITS funds which track an index or benchmark. When they were originally designed in the 1990s, they followed a relatively simple structure and were designed to track equity and bond indices. But the ETF sector has experienced very strong growth globally (on average 40% annual growth over the last 10 years) and has become considerably more complex. ETFs now address a wide range of sectors and assets, use physical or synthetic (derivative-based techniques) to replicate indices, can rely heavily on leverage, and are increasingly engaging in securities-lending activities, where they hold physical securities to track indices. ETF innovation and complexity is being associated with retail market risks. The FSA and the French AMF have recently highlighted the increased retailization of these products and the

[202] Eg, N. Tait, 'ESMA watchdog prepared to clash with Brussels,' March 2 2011, available at FT.com and R Froynovich, 'ESMA to be strongly independent,' March 2 2011 available at WSJ.com. Similarly, Keynote Address of Steven Maijoor, ISDA AGM, 13 April 2011.

[203] ESMA, Consultation on Guidance on ETFs and Structured UCITS ESMA/2011/220.

complexity risks which they pose, particularly with respect to investor understanding of counterparty and collateral risks and liquidity risks. In summer 2011, ESMA produced the draft Guidance on ETFs noted above. Although ESMA's Guidance is based on disclosure, some indications of a more robust approach to come are evident in the warning that ESMA may require product prohibition powers in this field.

Clauses 137C and 138N therefore reflect the current direction of travel in the Member States and at EU level with respect to prohibition powers, while the FCA's emerging and related policy with respect to oversight of the product design process more generally also reflects policy trends in the EU, particularly with respect to harmonized regulation and the MiFID Review.

5. The risks and benefits of the product intervention powers

The clauses 137C/138N powers are product prohibition powers. As such, they are untested and carry risks. But there is a strong case to be made in their favour.

The failure of recent retail policy suggests that the potential benefits of this power may outweigh the risks, and that it is time for new tools to be deployed. It is also the case that the distinction between discretionary investment products (not typically subject to product regulation) and consumer finance products (in respect of which there is more tolerance of intervention) is becoming obsolete, given the extent to which the state is withdrawing from welfare, and the increasing importance of the ability of households to navigate the investment markets safely for long-term funding needs (pensions, university education, etc). HM Treasury's position that the legislative proposals highlight the new 'early and proactive' approach to the retail markets and involve a 'fundamental shift in approach,'[204] represents an important shift in retail market policy.

The clause 137C power is confined. The FCA will be subject to consultation obligations with respect to 137C, the general principles which apply to rule-making apply, as does the requirement that the rules are 'necessary and expedient' to advance the consumer protection or efficiency and choice objectives. The clause 138N temporary power, which is likely to generate the greatest risks related to error or market uncertainty, must be exercised within a framework which the FCA is to develop (clause 138O). It is hard to discern, however, why the framework obligation does not also apply to 137C; the discipline which the framework will impose should also apply to 137C, particularly given the novelty of these powers and the importance of market certainty concerning their scope.

The prohibition powers should be placed in the wider context of the new product intervention strategies which are being developed by the FCA, particularly with respect to FCA oversight of the product design/product governance process. The clauses 137C/138N powers will therefore be 'last resort' powers and will sit at one end of the spectrum of product-related powers which the FCA will exercise. They carry the advantage of 'hardening' the less interventionist product design oversight powers which the FCA will exercise, and of enhancing the effectiveness of the new FCA product intervention policy, and should have useful deterrent effects.

The FCA's June 2011 'Approach' document suggests that significant regulatory resources will be deployed in the product intervention sphere generally. The FCA's expertise in this area

[204] HM Treasury, A new approach to financial regulation: building a stronger system (February 2011, Cm 8012). 60.

will therefore be strengthened as it develops its product intervention policy more generally. The risk of over-reaction, given the novelty of the powers, should therefore be tempered.

Clauses 137C and 138N are last resort, ex-post powers. They do not suggest a wider move towards product pre-approval. The related risks in terms of moral hazard, damage to innovation and regulatory error are therefore more limited - although the 'leakage' effects of the prohibition power should not be discounted. The 'leakage' effects may, however, have useful deterrent dynamics and lead to more productive and targeted retail product design.

Product intervention, whether design-oversight based (FCA June 2011 Approach) or prohibition-based (Clauses 137C and 138N), implies that the regulator can second-guess weaknesses in the retail product market; pre-emptive action and early intervention are recurring themes of the new regime. Expectations may accordingly be unrealistically high. The FCA appears alert to this risk, warning that it will need to communicate that it cannot guarantee a return on a product deemed suitable. The nuances of product intervention may, however, be lost on retail investors and careful communication of the nature of product intervention will be needed.

Product intervention (whether design-oversight-related (FCA June 2011 Approach), or prohibition related (Clauses 137C and 138N)) can be associated with a more intrusive approach to retail investor risk-taking. The placing of restrictions on the distribution of products to the public is a common feature of retail marketing regimes internationally, but the perimeter for retail marketing is usually drawn very widely. The new generation of intervention powers, including Clauses 137C and 138N, however, imply that a wider group of products might face restrictions on retail distribution. Making a determination as to whether a product is not suitable for retail distribution demands of the regulator that choices are made as to the optimum levels of risk and choice in the retail market. But repeated failures in the retail market, increased demand for long-term savings, and real limitations on the ability of individuals to make optimum choices all suggest that UK retail market regulation should be re-oriented from the empowerment/autonomy and choice-driven approach with which it can be associated, in part at least, in recent years. A more protective model should at least be attempted. FSA Chairman Turner has warned that the more a regulator intervenes in defence of the consumer interest, using more intrusive powers, the more the regulator makes crucial trade-off choices on behalf of society, which are judgmental and political.[205] But the very difficulty and visibility of these choices should bring a welcome prominence to retail market regulation.

It is certainly the case that difficult practical/execution issues arise. It would, for example, be concerning were the clause 137C and 138N powers to become associated with prohibiting 'complex' products, ex post. Complexity is difficult to capture. The UK has struggled for years with how to use regulatory and market mechanisms to deliver 'simple' investment products which can be price-capped and sold through a simplified advice process (the 'stakeholder products'). Appropriate targeting of these products can be difficult, price caps diminish industry interest, accompanying and diluted regulatory regimes have proved problematic in terms of cost and legal risks, and levels of consumer interest can, given limited industry incentives to market, be low.[206] The US Dodd Frank reform process, and the difficulties associated with the establishment of the Consumer Financial Protection

[205] Speech at FSA's Annual Public Meeting, 23 June 2011.
[206] J Devlin, A Report for HM Treasury, Literature Review on Lessons Learned from Previous 'Simple Products' Initiatives (2010).

Bureau, also underline the significant difficulties attendant on regulator approval of a suite of 'plain vanilla' consumer finance products. And some degree of complexity in the markets is good for investors and can deliver results. Innovation which - however complex - allows investors to achieve higher returns and better risk management should not be obstructed. Leading US economist, Professor Robert Shiller, for example, has recently suggested that the necessary democratization of finance post-crisis calls for a focus on 'creatively extending the capitalist principles of risk management so that they really work for everyone…[i]t means an adventure in financial innovation.'[207] Important determinants of investor outcomes also arise beyond complexity. The extent to which market risks were borne by households over the crisis suggests that close attention should be paid to diversification. The extent to which conflict of interest risk can lead to mis-selling also suggests that how commission and costs are embedded into a product's return should be addressed. But these issues are best addressed ex-ante under the new product oversight regime. The FCA commitment to ex ante review of the product design process also suggests that the cases when the prohibition power is activated ex post should be very rare. But clear guidance should be adopted by the FCA as to when the prohibition powers will be used.

Overall, the implementation issues should not detract from the merits of the new approach. Given repeated failures in the retail markets, the implementation of a new strategy can only be a good thing. Careful testing of these new tools will be required, as will careful delineation, ex ante, of how the FCA intends to use them.

3 October 2011

[207] R Shiller, 'Democratizing and Humanizing Finance' in R Kroszner and R Shiller (eds), Reforming US Financial Markets. Reflections Before and Beyond Dodd Frank (MIT Press, 2011), 1.

Money Advice Service – written evidence

Executive summary

1. The Money Advice Service is a new nationwide service that helps consumers understand financial matters and manage their money better. We provide information and advice online, by phone and face-to-face.
2. Our statutory function is to enhance the understanding and knowledge of members of the public about financial matters (including the UK financial system), and their ability to manage their own financial affairs. This includes providing information and advice to members of the public to help them understand money matters better and take control of their money.
3. The draft Bill proposes minor changes to our constitution: that the FCA will take over the FSA's current responsibility for our oversight; that we will be subject to National Audit Office audit; and that we will have a statutory, rather than voluntary, Memorandum of Understanding with the FCA. We support these proposals.
4. We believe that the draft Bill gives us appropriate independence, a comprehensive governance framework, an appropriate transparency mechanism, and a system which works coherently, with minimum duplication between ourselves and other organisations. We would not wish to see any further changes to the Bill that would reverse or undermine this.
5. We believe that the Money Advice Service is an important part of the Government's proposals and that, as well as fulfilling our own statutory function, we will make a distinctive contribution to the FCA's discharge of its own objectives. We support the proposals for the FCA and welcome the commitment to a stronger approach to consumer protection.
6. We will help protect and enhance confidence in the UK financial system by empowering people to engage confidently with the retail financial services market, engendering a sense of control of their financial affairs, promoting informed choices, providing trusted, free non-sales advice, and encouraging and enabling people to take appropriate further action.
7. We will help to secure appropriate consumer protection by providing the FCA (and others) with information about potential consumer detriment and communicating to the public about issues and risks associated with the financial marketplace.
8. We will work with the FCA, financial services firms and others involved in public policy to improve regulation, improve people's understanding of and confidence in financial services, enhance consumer choice and increase activity in the financial marketplace.

Introduction

9. The Money Advice Service is a new nationwide service that helps consumers understand financial matters and manage their money better. We provide information and advice online, by phone and face-to-face. We were set up by Government and are paid for by the levy on financial services companies raised by the FSA.

10. We fill a gap for money advice that we estimate extends to over half the adult population of the UK – 23m people are unaware or unsure of where to find free, unbiased money advice.
11. Since we were established as the consumer financial education body (CFEB) in April last year, we have concluded the FSA's five year national strategy for financial capability and have learnt that information and education alone are not enough to change people's behaviour. We have, therefore, begun the transition to becoming an advice-oriented service. Our aim is to offer advice that is personalised, directive, and above all leads to action and behaviour change. We are now in the process of reviewing all our existing products and services in support of that approach.
12. The Government's proposals for regulatory reform are relevant to us for four key reasons:
    - We were created by an earlier amendment to the Financial Services and Markets Act 2000 (FSMA). The current draft Bill includes minor changes to our current accountability arrangements.
    - The draft Bill includes reference to us under the proposals for the new Financial Conduct Authority (FCA).
    - The FSA has made it clear that we will have an important role to play in helping the new FCA fulfil its objectives.
    - The Treasury recently announced that we will perform a central role in the coordination of debt advice across the UK from April 2012. The final Bill will include a clause to make this responsibility explicit.

Financial Services Act 2010

13. The draft Bill will amend the Financial Services and Markets Act 2000 (FSMA), which was previously amended by the Financial Services Act 2010.
14. That Act established us in April 2010, with cross-party consensus, initially as the consumer financial education body, with a statutory function

    "to enhance–

    (a) the understanding and knowledge of members of the public about financial matters (including the UK financial system); and

    (b) the ability of members of the public to manage their own financial affairs."[208]
15. FSMA also sets out that our function includes, in particular—

    (a) promoting awareness of the benefits of financial planning;

    (b) promoting awareness of the financial advantages and disadvantages in relation to the supply of particular kinds of goods or services;

    (c) promoting awareness of the benefits and risks associated with different kinds of financial dealing (which includes informing the FSA and other bodies of those benefits and risks);

    (d) the publication of educational materials or the carrying out of other educational activities; and

[208] FSMA, section 6A(1)

(e) the provision of information and advice to members of the public.[209]

16. In discharging our function, we must have regard to the importance of maintaining confidence in the UK financial system and maintaining the stability of the UK financial system.[210]

Context to our response

17. Nothing in the Government's proposals significantly alters our constitution, as currently set out by FSMA.

18. However, the White Paper confirms that, in the final Bill:

- The FCA will take over the FSA's current responsibility for ensuring that we are "capable of exercising the consumer financial education function"[211].
- We will be subject to National Audit Office (NAO) audit.
- We will be required to have a statutory, rather than voluntary, Memorandum of Understanding (MoU) with the FCA. This is consistent with similar requirements for the Financial Ombudsman Service (FOS) and Financial Services Compensation Scheme (FSCS).

19. In addition, the Treasury recently announced that we will perform a central role in the coordination of debt advice across the UK from April 2012.[212] The final Bill will include a clause to make this responsibility explicit.

20. From our perspective, we believe the draft Bill achieves the following:

- Our statutory independence continues and is secured within a coherent, overarching regulatory framework. This independence allows us to focus on our core task while ensuring that we link into the wider regulatory architecture, as intended under the Financial Services Act 2010, and gives our Executive and Board the necessary authority and flexibility to deliver our statutory function.
- A comprehensive governance framework. This framework includes oversight by the FCA alongside clear and direct accountability to Government, Parliament, the public and our other stakeholders (for example, our levy payers). This accountability is through a number of different mechanisms, for example our public documents, our Industry and Consumer Forums, and NAO audits.
- Appropriate transparency through a statutory MoU with the FCA, and voluntary MoUs with other organisations as appropriate. Our MoU with the FCA will establish a clear framework for cooperation between the two organisations. The Government has asked the Bank and FSA to produce a draft version of the PRA-FCA MoU in time for the introduction of the Bill to Parliament. We are updating our MoU with the FSA with a view to creating a framework that will not only help us work more effectively now, but also continue through the transition to a new system and beyond.
- An efficient system which works coherently with minimum duplication between different bodies. Whilst it makes sense for the Government to align the

[209] FSMA, section 6A(2)
[210] FSMA, schedule 1A(6)
[211] FSMA, schedule 1A(1)(1)
[212] "The Money Advice Service should perform a central role in the coordination of debt advice, and should research and develop a delivery model for debt advice" Insolvency Service press release (19 July 2011)

accountability arrangements for the FOS, the FSCS and the Money Advice Service, and to promote greater coordination and information sharing across the regulatory framework, each organisation has its own distinct role to play.

Response to the Committee's questions

21. Given this context, it is clear that we can contribute most to those areas of the Committee's call for evidence that relate to the FCA and its proposed objectives. We answer several of the Committee's questions on this, explaining how we expect to work with the FCA in practice.

Q4. Are the accountability and governance arrangements of the Bank of England, FPC, PRA and FCA satisfactory?

22. We have no comments on the accountability and governance arrangements for these organisations. However, it might be helpful for the Committee if we explain our own arrangements.

23. Our current governance requirements are set out in Schedule 1A of FSMA:

    - The FSA appoints our Board acting, in the case of the chair and chief executive, with the approval of the Treasury.
    - We are required to consult with the Treasury, the Office of Fair Trading and the Department for Business, Innovation and Skills on our budget. The FSA must approve our proposal before including it in its fees consultation paper each year.
    - We are required to publish an annual plan before the start of each financial year setting out our objectives, how those objectives will be measured, our priorities and allocation of resources. The FSA must approve this plan.
    - We are required to publish an annual report once a year. This must set out the extent to which we have met our objectives and priorities as well as include a copy of our accounts.
    - Finally, the FSA may appoint an independent person to review the economy, efficiency and effectiveness with which we use our resources.

24. The Government has proposed minor changes to these arrangements, as set out in paragraph 18 above.

25. We are clear about where we will sit within the new regulatory framework. The FCA will have a formal role in our governance and accountability. We will support the FCA in discharging that role. In addition, we will contribute to and reinforce the FCA's ability to carry out its statutory objectives, particularly in relation to consumer protection. We go into more detail in paragraphs 43 to 52 below.

26. Similarly, the FCA will contribute to and reinforce our ability to carry out our statutory function. It can do this by creating a regulatory environment that reflects a better understanding of consumer needs, behaviours and experiences, supporting our work in conversations with key stakeholders, and highlighting the importance and value of more empowered consumers in its EU policy discussions.

27. We will operate together in a way that maximises the efficient use of resources, allowing us to focus on informing and advising the public and the FCA to focus on providing an appropriate supervisory framework for consumer protection.

Furthermore, we will conduct our relationship transparently, governed by a statutory MoU.

Q15. Are the FCA's primary objectives appropriate? Is significant emphasis given to the promotion of competition?

28. The FCA is given a strategic objective to protect and enhance confidence in the UK financial system. This is underpinned by 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.

29. The draft Bill is clear that the FCA and Money Advice Service have distinct, but complementary, objectives. The context for everything the FCA does is regulatory; our context is consumer-focused information and advice. Whilst we support a supervisory approach aimed at preventing consumer detriment before it crystallises, no amount of regulation will prevent people needing help.

30. There will always be people who feel disengaged from the marketplace, those who face choices they need help to make, and those who need reassurance that the choices they make are the right ones. All will need help understanding what to expect – and what is expected of them – to be able to use financial services and products effectively and make the most of their money. This is where we come in.

31. So there is an underlying presumption within the new regulatory framework that the FCA will act, and we will not, in:

    - supervising firms;
    - setting standards for firms' dealings with consumers; and
    - dealing with regulatory issues which arise from firms' conduct towards consumers.

32. Whereas our primary focus is:

    - informing and advising the public how to understand and manage their money; and
    - helping the public to make informed choices about which products and services they should use.

33. This means that our statutory function, set out by FSMA, contributes to and complements the FCA's proposed objectives.

34. In respect of the FCA's strategic objective, we will help protect and enhance confidence in the UK financial system by:

    - empowering people to engage confidently with the retail financial services market;
    - engendering a sense of control of their financial affairs;
    - promoting informed choices;
    - providing trusted, free non-sales advice; and
    - encouraging and enabling them to take appropriate further action.

35. And we will help to secure appropriate consumer protection by:

- providing the FCA (and others, including the financial services industry) with information about potential consumer detriment. MoUs with the FCA and others will set out how this will work in more detail. We believe that a permissive statute and a flexible MoU is the right framework to allow us to do this effectively.
- communicating to the public about issues and risks associated with the financial marketplace as part of promoting informed choices and providing information and advice.

36. By empowering people to manage their money better, we will in turn help promote stability in the UK financial system. Our information and advice will promote:
    - prudent and sustainable borrowing and spending;
    - persistent saving;
    - stronger and more resilient household finances, better able to withstand shocks; and
    - clear information, guidance and reassurance in times of crisis, including speedy and accurate information about protection and compensation arrangements.
37. There will be occasions when the FCA and the Money Advice Service engage in similar activities, for example in providing information directly to consumers. Where regulation triggers important messages for the public – for example under proposals for the FCA to order a firm to withdraw a financial promotion or where it has issued a warning notice to a firm – we will need to support the regulator (or indeed the FOS or FSCS) to deliver those messages. This will be done in line with our respective remits and based on a principle of non-duplication. The FCA's material will generally have a clear regulatory context and may often be delivered via regulated firms. Our material will be directed at engaging, informing, advising and, ultimately, empowering people (both current and prospective customers of regulated firms).
38. The FCA is also to play a significant role in promoting competition in financial services. The draft Bill sets out that the FCA "must, so far as is compatible with its strategic and operational objectives, discharge its general functions in a way which promotes competition."
39. We support this proposal. Financial services are not always transparent, comparable or understandable. Therefore a range of remedies will be needed on both the demand and supply sides.
40. We will have a role to play on the demand side, by equipping the public to be more active consumers who can help to drive competition. Our information and advice can help promote competition by encouraging people to shop around for the best deal, equipping them with the skills to engage confidently with the financial marketplace.
41. We also have a role to play in the supply side by sharing our consumer insight with the financial services industry. This can help the industry better engage with their customers and develop products that their customers want and need.
42. In turn, improved competition will help empower consumers, making it easier, more worthwhile and more rewarding to shop around when making financial decisions.

Q17. Does the draft Bill strike the right balance between the responsibilities of consumers and firms? Are the FCA's new powers in the area of consumer protection appropriate?

43. There are two aspects to our role here:
    i) how we will share information with the FCA and how they will use it; and
    ii) our role in empowering people.
44. As part of "ensuring the appropriate degree of consumer protection" the FCA must have regard to "any information which the consumer financial education body has provided to the FCA in the exercise of the consumer financial education function."
45. We help people take responsibility for their actions because taking responsibility is part of taking control. People are more likely to change their behaviour if they are able to take control of their money (for example, by setting a goal they are more likely to save to reach that goal).
46. By understanding people's behavioural biases and helping them make sense of the market, we aim to give advice that encourages people to act in their best long-term interests.
47. The FSA has already stated that "information provided to consumers by the FCA itself, by the Money Advice Service, and by other organisations working to support consumers in their financial decisions will also help."[213]
48. We are required to give the FCA relevant information that we uncover in the course of our work. This goes to the heart of better coordination between the FCA and those in a position to spot early signs of potential consumer detriment. Our statutory MoU with the FCA is likely to formalise this requirement.
49. We have also made clear that we expect to share our intelligence and research with others – policymakers, firms and consumers – to help the market work better for consumers. Our work is likely to uncover intelligence about:
    - decisions people are making (including product purchases);
    - the context for those decisions in terms of life stages;
    - socio-economic and other patterns; and
    - specific topics/decisions people are having difficulty with (including product-related issues).
50. It is appropriate that we should be required to judge what information we should share with the FCA and that it is required to take account of this information. We expect this will:
    - help the FCA to form medium to long-term risk judgements; and
    - provide a first-hand consumer context to the FCA's work.

    We expect that the FCA will want to consider our information alongside other sources (for example supervisory reports, product sales data, complaints information).

[213] para 3.10, FCA approach to regulation (June 2011) http://www.fsa.gov.uk/pubs/events/fca_approach.pdf

51. Given that our work is consumer-centred and driven by our users, the information we glean will constantly change. In this environment we think that a judgement-based approach to information sharing is right for us and the FCA. We will include further information on the framework and principles for information sharing in our MoU, but we do not think it would be helpful to include further constraints or prescription in the statute.
52. Over time, we can be expected to help improve demand-side weaknesses in the market (primarily consumer capability and the ability to choose appropriate products), so that consumers are more informed, aware and active. However there will continue to be a need for strong regulation to address issues on the supply side.

Q19. Will the new regulatory arrangements reduce the risk and cost of dealing with mis-selling of financial products?

53. The FSA's most recent Retail Conduct Risk Outlook noted that "the risk of consumer detriment in financial firms is increased by the prevalence of three inherent features of this market":
    - information asymmetry between consumers and providers;
    - limited financial capability; and
    - systematic behavioural biases.[214]
54. Until these inherent features are removed, there will always be a risk of mis-selling, as well as mis-buying, in the financial marketplace. We believe that a culture of putting the customer first within the financial services industry coupled with strong supervision remains the key to preventing mis-selling.
55. It's harder for consumers to take control when markets are complex, with information asymmetries and material from firms and regulators that is hard to understand. And there are powerful behavioural biases to overcome.
56. The regulator addresses this by prescribing information and standards of conduct. We complement this by intervening – ideally before people approach the market – and equipping them with the ability and knowledge to ask relevant questions, assess risks and make informed decisions.
57. We welcome the FCA's commitment to preventing consumer detriment in the first place, rather than focusing on ensuring redress after the fact. It will be important for the FCA to act quickly once it becomes clear that there is potential for mass consumer detriment.

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[214] p55, FSA Retail Conduct Risk Outlook (Feb 2011) http://www.fsa.gov.uk/pubs/other/rcro.pdf

Money Advice Service; Reserve Bank of Australia; Consumer Focus; Which?; Citizens Advice Bureau; moneysavingexpert.com; Mr Paul Lewis; Financial Services Compensation Scheme and Financial Ombudsman Service – oral evidence (QQ 99-206)

Transcript to be found under Consumer Focus

The Money Advice Trust – written evidence

1. The Money Advice Trust (MAT) is a charity formed in 1991 to help people across the UK tackle their debts and manage their money wisely. We do this through frontline provision of debt advice to 150,000 individuals and 30,000 small businesses via National Debtline and Business Debtline respectively, training free-to-client debt advisers across the country and undertaking research and developing products (such as the Common Financial Statement) to improve the credit and debt environment. We have also recently launched an internet based money-advice tool My Money Steps. In total, we supported 1,306,000 people directly and indirectly in 2010/11.

1.1 Based upon MAT's expertise in debt advice provision and research we are only responding to Question 17 *Does the draft Bill strike the right balance between the responsibilities of consumers and firms? Are the FCA's new powers in the area of consumer protection appropriate?*

2. MAT believes that while aspects of the Financial Services Bill are to be welcomed for new powers in consumer protection (such as product intervention), overall the Financial Capability Authority (FCA's) powers provide insufficient consumer protection to make the balance of consumer/firm responsibility appropriate.

2.1 The consumer protection objective as set out in Section 1C focuses upon preventative rather than remedial protection, most notably in subsections 2(e) and (f). Remedial protection is equally necessary in ensuring the right balance of responsibility and appropriate protection.

2.1.2 MAT's experience of callers to National Debtline and supporting research[215] suggests that consumers can and do take responsibility for their decisions, but life events unforseen at this time can render a previously acceptable financial situation unmanageable, especially if these events occur in sequence or combination (for example job loss and relationship breakdown). Our evidence suggests that most consumers want to resolve their debts by pro-actively managing the problem (for example negotiating and sticking to a repayment proposal with creditors): more than 2/3 of National Debtline clients agree a repayment proposal with creditors, of whom 95% have either repaid or are continuing to pay off their debts three years later[216].

2.1.3 Remedial consumer protection would support consumers in resolving their issues by ensuring that they were treated fairly and equally within and across firms. One example of this is the "breathing space" provision contained within the 2008 Lending Code which allowed struggling consumers 30 days' grace from interest and creditor contact to enable them to establish their financial position, seek advice and create a manageable proposal.

2.1.4 In MAT's experience firms also welcome these forms of remedial protection because it also ensures that firms are treated fairly and equally in for example recovering monies owed.

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[215] "Facing the Squeeze: A qualitative study of household finances and access to credit in a 21st-century recession" Sharon Collard, Andrea Finney and Kate Crosswaite Personal Finance Research Centre
ECOTEC Research and Consulting Ltd September 2009 . Commissioned by the Money Advice Trust.
http://www.infohub.moneyadvicetrust.org/content_files/files/090928_facing_the_squeeze_final_full_report.pdf An updated version of this study, taking into account the impact of the past 2 years, will be available in the Autumn and can be provided to the committee should they wish to review it.

[216] Money Advice Trust Impact Report 2010-11, data gained from external client survey conducted by Illuminas (a research agency) http://www.moneyadvicetrust.org/images/Impact%20Report%20Final%20Draft.pdf

2.2 Subsection 2 (f) - the principle that "consumers should take responsibility for their decisions" is already established in common law, and the consumer protection objective here does not appear to consider an equivalent requirement for firms to maintain an appropriate balance. This is particularly true for consumers requiring remedial protection, as outlined in paragraph 2.1 above.
2.3 Although the consumer protection objective refers to the "differing degrees of experience and expertise" (Section 1C, subsection 2(b)) it does not distinguish between the needs of wholesale consumers and individual/retail consumers. The needs of the latter group, for whom financial services are only one aspect of their lives as opposed to business activity are very different. Moreover, the needs within this group can vary significantly. It is interesting to note that by contrast to other regulators, there is also no financial inclusion objective addressing the needs of the more vulnerable members of the retail consumer group.
2.4 Subsection 2(e) refers to the need for accurate advice and information. However, the issue of consumers who are misled either deliberately or by accident is not addressed. In our experience, consumers can be misled by the context in which information is provided (for example celebrity endorsements of equity release/debt consolidation schemes) and by the complexity and volume of information (often described as "information asymmetry").
2.5 With regards to Subsection 2(e) we would also like to draw attention to advice and information needs with regards to remedial protection. Recent research undertaken into pre-collections engagement with 15,000 customers of a financial services organization[217] indicates firstly that such firms are often aware through behavioural data that individuals are at increased risk before the individuals themselves acknowledge this and that many of these individuals engage willingly with activities and services aimed at resolving the problem (such as negotiated repayments) once they are informed of and understand their position.

3. Our recommendations for the joint committee are as follows:

- Greater distinction drawn between individual/retail consumers and wholesale consumers, particularly with regards to information needs and responsibility for their own decisions.
- Consideration of the particular needs of vulnerable retail consumers, with regards to their access to information and capacity to take responsibility, and consideration regarding incorporation of a financial inclusion objective.
- Consideration of appropriate forms of remedial consumer protection in order to maintain a fairer and more appropriate balance between the responsibilities of consumers and of firms.
- Consideration given to the issue of "information asymmetry" between individual retail consumers and firms, and that even when accurate information is provided, the volume and language of information necessary for the individual to make a considered and responsible choice can act as a barrier towards them doing so. Plain English requirements would go some way towards reducing this barrier.

Consideration given to a responsibility on firms to provide accurate advice and information during the course as well as before commencement of the customer relationship, particularly if customer behavioural information indicates increased risk or financial difficulty.
September 2011

[217] Creditor engagement: The experiences of customers at risk of financial difficulty by Sharon Pollard, Personal Finance Research Centre, due to be published October 2011.

MoneySavingExpert.com – written evidence

Introduction

91. Martin Lewis and MoneySavingExpert.com welcomes the Joint Committee's call for evidence into the draft Financial Services Bill.

The site is looked at by over 10 million unique users each month and over 6 million get Martin's weekly e-mail – all looking for information on how to protect themselves in the ever changing and demanding world of consumer finance.

This response does not focus on the wider remit of the Bill but looks at the general issue of consumer protection in response to the questions posed by the committee:

Does the draft Bill strike the right balance between the responsibilities of consumers and firms?
Are the Financial Conduct Authority's new powers in the area of consumer protection appropriate?

The view of Martin Lewis and MoneySavingExpert.com

In order for the Financial Conduct Authority to work well for consumers it needs to work towards the following recommendations:

Information is not enough

Disclosure of information is not a solution to greater consumer protection of its own accord. The presentation of that information, and clear explanation surrounding it (and avoiding overload) is more crucial. For example, summary boxes on credit cards have a lot of information in, and are helpful if you know what you are looking for, but listing "repayment hierarchies" and "56 days interest free period" are meaningless to most consumers.

It's less the product and more the sales we need to focus on

Truly bad products that should be banned are rare – so product intervention is likely to be a very limited tool. Most products are not intrinsically unsuitable for everyone – so greater regulatory involvement in product design or even banning should not aim to stop niche products which *could* be detrimental if used incorrectly but *would* be of benefit to others (eg, short term introductory bonuses on savings accounts). Instead, it is a question of correct communication of how products work, who they are suitable for and how they are sold.

NB. We only deal with non-investment products, so don't have expertise on their suitability or toxicity.

It's not just the point of sale but the ongoing product management

Even if the product is good and the sales technique appropriate, if a product is one with which the consumer has an ongoing relationship – such as insurance, savings, credit cards – there can still be substantial consumer detriment. With many products using bait pricing

(good to start, bad later) enforced communication at those nodal points of timing is crucial. Many savings accounts still do not list their current interest rates on statements – this is a deliberate attempt to obfuscate their rate to try and prevent churn and is often done by relaunching accounts of similar names. The Financial Conduct Authority needs to not just look at new products but the ongoing management of existing ones.

No one's finances work in isolation

Banks and building societies don't take a holistic view of customers when selling products to them. For instance, the first question any customer looking to open a savings account should be asked is 'do you have debts?'. For most, if they do (excluding mortgages), repaying those will be the more profitable financial decision. Changing financial institutions behaviour on this is unlikely – and that's why any look at trying to improve the financial impact on consumers should start with ensuring there is decent financial education in our schools. Sadly that is not being addressed at the moment.

The disjoin between the regulator and Ombudsman must be addressed for two reasons:

The speed of reaction is woeful

There is a disjoint between the Financial Ombudsman Service and the regulator in that Ombudsman cannot force the regulator to speedily investigate areas in which it is seeing large consumer detriment. The publication of complaints data has been welcome, but we are yet to see practical improvements in bank's behaviour, or strong enforcement action towards banks that have a high percentage of complaints upheld at the Ombudsman. The complaints process is also heavily biased in favour of the banks and the new complaints handing rules do not address the key inequality. During both the Payment Protection Insurance and unauthorised overdraft charges court cases, institutions were allowed (either explicitly or tacitly) to put complaints on hold – denying consumers their right to redress – while still being able to continue the action being questioned.

There should be penalty for deliberate rejection and systemic mis-selling should trigger an investigation

Where a bank is deliberately using rejection and is found to be tactically rejecting valid complaints, even though it knows that the Ombudsman will award against it, it should trigger an investigation not just into current procedures but past as well as facing greater penalty and be subject to enforcement action and heavy fines. This has recently been the case for many lenders handling Payment Protection Insurance complaints. For example the Ombudsman complaints data for the final six months of 2010 had several large institutions (Lloyds TSB Bank PLC and Black Horse Limited, The Co-operative Bank Plc, Firstplus Financial Group Plc, MBNA Europe Bank Limited and Tesco Personal Finance) all receiving rate of between 80% and 90% being resolved in favour of consumers.

Communication and co-operation with wider consumer groups

For the Financial Conduct Authority to provide the consumer protection that is required – and particularly to avoid re-runs of the huge mis-selling seen in recent years – it must improve channels of communication with both consumers and their representatives. We live in a world of mass internet action. Often this is far speedier than the official consumer

groups with super complaint powers and they in turn are far speedier than the regulator. The current system of feeding in is too slow. By allowing other channels to feed in to the regulator – without requiring bureaucratic and demanding presentation - should speed things up.

No consumer representation for Financial Policy Committee and Prudential Regulation Authority

The proposed regulatory structure appears to have a lack of consumer representation in the prudential branches of the system. While stability is incredibly important, decisions taken by the Financial Conduct Authority and Prudential Regulation Authority could potentially have huge impact on consumers – for instance the restriction of mortgage lending. However, the Bill does not give any explicit routes for consumers to make its arguments on these issues. The Financial Services Consumer Panel will only have a formal relationship with the Financial Conduct Authority, and the proposed set up of the Financial Conduct Authority board representing consumer views to both the Prudential Regulation Authority and Financial Policy Committee, seems to be asking a lot of it when it is not a 'consumer champion' as originally proposed. It doesn't feel as if the new system is as consumer focused as some of the press around it is suggesting and this is a concern.

About Martin Lewis and MoneySavingExpert.com

MoneySavingExpert.com is the UK's biggest money website dedicated to saving consumers money on anything and everything by finding the best deals, beating the system and campaigning for financial justice. It's based on detailed journalistic research, cutting edge tools and has one of the UK's top ten social networking communities.

The site was created in February 2003 by specialised journalist Martin Lewis, and is still 100% owned and run by him.

In August 2011 there were over 11 million users a month visiting the site 20 million times and looking at over 80 million pages. Over 6 million people have opted in to receive the free weekly email and almost 950,000 users have registered on the forum.

Martin Lewis, is the UK's 2nd most internet searched person, Citizens Advice Consumer Champion of the year and has spearheaded major financial justice campaigns including bank charges reclaiming and PPI reclaiming. He has regular slots as resident expert on Daybreak, Lorraine, Radio 2's Vine, Radio 5's consumer panel and BBC1 Watchdog amongst others and is chair of trustees of the MoneySavingExpert.com Charity which provides consumer finances education grants.

September 2011

Moneysavingexpert.com; Mr Paul Lewis; Financial Services Compensation Scheme; Financial Ombudsman Service; Money Advice Service; Reserve Bank of Australia; Consumer Focus; Which? and Citizens Advice Bureau – oral evidence (QQ 99-206)

Transcript to be found under Consumer Focus

National Association of Pension Funds; Investment Management Association; British Private Equity and Venture Capital Association (BVCA); Association of Private Client Investment Managers; Association for Financial Markets in Europe (AFME);– oral evidence (QQ 351-437)

Transcript can be found under AFME

Nationwide Building Society – written evidence

Nationwide Building Society welcomes the opportunity to respond to the call for evidence from the Joint Committee on the Draft Financial Services Bill.

As we have stated in previous Government consultations on the future regulatory environment and measures to ensure stability, Nationwide remains broadly supportive of the Government's overarching objectives. A robust financial services sector requires similarly robust regulatory arrangements.

We support the Government's acknowledgement that financial stability acts as an important enabler of economic growth and that the Financial Policy Committee will be charged with taking economic growth into account. As an organisation that remained stable and navigated the financial crisis well this consideration is important. A strong mutual sector can deliver financial stability and competition benefits – we firmly believe that emphasis needs to be placed on the benefits of different "banking models" and the diversity they introduce to the financial system as a whole. It is vital, and firmly in the interest of consumers, that a level playing field is created between banks and building societies. In this sense the new framework should recognise the benefits of "challenger brands", such as Nationwide, in the way that the Independent Commission on Banking (ICB) has recognised them.

The Committee is correct not to view the draft legislation in isolation, given the potential for action affecting future regulation, such as the Government's eventual response to the imminent proposals from the ICB and those being developed and implemented at European and international level. Regulatory reforms in these areas will have important implications for financial stability.

We set out below our six-page submission: key points for the Committee's consideration (in Annex A – see p. 2) followed by detailed responses to relevant specific questions (in Annex B – see pp. 3-7). Please do not hesitate to contact us should you wish to discuss our submission further.

Annex A

Key points for the Committee's consideration

Proportionality

- These reforms present an opportunity to emerge from the crisis and implement new supervisory mechanisms and tools, to promote greater stability and rebuild the trust of consumers. However, this must be balanced with careful thought as to the resulting complexity and burdens that risk being placed on firms, especially those that are dual-regulated.
- Regulation should adhere to the "golden rule": it should be a proportionate response to the problem it seeks to tackle with sufficient focus on the opportunity cost to firms. The reality is that the increasing cost of regulation will indirectly flow through to more expensive products and services.

- A focus on proportionality should naturally translate to a regime that is absent duplicative rules that are designed to achieve the same end. Prudential *and* conduct regulation designed to tackle issues in the mortgage market is one such example.

FCA and competition

- We support the FCA's strategic objectives as set out in the draft legislation, which we hope will provide consumers with the degree of protection they require and promote greater choice within the market.
- Improving consumer outcomes and increased competition should be a pivotal element of regulatory reform. The draft Bill strikes an appropriate balance between ensuring that competition is at the heart of the FCA's operational model, while ensuring that its remit does not cut across the existing competition law regime.
- We believe that effective competition occurs where consumers can easily compare products using clear and transparent sales literature, make informed choices and switch providers within a regulatory framework that provides a level playing field for firms irrespective of their ownership structure.

Financial Services Compensation Scheme (FSCS)

- It is important to us that the regulators are able to assess the risk posed by firms under their supervision so that levies can be set on the basis of that risk-based assessment. We would likely support any proposal that allows for a fairer contribution from financial services providers based on the risks taken with customer deposits.
- Our contention with the current system is that the size of our retail deposit base dictates the size of the levy we pay – with no regard to the inherently low risk nature of our business. Building societies have always raised the great majority of their funds from traditional retail sources, and in any case are required to do so by law. We will therefore pay disproportionately more relative to our balance sheet size than those banks that have chosen to neglect their retail deposit base and instead rely excessively on wholesale funding and pursue higher risk strategies – the type of strategy which ultimately contributed to the financial crisis.

Mutuals

- We welcome the Government's efforts to recognise diversity in financial services, and welcome specifically the planned removal of some out-dated anomalies within the Building Societies Act 1986 (although we do not believe changes to the Act should result in fundamental changes to the sector).
- We believe that an explicit diversity 'have regard' or objective is appropriate as a means of recognising the benefits of different "banking models" and the diversity they introduce to the financial system. The Government's alternative to this is the proposal to require the PRA and FCA to assess the impact of new rules on mutuals (new section 138L). This is encouraging, and if the Government pursues this alternative proposal then we would go further and suggest that the regulators should consider, as part of the section 138L impact assessment, the appropriateness of a rule given the legal structure to which it will apply as well simply the cost.

- Similarly, we would advocate a further extension to certain parts of the Bill that would involve a joint committee of regulators performing the impact assessment currently set out in new section 138L in order to inform the UK's negotiating position in the context of proposed EU directly-effective regulation.

Co-ordination and costs

- While we broadly support the focus of the future regulatory approach on financial stability we are cautious to unconditionally support the "twin-peaks" approach given the scope – without sufficient co-ordination mechanisms in place – for duplication in certain areas and gaps in others.
- We are concerned that the upper limit for transitional costs for dual-regulated firms has increased considerably from £50-60m to £100m, with total cost estimates now up from £400m to £770m. The primary reason appears to be because the Bank of England does not wish to use the FSA's apparently expensive IT systems. It is crucial that the new regulators avoid transitional paralysis while they develop their own operating models.
- We note that regulators and the Government will review periodically the contents of the statutory memorandum proposed to be drafted jointly by the PRA and FCA. We note with caution, however, that some areas appear to be discretionary. We believe that this review should be extended to consider the cumulative impact of dual regulation and the effectiveness of the arrangements designed to minimise the burden on dual-regulated firms.
- We would take this opportunity to endorse the response of the Building Societies Association ("BSA") and its work to date in engaging with the Government and the FSA on matters of significant practical importance, in particular a common gateway for regulatory processes and a shared regulatory handbook.

Governance and accountability

- It is essential that the issues of roles, accountability and responsibility, and an appropriate appeals process, are considered. This is important given the lack of accountability and responsibility that hampered the tripartite system and contributed to the severity of the last financial crisis.

Annex B

Responses to relevant specific questions

Question 1. Is the separation of prudential and conduct regulation into a "twin peaks" system the right approach?

We believe the focus on financial stability is correct given the widespread turmoil experienced. It is of critical importance that the UK benefits from more effective macro-prudential supervision and a situation is avoided in the future where a single regulator is unable to balance conflicting priorities. The creation of the FPC is therefore appropriate.

This is not to say that we prefer disintegrated micro-prudential and conduct supervision – a single regulator with the correct objectives, culture and leadership might equally be capable of supervising the UK financial services market place.

Within the proposed framework, there needs to be appropriate focus on minimising the complexity and operational burdens that will be placed on dual-regulated firms. Without strong co-ordination mechanisms, the structure could easily suffer from the same regulatory "underlap" that was exposed as being present in the current tripartite system. The Government should secure arrangements that will ensure the new authorities interact effectively with each other to avoid duplicative and expensive regimes, the costs of which will ultimately be borne by consumers, the people whose interests the regime is designed to protect.

Finally, it is essential that both the FCA and PRA are of equal status.

Question 3. Is it appropriate to make such major changes to the regulatory system by way of amending legislation, rather than starting afresh?

We are not opposed to the approach the Government is taking in amending rather than re-inventing the existing framework. It is possibly less onerous from a drafting perspective to amend existing legislation and potentially clearer what elements are subject to change. The industry is familiar with the current FSMA statutory framework having worked within it for over 10 years, so the chosen approach is understandable.

Question 4. Are the accountability and governance arrangements for the Bank of England, FPC, PRA and FCA satisfactory?

We have called on the Government to impose on the FPC an "MPC-style" framework to ensure equivalent governance, accountability and transparency arrangements. We recognise that considerations around market sensitive information might preclude entirely or limit significantly certain disclosures, but we see no reason why both the MPC and the FPC should not be on an equal footing as regards practical arrangements and governance. This is particularly important given that the FPC and MPC will have equally important roles to play in balancing financial and monetary policy considerations respectively. We believe the Government should consider promoting the FPC to a full committee of the Court of the Bank of England rather than a sub committee, as is currently proposed.

Question 5. Are the FPC's objectives the right ones? Is the concept of financial stability adequately understood for the FPC to be able to perform against its objectives?

We have previously called for all the supervisory bodies to have objectives that are aligned. This was primarily to encourage the Government to ensure their activities and thinking is joined-up. It was also to promote wider appreciation of diversity within in financial services, particularly in the context of the mutual model being a viable alternative to the plc banks. Overall the FPC's objectives appear to us to be appropriate.

How financial stability is defined depends upon *what state of affairs we are prepared to accept, tolerate or be exposed to at any given time*. This will change over time. We are arguably operating in an environment that is more stable than at the height of the credit crisis, though

many argue that there are improvements still to be made. The FPC will need to be clear about what it is expected to achieve, for example by setting targets in the way that the MPC does with interest rates. This will in turn be crucial in making the FPC properly accountable.

Question 6. Should the FPC be limited in the actions it can take which might affect the growth of the financial sector?

The Government has adjusted the FPC's objectives to include a qualification related to economic growth. This is welcome given the close relationship between economic growth and financial stability. It is important that actions taken in pursuit of one end do not adversely impact the other beyond a tolerable limit, which clearly will be influenced by an assessment of outcomes regarded as being priority at a given time. It will be key to ensure that the MPC and FPC work together and understand the consequences of each others actions. Consideration should be given to promoting the FPC to an equivalent status as the MPC.

Question 9. Can Parliament take an informed decision about the proposals for the FPC without details of the macro-prudential tools at its disposal?

The way in which the FPC will deploy the macro prudential tools available to it is not clear to us. These tools have been the focus of much international debate in recent months. The Government has committed to ensure the interim FPC conducts a detailed analysis of the effectiveness and indeed the viability of them. So we look forward to the results, which we expect to be influenced by the wider European efforts to align supervisory thinking and practice in the context of the emerging European supervisory framework.

Question 12. Are there any risks in the Government's proposed 'judgement-based' regulation?

Supervisors will need the requisite skills and experience to perform their role effectively. There are potential negative consequences of a judgement-led approach should it involve a confrontational supervisory style and supervisors who are unfamiliar with the specifics of a firm's business model and culture. The Government acknowledges this.

It is important that our supervisors understand our business so that they appreciate how we are different to our competitors – and how we exercise our judgement in managing our business. There should be mechanisms to resolve differences of opinion without firms having to resort legal action.

We would welcome the Government's intention that the PRA will supplement its rules with purposive statements to aid interpretation if this leads to greater certainty as to how supervisors are likely to exercise their judgement. We believe that firms should, within lawful and morally-sensible boundaries, be free to take a pragmatic approach to compliance and risk management activities. We understand that the PRA may wish to take a judgement-led approach but believe that it should ultimately be outcomes-focussed.

Question 14. Given that the PRA and the FCA will inherit FSA staff does the draft Bill do enough to ensure a new regulatory culture and a more proactive approach to regulation? Will these two new bodies have staff with the appropriate skill and expertise?

We have seen a definite cultural shift in the way in which the FSA has operated since it implemented a shadow structure in preparation for the coming into force of the Act, and earlier as a result of the FSA's Supervisory Enhancement Programme. These changes were FSA-initiated without having to amend primary legislation, so it could be argued that legislation is unnecessary to succeed in this respect. Firms know their business models better than anyone. Supervisors therefore need to spend time understanding their firms' business and cultural drivers for the regime to work effectively. This will necessarily require mature and productive dialogue. It seems to us that the key to success will be a combination of political will, close public scrutiny and strong leadership rather than broad brush legislative reforms of the entire supervisory infrastructure.

Question 15. Are the FCA's primary objectives appropriate? Is significant emphasis given to the promotion of competition?

Improving consumer outcomes and increasing competition should be a pivotal element of reform. We believe that effective competition occurs where consumers can easily compare products, make informed choices and switch providers within a regulatory framework that provides a level playing field for firms irrespective of their ownership structure. The draft Bill strikes an appropriate balance between ensuring that competition is at the heart of the FCA's operational model and ensuring that its remit does not cut across the existing competition law regime.

Question 17. Does the draft Bill strike the right balance between the responsibilities of consumers and firms? Are the FCA's new powers in the area of consumer protection appropriate?

We believe that the FCA will be given sufficiently wide powers to protect consumers. However, the proposals set out in the draft Bill are framed such that financial services providers will be deterred and penalised for getting things wrong rather than finding appropriate resolutions. The Committee should consider the role of the FCA as a consumer champion and whether a statutory obligation towards this is necessary to safeguard this feature. The role of the future regulator should be balanced with the principle that consumers can and should be empowered to take responsibility for their actions. Consequently, the FCA should be required to consider the relative sophistication of consumers in deciding whether a firm's actions are appropriate and indeed there are encouraging signs in the draft Bill that the Government has given this some thought.

Question 19. Will the new regulatory arrangements reduce the risk and cost of dealing with miss-selling of financial products?

We support and call for early, regular and productive dialogue during the product development lifecycle of financial services products to avoid issues, rather than pointed and prescriptive regulation applied in a mechanical way.

As outlined earlier, dual-regulated firms will be subject to two layers of supervision, which will give rise to additional costs. We reiterate the point that both regulators need to be co-ordinated in their approach, for instance in product design, in particular for dual-regulated firms.

Given Nationwide's mutual status and involvement of our members, we feel that a firm's culture and attitude towards its customers is a key determining factor to be appreciated from the outset in any regulatory approach. Careful regard needs to be paid to the differences in culture brought about by the differing governing structures across the financial services sector.

Question 20. Are the proposals for co-ordination between the PRA and FCA clear and adequate? What would be the advantages and disadvantages of having a Single Point of Contact and/or a joint rule book for dual-regulated firms?

There are encouraging points outlined in the draft Bill to suggest clear and adequate intentions for co-ordination. In particular, the specific duty to ensure a co-ordinated approach is important. The statutory memorandum of understanding setting out how the PRA and FCA intend to co-ordinate functions will also help – but this should be noted with a degree of caution as some areas appear to be discretionary.

We hope that the regulators pay significant regard to using resources in the most efficient way and that measures to guarantee this will be sufficient to ensure the supervisors interact with dual-regulated firms in a truly co-ordinated, non-duplicative way. This especially applies to information requests and supervisory visits – two areas where there is a clear risk of duplication.

Multiple points in favour and against a single point of contact and joint rulebook exist which we would encourage further investigation by the Committee.

A single point of contact and joint rulebook would:

- bring about continuity;
- ensure the division of rules between the regulators is clear and not over- or under-lapping; and
- encourage communication between supervisors to ensure thinking and decisions do not undermine or interfere with the others work.

We refer the Committee to the BSA's action in this area.

We acknowledge the drawbacks may include the potential for inflexibility if supervisors are prevented from operating with freedom, both now and in future, for example if they wish to change their practices.

Question 21. How do the proposals in the draft Bill fit within the new European regulatory regime? What freedoms and constraints will the UK have to operate within that regime?

As outlined in our introductory key points, the EU and international context for regulation needs to be kept in mind given that UK Financial Services is increasingly subject to directly-effective European regulation. There is a risk that the draft Bill and requirements under consultation could be ineffective or diluted.

This is not to say that we advocate a removal of the efforts the Government has made in recognising mutuals. We support the moves to require the regulators to consider the

impact of new regulation on mutuals. However, in light of the potential for directly-effective regulation, we would support the proposition of a joint regulatory committee designed to inform the UK's negotiating position and interests in Europe. This would ensure sufficient influence in advance of regulation coming into force and ensure that consideration is given to the needs of the mutual sector and the different business models in operation.

September 2011

NYSE Euronext – written evidence

1. NYSE Euronext

1.1 NYSE Euronext is a leading global operator of financial markets and a provider of innovative trading technologies. NYSE Euronext's exchanges in Europe (Amsterdam, Brussels, Lisbon, London and Paris) and the United States provide for the trading of cash equities, bonds, futures, options, and other Exchange-traded products. NYSE Liffe is the name of NYSE Euronext's European derivatives business and is the world's second largest derivatives business by value of trading. It includes LIFFE Administration and Management, which is a self-clearing Recognised Investment Exchange pursuant to the Financial Services and Markets Act 2000 ("FSMA").

2. Introduction

2.1 NYSE Euronext welcomes the opportunity to provide written evidence to the Joint Committee on the draft Financial Services Bill (the "Joint Committee"). In providing the evidence contained in this submission, NYSE Euronext has focussed on those questions raised by the Joint Committee which have a direct impact on core financial market infrastructure, particularly exchanges and central counterparties ("CCPs"). Those questions are reproduced in section 3 of this submission (in bold italics) and in each case are followed by NYSE Euronext's response (in normal type).

3. Questions Raised by the Joint Committee and NYSE Euronext's Responses

3.1 ***Is the separation of prudential and conduct regulation into a "twin peaks" system the right approach? (Question 1)***

3.2 Under the proposed "twin peaks" approach, the Financial Conduct Authority ("FCA") will be responsible for regulating exchanges and other trading platforms and the Bank of England will be responsible for overseeing CCPs and settlement systems. NYSE Euronext understands the underlying rationale for a bifurcated approach of this nature. However, it notes that trading, clearing and settlement cannot each be regulated in complete isolation as they are each a link in the same business chain. Activity in one link can and does have an impact on activity in the others. Moreover, certain functions, such as trade allocation, could be regarded as part of the trading link or, alternatively, as part of the clearing link.

3.3 In the case of on-exchange derivatives markets, like NYSE Liffe's, where contracts are held open for months if not years, regulation of the market must encapsulate both trading activity (i.e. the flow of transactions on a daily basis) and the stock of outstanding positions. Trading takes place on the regulated market, while resultant positions are held with the CCP. Such positions can and do have an impact on future activity on the market and issues concerning them are, in many cases, the key factors which must be managed actively in respect of the maintenance of contract and market integrity. The legitimate interest that the FCA should have in relevant areas of post-trade activity must therefore be explicitly acknowledged in its objectives and

remit. There is currently no such acknowledgement in Clause 1D (The Integrity Objective) of the draft Financial Services Bill ("the Draft Bill").

3.4 Furthermore, in moving to a "twin peaks" approach, the Financial Services Bill must avoid undermining the basis on which legitimate business is conducted today. There is a danger that technical modifications to the current FSMA regime will inadvertently remove the legal basis for some of this business. For example, as a consequence of moving from a unitary regulator to a "twin peaks" regime, Clause 25(3) of the Draft Bill would remove the FSMA provision (section 285(2)(b)) under which exchanges currently operate "cleared only" services, such as NYSE Liffe's successful and innovative Bclear service. Consistent with the objectives of the G20, such services have the beneficial policy effect of transferring business from the Over The Counter environment into the exchange/CCP environment. It is therefore a matter of significant concern that the legal basis for the future operation of such services in the UK is unclear as a result of the Draft Bill (e.g. whether such services can continue to be operated by an exchange or whether they can only be operated by an entity which has CCP status). Clarification is needed before the Draft Bill enters the legislative process in order to avoid damaging unintended consequences.

3.5 ***Are the responsibilities of the FCA towards the regulation of markets appropriate? (Question 16)***

3.6 NYSE Euronext believes that the proposed amendments to the existing approach to regulating exchanges and CCPs (together "Recognised Bodies") requires further scrutiny by the Joint Committee.

3.7 NYSE Euronext has welcomed the Government's decision not to proceed with its original plans to dismantle the tailored regime for regulating Recognised Bodies and instead to carry forward the Recognised Body regime in the Draft Bill. As the Joint Committee will be aware, the regime for Recognised Bodies was established through enactment of the Financial Services Act 1986. It was carried forward, substantially unaltered, into FSMA. As such, there has been over two decades of experience with the operation of the Recognised Body regime. In NYSE Euronext's view, that experience has demonstrated the following:

(a) The structure of the current regime is correct in recognising the unique position of Recognised Bodies as front-line regulators of the member firms which use their facilities. As such, the Recognised Bodies are partners in regulation with the FSA (as they were with the Securities and Investments Board before it). This has provided an effective framework for the maintenance of fair and orderly markets.

(b) The regime proved effective during the financial crisis. No Recognised Body was in distress – or in receipt of government funding – during the period of financial turmoil. On the contrary, the Recognised Bodies played an important part in managing the consequences of the default of major financial institutions, such as Lehman Brothers; and their markets continued to operate effectively and in an orderly and transparent manner, whilst liquidity in many other fora dried up.

(c) The legislative framework in most jurisdictions with major financial centres distinguishes exchanges and CCPs on the one hand from users of their facilities (e.g. investment firms and banks) on the other, and subjects them to appropriately tailored regulatory obligations. Subjecting exchanges and CCPs in the UK to a regime designed for investment firms and banks would have run counter to those established international standards and would have raised a question mark over the continued ability of UK-based exchanges and CCPs to provide their facilities to their many users based outside the UK.

3.8 Whilst NYSE Euronext therefore welcomes the proposal to retain the Recognised Body regime, it also notes that the Draft Bill contains a number of modifications to the regime, all of which would have the effect of increasing the formal powers which the relevant regulator (i.e. the FCA in respect of exchanges and the Bank of England in respect of CCPs) will have over Recognised Bodies[218].

3.9 In NYSE Euronext's view, the Government has not sufficiently justified such changes. Most significantly, it has not been able to point to any failures with the operation of the current regime which would be addressed by the imposition of the proposed new formal powers; nor is NYSE Euronext aware of any such failures.

3.10 The powers were described in HM Treasury's February 2011 Consultation on the proposed reforms as a small number of "technical improvements" to the regime. However, NYSE Euronext believes that far from being merely "technical" changes, such changes could, depending upon how they are implemented in practice, radically alter the nature of the cooperative relationship between Recognised Bodies and the statutory regulator, whereby the statutory regulator and the Recognised Bodies are currently partners in regulation, as described in paragraph 3.7(a) above.

3.11 Changing the nature of that relationship could prove to be counterproductive if it were to undermine the ability of the statutory regulator and the Recognised Bodies to work together effectively – making use of their respective knowledge, powers and regulatory reach - in the interests of the efficacy of the regulatory system as a whole. NYSE Euronext would therefore encourage the Joint Committee to call upon the Government either to justify properly the proposed new formal powers – by demonstrating that they are intended to address identified failures in the operation of the current regime – or if, as NYSE Euronext anticipates, this cannot be demonstrated, to remove the proposed powers from the Draft Bill.

3.12 ***How do the proposals in the draft Bill fit within the new European Regulatory regime? What freedoms and constraints will the UK have to operate within that regime? (Question 21)***

[218] The formal powers in question would allow the FCA and the Bank of England: (i) to exercise a power of direction over Recognised Bodies without all of the existing checks and balances (Clause 27); (ii) to fine and publicly censure Recognised Bodies (Clause 28); (iii) to have additional rule making powers in relation to Recognised Bodies (Clause 26); and (iv) to require a Recognised Body to appoint a skilled person to prepare a report on any matter in relation to which the FCA/Bank of England could require the Recognised Body to provide information to it (paragraph 12 of new Schedule 17A inserted by Schedule 6, and paragraph 4 of Schedule 11).

3.13 The proposed new regulatory structure in the UK will clearly need to dovetail with the revised arrangements at EU level, including the new European Supervisory Authorities ("ESAs") which were created as part of the EU Supervision Package which was agreed in September 2010. Under the terms of the Supervision Package, in most cases national competent authorities would continue to be responsible for the supervision of regulated entities within their jurisdiction, whilst the ESAs would be responsible for setting common rules and standards across the EU. However, the remit of the ESAs could be altered as a result of forthcoming EU legislation. This can be seen most clearly in the negotiations concerning the Regulation on OTC Derivatives, Central Counterparties and Trade Repositories (commonly known as "EMIR"), in which there is an ongoing debate about the role of the relevant ESA – i.e. the European Securities and Markets Authority ("ESMA") – in the authorisation and supervision of CCPs. Depending on the outcome of those negotiations, this could blur the distinction which was drawn in the Supervision Package between the role of the ESAs on the one hand and the role of national competent authorities on the other.

3.14 Even if the role of ESMA remains broadly unchanged, the current European Council and European Parliament texts of EMIR envisage that authorisation and supervision of a CCP will not be conducted by the relevant national competent authority in isolation. Instead, for each CCP the relevant national competent authority will have to share those responsibilities with other competent authorities and central banks who have an interest, within a college structure. Given the potential size and number of such colleges, and the specialist nature of CCP supervision, NYSE Euronext is concerned that such structures could prove to be cumbersome and unwieldy and are unlikely to be the most effective way in which to supervise CCPs in all circumstances and particularly in times of stress when timely decision-making is particularly important. NYSE Euronext believes that colleges of this type will be prone to becoming entangled in issues of process and being side-tracked from issues of substance due to variable expertise and politics among their members. The Bank of England will need to be mindful of, and devise a strategy for managing, these contingencies if it is to ensure the ongoing effectiveness of the supervision of UK CCPs.

4. Next Steps

4.1 NYSE Euronext welcomes the opportunity to provide written evidence to the Joint Committee and remains at its disposal should the Joint Committee require any further explanation of NYSE Euronext's views.

2 September 2011

Office of the Complaints Commissioner – written evidence

- # Executive Summary

1.1 This paper represents the Office of the Complaints Commissioner's submission concerning the draft Financial Services Bill (The Bill) relevant to the current role of the Complaints Commissioner. Given the specific role of the Complaints Commissioner this paper will focus on:

- The current accountability and oversight of the Financial Services Authority (FSA) as set out in the Financial Services and Markets Act 2000 (FSMA).
- The current remedies open to the Complaints Commissioner.
- Identifying the sections of the new approach that are relevant purely to the activities of any future Complaints Commissioner. That means addressing only the issues arising out of Questions 4 and 20 contained in the Joint Committee's call for evidence.
- The overlap in the roles and the interaction between the proposed new regulators of the financial services industry (the Industry).
- The issue of accountability that the two proposed new regulators will have in relation to quasi-legislative functions.
- The effect of replicating section 348 of FSMA.
- The aims of the current complaints scheme and the difficult and complex issue of compensation.

1.2 The current Complaints Commissioner took up his role on 4th September 2004 and, after being reappointed in 2007 for a further period of three years, has been reappointed for the current period of three years so that his period of office will expire on 3rd September 2013. All these appointments were subject to the approval of H.M. Treasury. In this response, the Complaints Commissioner has adopted the approach of identifying how the current system deals independently with complaints from either the Industry or consumers about the performance of the FSA, the way it has operated and where the pinch points are within the current system. That, on the assumption as contained in The Bill, that the proposed Financial Conduct Authority (FCA) will be subject to a similar mechanism as that required of the FSA in FSMA.

1.3 The terms of the relevant statutory provision in FSMA refers to "an Investigator" but the terminology given since putting these statutory provisions in place has always been to describe such a person as the Complaints Commissioner and that term will be used in the context of describing the current scheme affecting the FSA.

1.4 The Bill also provides that the Prudential Regulatory Authority (PRA) should have a duty to maintain a complaints mechanism but The Bill does not provide that it is similar to that required of the FSA involving the role of an Investigator (or Complaints Commissioner) independent of the appointing body.

1.5 The Complaints Commissioner currently investigates a number of complaints against the FSA which encompass a broad range of issues, falling mainly in the following categories:

- Mistakes and lack of care on the part of the regulator
- Unreasonable delay
- Unprofessional behaviour
- Bias; and
- Lack of integrity

1.6 If the two new regulators are formed, it would be crucial for the purpose of transparency and independent accountability that the same mechanism exists for reviewing complaints in the categories above in both the proposed new regulators. It would be prudent for the PRA to have a completely independent complaints scheme, and for any Investigator (or Complaints Commissioner) to remain therefore as the independent reviewer for both the PRA and FSA. The Bill's proposal for a complaints scheme for the PRA does not provide however for that to be the case.

1.7 One Independent Investigator (or Complaints Commissioner) for both regulators would ensure that consistency, continuity and transparency is applied across the board. This structure would also be the most cost effective option (given the alternative of having two independent Investigators (or Complaints Commissioners), as well as being the most equitable (given the alternative of an Investigator (or Complaints Commissioner) existing only for the FCA and therefore not replicating the provision for the investigation of complaints against the PRA).

1.8 There is a further issue worth identifying in connection with section 348 of FSMA which relates to "Restrictions on disclosure of confidential information by [the FSA]". That section with appropriate amendments will be re-enacted in The Bill and could impact upon the investigation of complaints by the FCA if the PRA would look to use that re-enacted section to withhold relevant information.

1.9 It would also be prudent if the forthcoming legislation addresses with clarity the issue of "compensatory payment on an *ex gratia* basis" currently allowed as a remedy to a well founded complaint under the current arrangements. In the past 10 years, since the appointment of the first Complaints Commissioner, this issue has remained open to different interpretations with regard to the actual monetary amount a complainant might receive from the regulator.

1.10 A copy of the most recent Annual Report from the Office of the Complaints Commissioner (OCC) is attached and copies of all previous reports are available.

• Current position regarding accountability

2.1 Under the Paragraph 7(1) of Schedule 1 of FSMA, the FSA must make arrangements for the investigation of complaints arising in connection with the exercise of, or failure to exercise, any of (the FSA's) functions (other than its legislative functions) made by eligible complainants. The rules of the complaints scheme are set out in the document entitled Complaints against the Financial Services Authority (also known as COAF). Specifically, paragraph 1.4 of COAF provides:

COAF 1.4 Coverage and scope of the scheme

(1) Allegations of misconduct by the *FSA* arising from the way in which it has carried out or failed to carry out its functions. The *complaints scheme* covers complaints about the way in which the *FSA* has acted or omitted to act, including complaints alleging:
(a) mistakes and lack of care;
(b) unreasonable delay;
(c) unprofessional behaviour;
(d) bias; and
(e) lack of integrity.

(2) [deleted]

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

2.2 The FSA must appoint a Complaints Commissioner, subject to the approval of H.M. Treasury, in order to carry out the functions imposed by the Complaints Scheme. The Appointee is totally independent of the FSA.

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

2.4 Currently, the Complaints Commissioner operates through a company limited by guarantee, entitled Office of the Complaints Commissioner (OCC). The post of Complaints Commissioner needs to establish a continuing identity, which is separate from that of the individual who is acting in the post, i.e. a "legal wrapper". This is particularly important in terms of the continuity of the role and for any individual who succeeds the current Complaints Commissioner if his role is continued. The continuity of the role should be established through the ongoing ownership of the contracts and liabilities of the Complaints Commissioner, although at the start under any different scheme there may be none. If any contracts or liabilities are subsequently assumed or established as being the Complaints Commissioner's then the Complaints Commissioner on leaving the post, would have to novate any such contracts which pertain to the post to a successor. Presumably any contracts which could not be novated would remain a legal liability of the outgoing Complaints Commissioner unless otherwise terminated. Furthermore, the ownership of the intellectual property of the post (the complainant files and database) would remain with the Complaints Commissioner in his own personal capacity. That would be undesirable.

2.5 COAF also sets out what are the possible outcomes are for a complainant following the investigation of a well founded (or upheld) complaint. Specifically paragraphs 1.5.4, 1.5.5 and 1.5.6 of COAF provide:

What are the possible outcomes for the complainant?

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

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

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

2.6 COAF also sets out the time limits for the referral of a matter to the Complaints Commissioner. Specifically, paragraph 1.5.6A of COAF provides:

COAF 1.5.6A Time limits for the referral of a matter to the Complaints Commissioner

(1) When the FSA writes to a complainant with its final report of its investigation (referred to as a Stage One Investigation), or explains that it will not investigate a complaint under the complaints scheme, the FSA will inform the complainant that, if he is dissatisfied, he must refer the FSA's decision to the Complaints Commissioner within three months of the date of that letter.

(2) If the Complaints Commissioner receives a referral of a matter outside the three months time limit it will be for the Complaints Commissioner to decide whether there is a good reason why the matter should be considered out of time.

2.7 The Complaints Commissioner's investigation is referred to as a Stage 2 Investigation.

2.8 The current complaints scheme is widely considered to have worked well. It was set up in order to give the Industry a feeling that its interests, in the context of safeguarding those

interests, would not be trampled on by an over-zealous FSA bearing in mind that any regulator must always have due regard to its statutory responsibilities.

2.9 It is recognised that the Industry has expressed concerns about the *modus operandi* of the Financial Ombudsman Scheme (FOS) and to a lesser extent the Financial Services Compensation Scheme (FSCS) but these concerns and these bodies do not come within the jurisdiction of the Complaints Commissioner. That jurisdiction relates only to the FSA and how it discharges its statutory functions both as to the Industry and to consumers.

2.10 Consumers also have access to the jurisdiction of the Complaints Commissioner but to a less successful extent when compared to the Industry. This is because any dispute will generally revolve around a particular advisor or product as opposed to the FSA exercising its statutory responsibilities.

2.11 A number of complaints arise where complainants are unhappy that the FSA will not provide them with details of what action, if any, it may have taken or is planning to take against an authorised firm as a result of information provided by such complainants. Section 348 of FSMA prevents the FSA from disclosing information that it has received from, or about, firms other than in limited circumstances. Unfortunately, informing an individual who has passed information to the FSA about discussions which take place between the FSA and the firm in question is not one of the circumstances where disclosure is permitted. Nevertheless the Complaints Commissioner is allowed to see the entirety of the information possessed by the FSA in this context and, with discretion, indirectly refer to it when concluding his Stage 2 investigation.

2.12 The issue of compensatory payments is addressed later in this response (Section 5.)

• The Legislative Proposals

3.1 The roles of the regulators and the issue of accountability and oversight

3.2 It is envisaged that the new proposed financial services regulators will have roles that can be summarised as follows:

3.3 The Prudential Regulatory Authority (PRA).

3.3.1 The PRA has been given the role of promoting a stable and prudent conduct of the financial services industry. It will also be given operational responsibility for the regulation and authorisation of larger enterprises which are believed to have significant balance sheet risks. This will include taking over responsibility for regulatory decision-making including the authorisation and supervision and also take the lead in imposing sanctions (taking action) against firms it regulates. From this it appears that the PRA will inherit the FSA's regulation and authorisation roles in certain firms. Where group firms operate under the jurisdiction of both the PRA and the FCA a decision will be made by the regulators on who is to be regarded as the lead regulator (where the lead group firm is a deposit taker, insurer or a significant investment firm this is likely to be the PRA, although this will not necessarily always be the case).

3.3.2 The PRA will move from "a tick box approach" to regulation, to a "judgement led" approach. Adopting this type of approach, whilst to be encouraged, requires different skills and improved documentation of the rationale for decisions. The Complaints Commissioner on occasions has commented that the FSA does not maintain adequate records and should improve its record keeping. This is referred to in his annual reports. The question therefore arises whether the staff, which will no doubt transfer from the FSA to PRA to undertake these roles, will have the necessary skills to adapt to this new, quite different, style of regulatory operation. Failing to maintain adequate records, and not explaining the rationale behind decisions will leave the PRA open to claims of bias, lack of integrity or

negligence. It is therefore important that the decisions made by the PRA staff are subject to review and oversight by a completely independent body. Where complaints are made, particularly by the Industry, an independent review should be conducted and be seen to be outside the influence of the Bank of England.

3.3.3 Although the FSA has, and the new regulators will have, a statutory immunity from claims for negligence with the possibility of an award of damages by a Court, complaints of this nature can be considered under the rules of a complaints scheme. Should this approach be adopted for the PRA (and the FCA) then, in the event that there are failures in record keeping and a detailed note of the consequent rationale for a decision is not given (or recorded) then it is likely that a considerable number of complaints will be made against the PRA.

3.3.4 Criticism has been made of the FSA by both the Industry and consumers, but not always justified, that the FSA is an entity which operates as it sees fit and is not accountable to anyone. Whilst much of the criticism relates to the failures of the Tripartite arrangement which led to the events of 2008/09, it is important that the PRA, as the lead prudential regulator in particular is seen to be open and to have accountability to both Parliament and an independent body in a similar way to the FSA. It should be easily accessible as well as answerable both to the public and the Industry.

3.3.5 It is essential the PRA assumes and retains the confidence of the public in carrying out its role and duties. One of the ways of achieving that, from the perspective of the Complaints Commissioner, is to ensure that where complaints arise about the PRA, there is provided in the legislation an independent mechanism for addressing them. By independent in that context means that the Investigator carrying out the investigation of such complaints has no connection with the Bank of England or the PRA.

3.3.6 This, it appears to the Complaints Commissioner, is even more important where, as will be the case, there is an overlap of functions carried out by the proposed regulators and those responsible for the direction and input in respect of the proposed regulators.

3.3.7 Accountability can always be achieved through access to the Courts but that is time consuming and expensive and is not always a viable option. For all the reasoning applied in this section it seems that a wise course is to provide for a complaints system similar to that which the FSA is currently subject.

3.3.8 With that in mind, Schedule 1ZB of The Bill in Part 2 on page 157 sets out what is proposed for the PRA. These proposals do not replicate those for the FCA. It appears that any complaints Investigator for the PRA while stated to be independent is subject to the overarching approval of the Bank of England who will appoint the investigator. Treasury approval for the appointment will not be required. Effectively the total independence of any Investigator, as proposed in the Bill for the FCA (which replicates what is currently the case now for the FSA), is not replicated for the PRA given the intended overarching involvement of the Bank of England and its Court of Directors.

3.3.9 Given what has been set out concerning the proposals for a separate complaints scheme for the PRA what is the rationale for keeping it separate (as well as less independent) from that to be put in place for the FCA. Such rationale as is provided so far consists of this statement:

"*The complaints scheme deals with operational matters (rather than regulatory judgements), and for the scheme to be rum by the Bank is consistent with the PRA's position within the Bank of England group (and the role of the Bank of England on non-supervisory matters related to the PRA)*".

That reasoning however seems somewhat on the thin side given both the obvious convenience of a combined Investigator (or Complaints Commissioner) as well as a reduction of cost quite apart from what will inevitably be the case of mistakes arising

through overlapping functions. In addition there is the unknown operational outcomes arising out of section 348.

3.3.10 The PRA is under Part 5 of the same schedule (like the FSA currently) to be exempt from all liability in damages in the discharge of its functions save for the presence of bad faith or to make an award if there is a breach of the Human Rights Act 1998.

3.3.11 Section 348 of FSMA is replicated, with appropriate amendments for the split between the PRA and the FCA, in The Bill. At this stage it is premature to try to establish how the PRA will be concerned as to allowing full disclosure as to its operations given the ambit of such a clause. At first blush it is possible, without more clarification, to envisage a position where the FCA may not be able, for the purpose of dealing with a complaint about its services to a complainant, to divulge information that in the normal course of events that the FCA itself would be prepared to divulge to a complainant or to any Investigator being information the PRA either does not disclose to the FCA or having disclosed it to the FCA wishes the FCA in turn not to pass that information on to a complainant. This issue, as well as the impact about the investigation of a complaint within the PRA itself and how far it, in such a case, will wish to invoke section 348 and thereby not reveal information needs to be considered in depth.

3.4 Financial Conduct Authority (FCA)

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

3.4.2 The Bill proposes that the FCA will have responsibility for the prudential regulation as well as the supervision of most firms offering consumer financial services. Thus all firms will be regulated for their conduct by the FCA, and the vast majority of firms will be prudentially regulated by the FCA as well. The PRA will only be responsible for the prudential regulation of about 2,500 firms across the board. Those firms will therefore be "dual regulated", and effectively supervised by both regulators in their own spheres (PRA for prudential, FCA for their conduct of business). Both authorities will have the power to sanction the firms they regulate for a breach of their rules. On authorisations, where it concerns "a PRA firm", the PRA will take the lead in the authorisations process, but the FCA will have to give its consent for the firm to become authorised. Having the PRA and the FCA effectively both supervising a firm is introducing an 'overlap' situation which could cause confusion as well as imposing further regulatory burdens on the Industry which is something which the proposals were intended to avoid.

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

3.4.4 It is clear that it is intended that there should be a degree of independent oversight of both the PRA and the FCA. It is not clear from The Bill (as is referred to in 3.3.8 above) exactly what will be the degree of independence required in the conduct of the complaints regime of the PRA. This point is raised as, from the above, it does appear that there will be a considerable 'overlap' between the roles of both the PRA and the FCA even though the PRA will be regarded as the lead regulator.

3.4.5 Whilst both regulators will have different functions, they will also have to work together. In these situations, it is likely that there will be delays and/or mistakes. Where this is the case it is inappropriate for an affected party to be unable to pursue a complaint if the regulator whose actions caused a delay or a mistake is not subject to the same level of independent

accountability and/or oversight. Transparent lines of accountability therefore need to be in place. Adopting a different level of accountability and oversight would allow a culture of blame passing and a 'muddying of the waters' and possibly prevent the correct resolution of disputes for affected parties.

3.4.6 Although reference is made to the operation of accountability and oversight in a similar manner to that which is currently in operation, it is not understood why the complaints regime in this part of The Bill is not identical in drafting terms for both the PRA and the FCA. The rationale provided in the document entitles "*A new approach to financial regulation: the blueprint for reform*" justifies this approach on the basis that the PRA primarily deals with regulatory judgements. Quite apart from the fact that regulatory judgements impact upon operational matters, in any event it is the case that the legislative proposals do impact upon the PRA duties and include operational matters. In addition, the operational matters carried out by the FCA can on some occasions stem from decisions made by the PRA. If they are not to be identical it is the view of the Complaints Commissioner that this will be a serious mistake.

3.4.7 Bearing all that in mind, Schedule 1ZA of The Bill in Part 2 at page 147 sets out what is proposed for the FCA. To all intents and purposes it replicates what is contained in FSMA and what is the position currently for the FSA. Before making this complaints scheme the FCA is obliged to consult as to its functions. Interestingly there is no similar obligation on the part of PRA. Finally Treasury approval is needed for any Investigator (or Complaints Commissioner) appointment.

3.4.8 The FCA is, under Part 5 of the same schedule (like the FSA currently), to be exempt from all liability in damages in the discharge of its functions save for the presence of bad faith or to make an award if there is a breach of the Human Rights Act 1998.

3.4.9 What is set out in 3.3.11 above concerning the issue of section 348 applies *mutatis mutandis* to the position of the FCA and is therefore repeated.

• Additional comments on the proposed arrangements

4.1 The Bill raises a number of other questions. Currently the FSA, as the sole regulator, has overall responsibility for the regulation of the Industry and the supervision and enforcement of its rules upon the firms operating in the Industry. Under The Bill as drafted, there will be two regulators who will each have shared responsibility for the regulation and supervision of the Industry. Whilst it is accepted that under the current regime there may be an 'underlap' in the regulation of the Industry and that this 'underlap' could have led to the recent financial crisis, is it correct to replace this 'underlap' with an 'overlap'?

4.2 The proposed 'overlap' will impose two sets of rules on the Industry which will increase the 'compliance' burden on regulated firms. It also opens the Industry to the possibility of conflicting requirements set out within the rules within which the PRA and the FCA expect the Industry to operate. This is even more the case where the regulation is judgement based. Ultimately, having two regulators taking responsibility for authorised firms could lead to the possibility that, where action is needed, there will be confusion over which body is to take action and whether either body is also to take action against a firm or individual. This could have an impact on consumers particularly where there is concern over whether a firm has sufficient permissions (or even authorisation) to conduct a specific type of business, as well as complying with the appropriate rules. This could also give rise to "whistle blowing" issues in the future.

4.3 Adopting, as will be the case, two sets of rules will clearly increase rather than reduce the burden as well as costs on firms, particularly in relation to compliance costs, record keeping and reporting requirements as well as the likelihood of complaints.

4.4 The key issue as far as any complaints system is concerned is that transparency as well as accountability needs to be clearly demonstrated. If the two new regulators are formed, it would be preferable for the purpose of transparency and accountability that the same mechanism exists for reviewing complaints in the categories above in both the proposed regulators. While it may be prudent for the PRA to have its own internal complaints scheme, it would be sensible for any Investigator (or Complaints Commissioner) to remain the independent reviewer for both the PRA and FCA.

4.5 One Independent Investigator (or Complaints Commissioner) for both regulators would ensure that consistency, continuity and transparency is applied across the board. This would be especially the case where a complaint relates to the actions or inactions of both the PRA and the FCA in relation to the same issue. This structure would also be the most cost effective option (given the alternative of having two Investigators), as well as being the most equitable (given the alternative of an Investigator (or Complaints Commissioner) existing only for FCA) particularly where a complaint may involve the actions of both regulators.

4.6 Further background information is helpful. Currently the case with the FSA under paragraphs 1.4.2, 1.4.2A and 1.4.3 of COAF is that the following apply:

COAF 1.4.2 Exclusions from the scheme

Each of the following is excluded from the *complaints scheme*:

(1) complaints about the *FSA*'s relationship with its employees;

(2) complaints connected with contractual or commercial disputes involving the *FSA* and not connected to its functions under the *Act*;

(3) complaints in relation to the performance of the *FSA*'s legislative functions under the *Act* (including making *rules* and issuing codes and general *guidance*); and

(4) complaints about the actions, or inactions, of the *Financial Ombudsman Service* or the *Financial Services Compensation Scheme*.

OAF 1.4.2A Circumstances under which the FSA will not investigate

The *FSA* will not investigate a complaint under the *complaints scheme* which it reasonably considers amounts to no more than dissatisfaction with the *FSA*'s general policies or with the exercise of, or failure to exercise, a discretion where no unreasonable, unprofessional or other misconduct is alleged.

OAF 1.4.3 Complaints that are more appropriately dealt with in another way

The *FSA* will not investigate a complaint under the *complaints scheme* which it reasonably considers could have been, or would be, more appropriately dealt with in another way (for example by referring the matter to the *Tribunal* or by the institution of other legal proceedings).

4.7 A reduced and simplified rule book is to be encouraged. Where rules are open to interpretation by both the firm and the regulator, concern must be raised, particularly if the regulator is not open to clear and independent accountability and oversight. This illustrates how important it is that the PRA and FCA are subject to independent accountability and oversight through a complaints scheme.

5. The issue of Compensation and the meaning of *ex gratia*

5.1 Earlier paragraphs set out the current position on the issues raised by the heading of this section. The current complaints scheme does not give a right to financial awards, called damages, to successful complainants, and is only under the obligation to offer compensatory payments if a complainant can demonstrate a direct financial loss (which would not have been incurred had it not been for the FSA making a decision which upon review of the information available to it at the time was incorrect). If that is the case then

the FSA can then make an award on an *ex gratia* basis. Will that position change as a result of what is now under consideration?

5.2 The last time this matter arose was during the passage through Parliament of the Financial Services and Markets Act 2000. In Appendix A to this response is attached a reproduction of a debate that then took place without ultimately arriving at a final conclusion. The report in Hansard (27 January 2000) is worthy of consideration at this juncture as the difficulties that were canvassed then remain alive today.

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

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

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

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

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

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

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

5.4.6 what is called a *novus actus interveniens* (an intervening act) breaches the chain of causation.

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

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

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

5.8 The view could be taken when considered objectively that the current position, despite some uncertainties, represents a reasonable compromise having regard to the existence of the FOS, the FSCS and this office that ensures accountability of the Regulator as set out in 2.1 hereof.

5.9 Any complaints scheme which is put in place must address the issue of Compensatory Payments possibly on the same basis and taking account of both the requirements of EU law and the Human Rights Act (which FSMA does).

6. Overall Conclusion

6.1 There is no understandable nor relevant rationale given for separating a complaints scheme for the PRA from that applicable to the FCA and without such a detailed rationale it is

difficult to understand why what is currently one scheme should be divided into two with all the difficulties that that could create.

6.2 The first difficulty is the problem that will arise with the overlapping functions of the PRA and the FCA and how the cause of the complaint may be attributed, in part, to both bodies.

6.3 The second difficulty arises out of the effect of section 348 as amended.

6.4 The third difficulty is if that is the position how will the issue of *ex gratia* compensation be addressed as between the two bodies.

6.5 The fourth difficulty is how far investigation of a complaint about the FCA will be allowed or entitled to investigate whether the cause of the complaint was contributed in part (to a lesser or greater extent) by the actions or inactions of the PRA.

6.6 The fifth difficulty is how far the PRA process will be compliant with the Human Rights Act 1998 (in particular as examples Article 1 of the First Protocol of the Convention and Article 8 of the same Convention).

6.7 The sixth difficulty is the possible loss of independence if, as is proposed, the investigation of the complaint about the PRA is made by an appointee of the Bank of England.

6.8 The seventh and final difficulty arises out of the issue of transparency that would be likely to be insufficient if the current proposals were to be put in place.

6.9 In the light of these difficulties it is suggested that there would be considerable unease both by consumers and the Industry if the proposals currently under consideration are implemented.

6.10 It is now widely recognised that it is axiomatic that any complaint scheme put in place must be clearly independent of the body that is the subject of the complaint, transparent and robust in its processes, makes an annual report and is subject to forensic examination whenever that is considered appropriate. The current intentions do not meet that agenda.

18 August 2011

APPENDIX A

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Is the hon. Member for Arundel and South Downs (Mr. Flight) pressing the amendment?

Mr. Flight: I thought, Mr. Deputy Speaker, that I had indicated in what I just said that we would not press the amendment to a vote.

Mr. Deputy Speaker: Is the hon. Gentleman therefore withdrawing his amendment?

Mr. Flight: I beg to ask leave to withdraw the amendment.

Amendment, by leave, withdrawn.

Miss Melanie Johnson: I beg to move amendment No. 480, in page 197, line 47, at end insert--

"( ) The complaints scheme must be designed so that, as far as reasonably practicable, complaints are investigated quickly.".

Mr. Deputy Speaker: With this it will be convenient to discuss the following amendments:

No. 186, in page 198, line 27, leave out "reference" and insert "submission".

No. 187, in page 198, line 27, leave out--

"which the Authority is investigating".

No. 23, in page 198, line 33, leave out "and".

No. 32, in page 198, line 36, at end insert--

"; and
(iv) to recommend to the Authority the award of such sum as appears to him to be fair and reasonable in all the circumstances of the case in relation to any maladministration by the Authority.".
No. 188, in page 198, line 36, at end insert--

"(iv) to make an award against the Authority of such amounts as he considers fair compensation for loss or damage resulting from the subject matter of the complaint".
No. 189, in page 198, line 37, leave out "Authority" and insert "investigator".
No. 190, in page 198, line 37, leave out--

"it must notify the investigator"
and insert "must notify the complainant".
No. 191, in page 198, line 39, leave out sub-paragraph (4).
Government amendments Nos. 437 to 441.
Miss Johnson: The complaints scheme is an important part of the accountability package delivered by the Bill. The Bill should deliver an open and transparent mechanism that will allow people's complaints to be dealt with quickly, cheaply and informally.
However, the Bill delivers other important protections as well. For example, firms will be able to go to the financial services and markets tribunal to challenge the FSA's decisions. The Government introduced amendments to the complaints scheme provisions following the Joint Committee's recommendations, to make it clear that the investigator should be fully independent of the FSA. That independence will include having adequate funds and staff. The investigator's appointment is also to be approved by the Treasury, and he or she cannot be removed from office without the Treasury's consent. It is important that
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everyone is happy with the independence of the arrangements, and the FSA will consult further on them fairly shortly. I understand that the issues to be studied are likely to include ways to secure the investigator's independence through the appointment arrangements and the provision of independent support staff. I recognise how important it is to secure the investigator's independence. The Government amendments, together with the provisions already in the Bill, will achieve that.
I shall not respond to the Opposition amendments now, Mr. Deputy Speaker, in the hope that I will have the opportunity to do so later.
Mr. Flight *rose*--
Mr. Deputy Speaker: Order. Perhaps I can help the Minister. By leave of the House, she is able to speak a second time, as she would be were she tabling her own amendment. However, it may be for the convenience of the House were she to say all that she wishes to say on this occasion, in case she wishes to come back a second time later.
Miss Johnson: Thank you for your guidance, Mr. Deputy Speaker. I shall take this opportunity to make some brief remarks about the Opposition amendments in this group. The amendments would partly take the FSA out of the process--or at least, they would not give it the opportunity to deal with complaints in the first instance. The Government consider that it would not be sensible to take the FSA out of the process in the way proposed. Most complaints arrangements--such as those relating to regulating firms under the current system--give the subject of the complaint the chance to put his house in order before an independent investigator is brought in. What would be the implications for the time and resources of the investigator if he or she were to investigate all complaints in the first instance? We are trying to set up a mechanism for cases which the FSA cannot resolve

with complainants, not a first port of call, and not a port of call for every single case that might arise.

3 pm

The scheme nevertheless ensures transparency, so if the FSA decides not to investigate a complaint, the investigator should know about it; and if the authority decides to go ahead and investigate, again, the investigator should be informed. The investigator can then take up the complaint if he or she sees fit.

Of course, if the FSA does not sort out a complaint satisfactorily, the independent investigator comes in. Taking the FSA out of the picture in the first instance would not be right or efficient.

The Joint Committee suggested that we consider the possibility of ex gratia payments. We have been doing that, and we continue to do so, but it is not appropriate to come to a decision until we see the FSA's consultation paper on the proposed arrangements for the complaints scheme. Amendment No. 188 argues for just such compensation.

It is important that the complaints scheme is not seen as a means of circumventing the FSA's statutory immunity. We do not want to encourage people to take

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pot shots at the FSA and distract it from its proper business of regulating. As the scheme is not part of the Court Service--indeed, the investigator need not be a lawyer--he or she would not necessarily come to a decision based on legal principles that a court would apply. The complaints scheme is an informal mechanism for investigating complaints and, where appropriate, bringing shortcomings into the open; it is not a court, nor is there a right of appeal for the FSA if the investigator makes an adverse finding against it.

Although the Bill does not give the investigator the power to award damages, the complaints scheme will have real teeth. The investigator can publish his or her reports and has the power to name and shame the FSA--or, if he or she sees fit, individuals within it. Therefore, the strength of the arrangements should not be underestimated. The FSA will also need to include details concerning complaints in its annual reports to the Treasury and to Parliament.

I hope that, once they have considered my remarks and the Government amendments, hon. Members may see fit to withdraw their amendments in this group.

Mr. Flight: Government amendment No. 480 is quite acceptable. It responds to an issue that we raised about speeding up the handling of complaints.

We are now in the single most important territory of principle. As the Burns committee set out in its doctrine, and as has been the universal response from the industry, if there is to be effective legal immunity, there must be a clearly independent system of complaints--if not with the ability legally to award compensation, with the ability to recommend and suggest fair recompense when businesses have been damaged by incorrect or wrong conduct by the FSA.

As the Minister has just said, in Committee the Government accepted the principle that the investigator could suggest ex gratia payments. There is no Government amendment to that end, and the Minister has said that the matter is still under consideration, awaiting the FSA's comments. We ourselves have had discussions with the FSA on this issue. It pointed out that, if the payments were compensation, there would be a potential problem of legal disputes, particularly over matters such as the refusal of applications, but it is perfectly happy with the principle of ex gratia payments being recommended to it. Amendment No. 32 has been worded deliberately to accommodate that. It proposes that the investigator recommend suitable sums for payment by the FSA, so that it will ultimately be an ex gratia regime.

We will wish to withdraw amendment No. 188, which is clearly stronger, and sets out a specific proposal for compensation. Our other amendments seek to create a complaints

regime that is fully independent. While there may be something in the argument that the complaints investigator's time should not be wasted with minor issues, the bigger argument is that it is inappropriate for all complaints to come to the FSA first. The FSA has the power of life or death over businesses in terms of authorisation. There is considerable fear of the FSA in the industry--fear that, if offence is given or a foot is put out of line, a business may suffer. It is therefore inappropriate that complaints should first be vetted by the FSA. The investigator needs to be fully independent to receive and consider complaints, and recommend recompense if a business has been genuinely damaged by a wrong action by the FSA.

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We shall come in due course to the issue of legal immunity. The two issues might best have been debated together, but it is absolutely clear that, in achieving a fair and sensible balance of power--if there continues to be effective legal immunity, as the Bill at present prescribes--it is essential, as the Burns committee made clear, to have an independent system of complaints, and for the body concerned to be able to recommend, if not award, fair payments for damage suffered by businesses as a result of the FSA's mistakes.

Sir Nicholas Lyell: I agree with the points made by my hon. Friend the Member for Arundel and South Downs (Mr. Flight), including those about the importance of having an independent investigator who can award compensation, of at least a reasonable nature.

My hon. Friend pointed out that our amendments are in two forms--amendment No. 188, which requires that the investigator be able to award compensation, and amendment No. 32, which requires that he or she be able to recommend an award of compensation, leaving the ultimate decision to the authority. To that extent, it would be ex gratia. We put that in to water down our recommendation, to make it easier for the authority, and to stop it being frightened that its immunity would thereby be completely undercut.

We are the Opposition, not the Government. The Government need to reflect seriously and carefully on exactly how to handle this matter. I echo my hon. Friend's statement that the recommendation was made by the Burns committee, which gives it great weight, just as the committee's views on the chairmanship and the question of chairman and chief executive gave that great weight. I hope that both those matters will be reflected on extremely carefully.

This group of amendments and the next group, on immunity, hang together, as my hon. Friend rightly said. The Minister knows that I support a substantial degree of immunity for the FSA. I think that it is necessary, for the reasons that my hon. Friend stated. We do not want to see the authority undercut, and, as the Minister said, we do not want unreasonable pot shots. They may be much more than pot shots; they may be major attacks by extremely powerful institutions.

That is one side of the picture. The other side is that the FSA is being given immense power over the livelihoods of thousands of people whose own money is at risk. If it performs its functions badly, it should be capable of being held to account. If it does significant damage to individuals working in the market through its own fault, there should be some comeback and some financial compensation. The authority is big enough to be able to behave properly to those whom it has a duty to regulate, but whom it has let down as a result of inadvertence, stupidity or worse.

I hope that that will not happen very often, but I would feel much more confident about its being a rare occurrence if I knew that the authority was aware that it must look over its shoulder, at least to a limited extent, and realise that if it messes up those working in the market or others through its own incompetence or error, it can be held reasonably to account for at least reasonable sums to return them to the position in which they ought to have been.

We are setting up a huge institution. What we are doing is unprecedented. We really must be big about it: we must not be frightened--Governments, whatever their

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complexion, must not be frightened--to be prepared to pay compensation to those who suffer when misregulated. There is no reason why the whole regulatory system should collapse as a result of that balance.

If we do not get this right, Strasbourg may eventually force us to get it right. One of the problems of this Bill is that it is so defensive about the idea of judicial review. Nearly every provision that could be drafted so as to inhibit the opportunity for judicial review is thus drafted. It will not prevent judicial review on the part of financial institutions that are rich and powerful enough to afford that expensive and complex process, but judicial review would be far less necessary if the system involving the investigator and reasonable compensation were established properly.

I am in favour of that system. I am in favour of a comparatively formal process. However, if it is so boxed in--if I may use another contentious phrase--that it is not effective, people will look outside it. Eventually, they will take the cases to Strasbourg. They will rely on article 6 of the European convention on human rights in relation to lack of due process, on article 7 in relation to the right not to be punished except in accordance with the law, and on the first protocol of article 1, which relates to the right to possession of property. If someone is running a business that is also his property, and if that business is seriously damaged as a result of the authority's incompetence, possession of the property may be denied him. In one way or another, people will find a way of bringing a case outside the confines of this country.

Let us get the legislation right. Let us ensure that it is reasonable and balanced.

Miss Melanie Johnson: We are still considering the issue of ex gratia payments. The FSA is consulting on it, and I do not think it appropriate to pre-empt the results of its consultation. I am not saying that we will decide one way or the other; I am saying that we are waiting for the results.

I do not think that people should view the complaints investigator as a potential first port of call, as the Opposition seem to suggest. In any event, the post is not being established for the purpose of financial redress; the point is for the focus to be on the process, and on the importance of transparency.

3.15 pm

Mr. Heathcoat-Amory: We have had a short but important debate on some important amendments.

The Opposition consider the investigator's role to be crucial in providing a check on any abuse by the FSA, and any negligence or incompetence on its part. We may have regard for, or even confidence in, the authority's senior management, but that is not always reflected in people's experience of its staff at the coalface, as it were.

Hon. Members receive many complaints about regulators. It is important for complaints to be dealt with promptly by an independent inspector who is seen to be independent, and who can receive them separately from any filter mechanism that may exist in the authority. The inspector must be properly resourced, and able to respond to complaints--including, we believe, complaints involving financial awards against the authority.

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Our proposals would also establish an essential counterbalance against statutory immunity. We shall debate that shortly, so I shall not go into it now, but I want to quote one sentence from the report of the Joint Committee on Financial Services, of which I was a member last year. It concluded, among other things:

"We agree with those who see a robust complaints procedure as the central counterbalance to the FSA's statutory immunity."
It asked the Government to give serious consideration to the issue of financial awards.
I do not think that it is enough simply to refer to the possibility of ex gratia payments that are not mentioned in the Bill. That is not an assurance at all. I know that the Government do not want to allow the FSA to get into a legal tangle in regard to what might be compensation, and that that might have to be judged against some objective criterion. I think we should leave open exactly how awards are to be measured and made, but they must be referred to in the Bill. That is the thrust of the Joint Committee's conclusions, and it is the strong view of the Conservative Members who have spoken. We do not intend to press the other amendments, but we will press amendment No. 32.
Amendment agreed to.
Amendment proposed: No. 32, in page 198, line 36, at end insert--

"; and
(iv) to recommend to the Authority the award of such sum as appears to him to be fair and reasonable in all the circumstances of the case in relation to any maladministration by the Authority.".--*[Mr. Heathcoat-Amory.]*
Question put, That the amendment be made:--
The House divided: Ayes 141, Noes 267.

Office of the Complaints Commissioner; Association of British Credit Unions Limited (ABCUL); Association of Financial Mutuals; Building Societies Association; Association of Independent Financial Advisers; Institute of Financial Planning; International Regulatory Strategy Group; Financial Services Practitioner Panel; FSA Smaller Businesses Practitioner Panel and Financial Services Consumer Panel – oral evidence (QQ 438-557)

Transcript to be found under Association of British Credit Unions Limited

Office of Fair Trading – written evidence

Competition and Financial Regulation

I have written to the Chair of the Treasury Select Committee setting out the OFT's views on the interaction between competition and financial regulation in the context of the reforms proposed to the system of financial regulation and in particular the role and functions of the FCA and PRA. In view of the role of your committee, I thought it appropriate to also write to you.

In brief, the OFT believes that the FCA should have a 'top line' objective to promote competition, ideally expressed in terms of making financial markets work well for their users. As an authority with a significant economic impact, the PRA should also be required to take account of the need to promote competition as part of its weighing up the costs and benefits of different regulatory approaches. However, the OFT also believes that giving the FCA certain 'concurrent' competition powers (overlapping with its own) would risk weakening the competition regime. Instead, it recommends some pragmatic mechanisms to 'lock in' a pro-competition approach in the work of the FCA.

On the first issue, I explained to the Treasury Select Committee on 20 January my view that the FCA should have a top line objective to promote competition. It is critical that the new FCA regards competition as a mechanism for achieving outcomes for consumers - and in that sense it should be clear that having such an objective does not conflict with the need for consumer protection. Making this explicit in the objectives of the FCA is one important element in making sure that this happens. It is important, for example, in ensuring that cost-benefit assessments of regulatory changes by the organisation can include the benefits of dynamic market change through competition, rather than simply the static benefits to an individual consumer of being protected. We note that our view on the importance of the competition objective is substantively shared by the Independent Commission on Banking and is consistent with the Treasury Committee's own report.

We see merit in framing such an objective in terms of contributing towards making financial markets work for the benefit of their users - whether retail or business users. Such a formula would make clear that competition is about achieving better outcomes for consumers and other users, and help ensure that the FCA will regulate in the interests of users and not market incumbents. We believe that an objective relating to confidence in financial markets is not the way to achieve these outcomes: it relegates competition to a potential contributing factor and one which may be seen as secondary to other

factors. We would therefore recommend that the strategic objective of the FCA is changed to: "making financial markets work well for their customers" rather than generating confidence - "protecting and enhancing confidence in the UK financial system" - as currently phrased in section 18(2) of the draft legislation (concerning the FCA's general duties).

We also believe that the PRA should have regard to competition as it takes its regulatory decisions. Although its work is not so closely related to the conduct of markets as that of the FCA, its actions may have significant consequences for markets. A good example would be in the setting of capital requirements differently on competing types of activities or businesses: this would tend to have consequences for barriers to entry, and hence for competition in markets. It would seem reasonable for the PRA to have regard to such concerns, even if it has the ability to assess that the total economic benefits of such arrangements outweigh the competition worries; it would, for example, encourage the PRA where it has a choice of different regulatory approaches to achieve the same financial stability outcome to select the one with the least impact on competition.

On the second issue, we believe it is important that the ability of the OFT - or the future CMA - to use its competition tools in financial markets is not reduced or compromised by giving the FCA 'concurrent' competition powers. The ability to review financial markets, including through its market studies and to make recommendations and references as appropriate through the procedures laid down in the Enterprise Act, is vital for the OFT as a national competition authority. Giving the FCA a formal 'concurrent' remit alongside the OFT for making market investigation references to the CC would give us concern for many reasons including:

- The risks of inconsistent use of these tools across the competition regime which lead to greater uncertainty for business, and the likelihood of financial business pressing for 'special treatment' within the competition regime;

- The need for the FCA to develop a skillset that the FSA currently does not possess around competition assessments - and the parallel risk of then creating a duplicative set of skills in different public authorities;

- The fragmentation of roles weakening the ability of the competition regime to support the Government in tackling strong vested interests and the usual problems of overlaps or, more likely, gaps in action;

- The risk, as with other sector regulators, that the tool is used by neither the FCA nor the OFT; and

- Partly as a result of these, the likely withdrawal by the OFT from working on the markets covered by the FCA leaving the 'sectoral' body to conduct these activities. We see this risk as especially important. One specific consequence of this would be that external assessment of the impact of the FCA's own rules on competition - despite their potential significance themselves as a barrier to market entry, for example - would be diminished. In short, would the FCA ever be capable of carrying

out thorough independent analysis of its own rulebook from a competition perspective as part of a market study?

These concerns arise even more markedly with regard to anti-trust actions - such as acting against cartels or other collusive behaviour. The Government has not proposed giving any such anti-trust powers to the FCA, and the OFT would be very concerned if it did. In the case of anti-trust actions, the need to develop and follow a consistent body of law is even more marked than around market studies. International cooperation with other national competition authorities can be a critical ingredient in pursuing actions against large, international groups. The FCA would have none of this expertise or the necessary relationships.

Turning to my third point, we have supported a range of further alternatives - in addition to setting the competition objective for the FCA correctly - to 'lock in' a pro- competition approach to the work of the FCA (and, in some respects, the PRA). These include:

- Giving more consumer bodies with an interest in financial services, such as any successor to the FSA's Consumer Panel, the right to make super-complaints directly to the OFT, mirroring the powers currently enjoyed by, for example, Consumer Focus and Citizens Advice. This would allow such organisations to refer issues directly to the OFT for rapid consideration, ensuring that those issues were prioritised. It would allow the OFT to continue to become involved in assessing the impacts of financial regulation on competition, where such bodies regarded it as important. The OFT has, over the past 18 months, carried out work on cash ISAs, credit brokers and debt management companies, and travel money as a result of super-complaints (the last of these under way at the moment);

- Placing both the FCA and PRA under the same requirements as government departments to respond publicly to recommendations from the OFT. At present, government departments undertake to respond to recommendations from the OFT arising from market studies within three months. Not being part of the Government, these requirements would not apply to the FCA and PRA but would, I think, be regarded as best practice by business. The Government has adopted a proposal related to this;

- Rather than having powers to make market investigation references to the CC, giving the FCA the ability to refer markets to the OFT, with a requirement on the OFT to consider them and respond setting out whether or not it will take action. Again, the Government has made a proposal related to this; and

- The FCA and OFT cooperating more fully, for example where anti-trust and financial market abuse issues may overlap. We have some experience of doing this, but there is undoubtedly more scope to do so. We currently have an MoU that covers aspects of the work of the OFT and FSA, and some coordination arrangements but this would benefit from being reviewed as the FCA and PRA are set up in light of their remits.

7 November 2011

Office of Fair Trading – supplementary written evidence

Thank you for your letter of 11 November.

The market investigation reference (MIR) is a powerful mechanism that allows the Competition Commission (CC) to investigate markets and, where it believes that any market feature, or combination of features, prevents, restricts or distorts competition, put in place remedies. These remedies can include structural or behavioural changes requiring businesses, for example, to change how they operate or, indeed, to divest themselves of certain assets or activities. The use of the power does not rely on any finding that a business, or businesses, have infringed the law; indeed, where competition law is believed to have been broken, for example by businesses colluding, then it is usual to consider competition enforcement powers which can result in fines, injunctive relief or more serious penalties. The CC aims to conclude MIRs within 18 months, although it may extend this to 24 months.

Given the significance of such remedies affecting businesses which, potentially, have not infringed the law, the Enterprise Act 2002 places clear parameters on the use of MIRs and the steps required to use the powers. In particular, it requires a two-stage process:

- The decision to initiate the use of MIRs can only be taken by the OFT or another regulator with concurrent competition powers;
- The conduct of the MIR is carried out by the CC, using independent panels of experts, without any involvement in the decision to initiate the MIR.

The Government is currently consulting on whether to merge the CC and OFT. It has made clear that, if this were to happen, it would ensure that the exercise of the MIR power within the proposed new authority – the Competition and Markets Authority (CMA) – would need to be subject to the same disciplines as currently exist. In particular, it has proposed that there should be a clear two stage process, with the operation of the second stage continuing to be undertaken by panels of experts from outside the executive of the CMA.

The OFT believes that the FCA should have the ability to raise concerns about a market so that they can be considered at the first stage of this process, whether that is by the OFT (at present) or within the first stage operated by the CMA (in future, if a merger goes ahead). It believes that the legislation setting up the FCA should seek to achieve this outcome. The OFT believes that it would be wrong to provide the FCA with the powers to submit markets directly to the second stage of the process, for a MIR (whether to the CC at present or the second stage of a process to be conducted by the CMA), for the reasons set out in my previous letter, relating to its skills, resources and the inevitable consequence that, as in sectors where there is a concurrent competition regulator, the OFT would step back from carrying out market studies or other reviews of the relevant markets (in this case, financial markets).

At a practical level, the MIR tool operates alongside competition law. The OFT's approach to MIR is that we do not generally make references if we believe competition law enforcement would be a more appropriate remedy, because competition law is generally more effective in terms of deterrence where there is an anti-competitive agreement or

abuse of dominance, because MIRs are designed to address whether competition is working effectively in markets as a whole and because, if the CC, in the course of an MIR, finds an infringement of the EU prohibition on anti-competitive agreements, it must refer the matter back to OFT for action: where agreements affect trade between member states, they can't be remedied by the CC. We would be concerned about the ability of the FCA to eliminate possible enforcement of competition law; conversely, it would be highly undesirable for the FCA to refer matters to the CC, only to have the CC then refer them back to OFT.

I should also note that the Government's own consultation on the creation of the CMA recognises the paucity of MIRs that have been made by the relevant sectoral regulators to date, and proposes ways to streamline and better coordinate the use of those powers, with the CMA playing a more central role. One of the concerns is that such sectoral regulators have a natural tendency to use their own narrower tools and that the development of a strong set of cross-economy precedents around the use of competition powers is weakened. The OFT also considers that the rationale for the merger of the OFT and CC is inconsistent with further fragmentation in the application of UK competition powers. In its consultation, the Government referred to the benefits of the merger including providing for the more flexible use of resource between, for example, the two phases of the market investigation regime, and the benefits of creating a single more powerful advocate for competition in the UK, Europe and internationally. Providing the FCA with competition powers would appear to be inconsistent with both objectives.

In short, therefore, the OFT does not believe that the proposed merger of the OFT and the CC into the CMA makes any difference to the case for the proposal under discussion: the FCA should have powers to propose markets for consideration as possible MIRs, rather than to determine whether such markets should be subject to MIRs.

21 November 2011

Old Mutual plc – written evidence

On behalf of Old Mutual plc, a financial conglomerate with its primary listing in London, I welcome the opportunity to respond to the above call for evidence and you will find our views on a select number of questions attached to this document. We appreciate that your deadline for comments was Friday 2nd September but hope that these comments will still be of use to you.

Although much progress has been made on addressing issues raised by respondents to the previous consultation papers, the call for evidence is the first time that a request has been made for comment on whether this regime change is necessary. In our view, taking into account the significant regulatory activity already in train (Solvency II, RDR and a swathe of European developments) as well as the material costs that such an exercise will entail, we believe there should be more consideration of whether this is the right action to be taking, whether there are other options that can achieve the same objectives as well as timeframe considerations.

In particular, we believe that the changes already in train within the auspices of the FSA to have separate divisions which focus on prudential and conduct issues could, with some modification, achieve many of the intended benefits of the reforms. This would mitigate the significant additional costs and potential confusion to the industry and consumers of fragmented regulatory bodies at a time when there is already a lot of other, substantial regulatory changes. There is also a need, regardless of which system is adopted, to have greater external scrutiny of judgement based supervision, and this should be a specific aspect of the proposed reviews by the National Audit Office.

We believe that a delay in the timetable for implementation will enable these practical aspects to bed down, and other alternatives to be properly explored which could achieve the desire effects in a more cost effective way.

Response to questions

Question 1 - Is the separation of prudential and conduct regulation into a "twin peaks" system the right approach?

It is an option, but not the only one. The flaws in the regulatory infrastructure concerned insufficient focus on macro-prudential (MaPru) regulation, lack of a coordinated approach between those responsible for the financial system (including responsibility gaps and flawed assumptions) as well as poor judgment by FSA on where firm specific risks existed. In essence there was no joined up approach to what was important (which is a dynamic issue). Addressing this requires a system that has ongoing focus "at all times" on MaPru, firm specific issues and thematic developments resulting in a proportionate and coordinated response. A "twin peaks" model with separate MaPru, prudential and conduct bodies is one way of addressing this but as mentioned below, it is not the only one.

An alternative could be to retain the FSA and establish a separate MaPru regulator on the lines of the FPC. There would need to be adjustments to FSMA to cater for FPC

responsibilities etc and interaction with the FSA, but this is likely to be less extensive than the changes proposed in the current draft Bill, many of which are required to deal with the need for co-ordination and avoidance of duplication between the PRA and the FPC.

It is our view that one of the problems with the FSA is its tendency to change direction and focus based on internal management views on what is important. From a practitioners perspective this means that prudential issues will be key at one moment and conduct issues key the next. Although having separate prudential and conduct regulators as mooted in the draft Bill is one way of addressing this, there are no reasons why the same outcome could not be achieved by internal changes to the current system. For example, it may be possible to set up distinct prudential and conduct functions within the FSA that have defined objectives subject to external scrutiny on their delivery. This would be akin to having separate prudential and conduct legal entities within the FSA each with their own Board structures rather that just separate management divisions (which is where the current weakness lies). ***Clear objectives, accountability and external scrutiny are the keys to delivering a successful regulatory regime. The structure can support or hinder that, but is not the answer of itself.***

<u>Question 2</u> - What lessons can be learnt from the approach of other countries to the regulation of the financial sector?

The UK has one of the largest financial services industries in the World with some of the biggest firms domiciled here. In this respect it is important that too much store is not placed on how "twin peaks" has worked in Country A or a mono regulatory system in Country B if their financial services industry is significantly smaller or less diverse than here. Whilst analysis of other systems may deliver some useful pointers, in our view the benefits of such analysis will be limited. The financial services industry in the UK is unique, has its own distinct history, and development and awareness of these factors is the key driver to determining the appropriate regulatory system.

For your information, Old Mutual is an international financial services Group with its origins in South Africa and with businesses subject to a range of different regimes. In this respect, you may be aware that a twin peaks model is also being considered in South Africa as a development from the separate banking and insurance regulators. South Africa did however fare relatively well in terms of the credit crunch and does not have a chequered regulatory history. Its move to the new regime to our understanding is not therefore driven by a sense that their existing system has failed. Overall therefore we reiterate that we don't feel a great deal will be gleaned from analysis of other regulatory systems.

<u>Question 3</u> - Is it appropriate to make such major changes to the regulatory system by way of amending legislation, rather than starting afresh?

We see no problem with this approach provided the right outcome is achieved. Whatever route is taken, there must be sufficient time for proper scrutiny of the new or amended legislation.

Question 4 - Are the accountability and governance arrangements for the Bank of England, FPC, PRA and FCA satisfactory?

In general yes, albeit we see no reason why complaints against the PRA should be handled differently to those against the FCA. In our view PRA complaints being handled by the Bank of England will not be perceived as impartial by the industry. The arrangement is akin to a financial holding company investigating complaints against a subsidiary when clearly to the complainant they are both part of the same group. For proper integrity of the complaints process there needs to be greater independence. This issue is particularly relevant in the context of the increased use of judgement based regulation where the industry needs to have confidence that concerns on the use of these tools will be properly considered.

Question 6 - Should the FPC be limited to the actions it can take which might affect the growth of the financial sector?

An objective coined in the terms expressed above would need to be supplemented by guidance on what was intended. "Actions that might affect the growth of the financial sector" could be interpreted in a number of ways, not all of which were positive. For this reason, we think the current draft focusing on removing and reducing systemic risk with a view to protecting and enhancing the resilience of the UK financial system is preferable.

Question 9 - Can Parliament take an informed decision about the proposals for the FPC without details of the macro-prudential tools at its disposal?

We don't believe Parliament can. It is important that these details are made available as part of the pre-legislative scrutiny.

Question 12 - Are there any risks in the Government's proposed "judgement based" regulation?

The increased powers of the new regulators combined with greater use of judgement is a cause of concern. Although conclusions may be drawn that the regulators have achieved their objectives in terms of less consumer detriment and a more robust financial environment, it is quite likely that there may be a large number of practitioners who experience poor regulatory judgement whose experience is not picked up via the accountability mechanisms (because the focus is on the bigger picture). Although the main safeguard to poor regulatory judgement is the principle of "proportionality", we do not believe this is sufficient. In our view, as judgement based regulation is such a fundamental component of the new regime, the level of scrutiny on the use of this tool should be similarly weighted. We suggest the reviews by the National Audit Office should include a specific requirement to consider how the regulators have used their judgement, not just on high profile cases, but also on more routine regulatory interactions. As part of this process, practitioners or their industry representatives should be invited to provide details of their experience under the judgement based regime.

Question 14 - Given that the PRA and FCA will inherit FSA staff does the draft bill do enough to ensure a new regulatory culture and a more proactive

approach to regulation? Will these two new regulatory bodies have staff with the appropriate skill and expertise?

In our view the draft Bill is sufficiently clear in terms of the proposed culture and approach to regulation. Whether the regulators have sufficient staff or they have the requisite skills and experience is a separate issue that is accentuated by the proposed regulatory change but not caused by it. On this issue we believe there is a need for the PRA and FCA to employ a greater proportion of its numbers from industry to support its judgement based approach to regulation. However, many of the key personnel will be transferred across from the FSA to the new regulators, and it is difficult to see how this will facilitate a change of culture. A key issue is whether the FSA can attract experienced people from industry at the current time particularly during this period of change. This is an operational issue that is not strictly part of the bill consideration, but a relevant and important point nevertheless

Question 19 - Will the new regulatory arrangements reduce the risk and cost of dealing with miss-selling of financial products?

We believe that the risk and cost of dealing with miss-selling of financial product will be reduced. It is important however that this measure is considered in the context of the overall market impact of the new arrangements. A zero risk tolerance to miss-selling could result in measures that prevent bona-fide selling. It should not be the objective of the regulators to remove all miss-selling risk from the system as this could have unintended consequences.

Question 20 - Are the proposals for co-ordination between the PRA and FCA clear and adequate/ What would be the advantages and disadvantages of having a single point of contact and/or a joint rule book for dual-regulated firms?

The proposals probably go as far as practicable in establishing a coordination regime between two separate regulators. Whether this will actually work is a separate issue heavily dependent on operational processes and staff. We believe that the benefit of the current regulatory system is contact clarity and a single reference point for rules. Moving away from this regime will invariably lead to some coordination issues.

In terms of the position of a single contact for Dual regulated firms, this would be easier administratively but is likely to lead to some issues being lost in translation. Direct contact with the relevant regulator may lead to greater clarity of what is required.

Question 21 - How do the proposals in the draft Bill fit within the new European regulatory regime? What freedoms and constraints will the UK have to operate within that regime?

We believe a natural consequence of the regulatory change is additional coordination challenges between the new regulators on European issues. Again, the steps proposed to deal with this seem reasonable, but it is important that what is actually happening is closely monitored when the regime commences. There is increased risk of confusion here.

September 2011

Positive Money – written evidence

The draft Bill will not prevent another financial crisis or protect the public purse, because it ignores the fact that banks have the power to create the UK's money supply.

This creation of money is essential to understanding the health and stability of the economy, yet it is mentioned only once in the entire draft Bill[219]. Consequently, the Bill completely ignores key features of the financial system:

0. 97% of the UK's money supply is now created by high-street/commercial banks
1. Banks create new money when they make loans to businesses and members of the public
2. As a result, we can only put additional money into the economy if the public are willing and able to go further into debt
3. The Bank of England has very limited ability to restrain the amount of money/credit that banks create (although they would be loathe to acknowledge this)
4. As a result, the nation's money supply, and therefore the stability of our economy, is dependent on the psychology and mood swings of banks and the senior bankers that run them

The business model which allows banks to create money is fundamentally unsound. The incentives that are inherent to this business model lead to banks taking excessive risks, rapidly expanding the money supply (leading to house price bubbles and inflation). Then, when one or more banks inevitably collapse, the fundamental structure of the financial system requires that the taxpayer steps in to prevent any bank failures.

An Alternative Business Model: Full-Reserve Banking

'Full-reserve banking' is a proposal that arose out of the Great Depression and which has been endorsed, in one form or another, by experts such as Irving Fisher, Milton Friedman, James Tobin, John Kay, Martin Wolf and Sir Mervyn King. It has numerous benefits, while the main arguments against it are based on misconceptions and the vested interests of the banking sector.

Full-reserve banking involves making a few simple changes to the banking system to ensure that toxic banks can be allowed to fail with no cost to the taxpayer. It would stabilise the money supply of the UK and make it independent of the lending of banks.

Full-reserve banking is relevant to the draft Financial Services bill because full-reserve banking can help to:

5. prevent another financial crisis,
6. handle a financial crisis, and
7. deal with bank failure and protect the public purse.

Unfortunately, the current draft Bill, and the recommendations of the Independent Commission on Banking, will fail to achieve the above.

[219] Section 9C (3)(b): "[Those system risks include, in particular:] unsustainable levels of leverage, debt or credit growth."

The rest of this submission explains what is really wrong with the current banking system, focussing on the central issue of money creation. It highlights some of the social and economic consequences of allowing banks to operate as they currently do. We then explain how full-reserve banking addresses these problems.

97% of the UK's Money was Created by High-Street Banks

The current business model of banks allows them to effectively create the nation's money supply. In the words of Martin Wolf (of the Independent Commission on Banking), "The essence of the contemporary monetary system is the creation of money, out of nothing, by private banks' often foolish lending."[220]

Banks are able to create money through the accounting process they use when they make loans. As the Bank of England describes it, "When banks make loans, they create additional [bank] deposits for those that have borrowed the money"[221]. These bank deposits - the numbers in your bank account - now make up over 97% of the money supply of the nation[222], while cash created by the state makes up just 3% of the entire money supply.

Members of the public and businesses depend on access to these electronic bank deposits in order to run the economy: without money, nothing happens. But this electronic money is only created by commercial banks when they make loans to members of the public. As a result, banks have an effective monopoly on the supply of money to the economy, and the public as a whole must go into debt to the banking sector in order for there to be a money supply for the UK's economy.

This means that our money supply, and the stability of our economy, is dependent on the psychology and mood swings of senior bankers. If banks are over-confident and lend too much, new money (in the form of bank deposits) is created and causes a debt-fuelled bubble (think of 2002-2007). Eventually this leads to a crash. The banks then panic and stop lending, the economy slows down and we approach a recession or depression (2009-2011).

Instability is Inevitable When Banks are Able to Create Money

An unstable money supply will lead to an unstable economy. Banks create money when they make loans to the public. Bank staff are incentivised by bonuses, commissions and the possibility of promotion to maximise their lending. Most of these staff have no understanding that their lending actually creates new money or increases the amount of money in the wider economy. They have no interest in whether their excessive lending is creating inflation or unsustainable asset bubbles. In fact, they often get caught in a positive feedback loop, whereby excessive lending pushes up house prices, which encourages the public to borrow even more, which further pushes up house prices, and so on.

In short, bank employees are incentivised by short-term profit-seeking to always increase their lending (and therefore create new money), right up until the point where the debt burden becomes too great, people start to default and we suffer a financial crisis. This is

220 Martin Wolf, Financial Times, 9th Nov 2010
221 Bank of England Quarterly Bulletin 2007 Q3
222 Bank of England figures for M4, accessed May 2010

why the money supply doubled between 1998 and 2007 - through excessive money creation by high-street banks.

Many people assume that the Bank of England is able to control this system and regulate the amount of money in the economy. The last few years and extensive research by Positive Money and the New Economics Foundation has shown that this is untrue. The Bank of England was unable to stop the excessive creation of money (via excessive lending) before the crisis, and was unable to encourage banks to create more new money via lending in the after-math.

Banks will always need a taxpayer-funded guarantee

The Financial Services Compensation Scheme, which promises to reimburse customers if their bank goes bust, also means that it will be more expensive for the government to allow a bank to fail than to rescue it (because the cost of a capital injection (bailout) will be less than the cost of reimbursing all depositors). This means that banks can be almost certain that they will not be allowed to fail, regardless of their behaviour. This guarantees that banks can take excessive risks whilst passing the risks back onto the taxpayer. The recent increase in the guarantee to £85,000, rather than making the system safer, has actually exacerbated this problem.

How Full-Reserve Banking Would Work

There are two core elements of the full-reserve banking proposal:

1. Money that customers wish to keep safe is separated from the money used for risky lending.
2. Rather than allow private banks to create the nation's money supply through lending, the Bank of England will be responsible for initially creating new money, in accordance with the needs of the economy as a whole.

Separating Risky Lending from Money that Customers wish to Keep Safe

To do this we simply require banks to offer two separate types of account:

- Current accounts would become custodial, '100% reserve' accounts, meaning that the banks would not be able to use the money in them to fund their own risky lending. Money placed into one of these accounts would be completely safe and would not be considered the property of the bank. Because all the money placed in these accounts would just sit there until the customer withdraws it, it means that even if there was a run on the bank, the bank would have the funds to repay all its current account customers. Even if the bank goes bankrupt, because the money is owned by customers and held in custody for them, all current account customers could be reimbursed in full without the use of taxpayer funds.

- Savings accounts would be replaced by 'Investment Accounts'. Under full-reserve banking, the bank would need to attract the funds that it wants to use for any investment purpose (whether for loans, credit cards, mortgages, long term investing in stocks or short-term proprietary trading). These funds would be provided by customers, via their Investment Accounts.

At the point of investment, customers would lose access to their money for a pre-agreed period of time. There would no longer be any form of 'Instant Access Savings Accounts'. Customers would agree to either a 'maturity date' or a 'notice period' that would apply to their account. The maturity date is a specific date on which the customer wishes to be repaid the full amount of the investment. The notice period refers to an agreed number of days or weeks notice that the customer will give to the bank before demanding repayment.

Unlike the current accounts, the Investment Account will not actually hold money that can be readily withdrawn. Any money placed in an Investment Account by a customer will be transferred to a central 'Investment Pool' held by the bank, and then be used for making various investments. In effect, the Investment Account is a customer-friendly method of representing a fixed-term investment made through a bank.

How to Deal with Bank Failures

Under full-reserve banking, any bank can be allowed to fail, regardless of its size. A bank can be wound down in the following way:

- Current accounts would be transferred to other banks (with the customer nominating the new bank that they want to move to). In practical terms and with intelligent design of the computer systems, this process could be completed within days of a bank's collapse and current account holders should not experience more than a few hours when they are unable to access their money.
- Investment Account holders would become creditors of the bank and need to wait to recover as much of their investment as possible through normal liquidation proceedings.
- At no point would taxpayer's money need to be spent on compensation or covering the liabilities of the bank, in contrast to the bailouts of recent years.

The Creation of New Money

The switch to full-reserve banking includes some simple changes that prevent banks from being able to create new money when they make new loans (but will not prevent normal lending with money that customers have asked them to invest). As banks have been increasing the money supply by an average of 7.8% a year over the last 4 decades, removing this power from them will reduce inflationary pressure and lessen the boom-bust cycle.

However, there will still be a need for a regular injection of new money (at a slower and more responsible rate than that of the banks). The Monetary Policy Committee would be responsible for this role of creating money. The Monetary Policy Committee would decide to increase or reduce the money supply of the economy, as a way of reaching the target rate of inflation. (A small increase or no change in the money supply would be most common; a reduction would be very rare).

The MPC would no longer set the base rate of interest (as interest rates would now be set by the market between savers and borrowers).

Any money that was newly-created by the MPC/Bank of England would be paid over to HM Treasury, where it can be used to fund public services, reduce the national debt, or to reduce the overall tax burden.

To avoid conflicts of interest, the Bank of England and MPC will remain independent of elected government, and ministers and the Chancellor will be unable to influence the MPC. The MPC will also be prohibited from considering the political objectives or needs of the current government, to ensure that the health of the economy is the only consideration in the creation of money.

However, the government would be free to choose how to use this money, in line with its democratic mandate.

This idea is not as radical as it may sound at first. The government already receives the profit on the creation of bank notes, which has brought in over £18billion for the Treasury over the last 10 years. By giving commercial banks the privilege (and monopoly) of creating electronic money, the state is effectively handing over around £100bn in revenue each year, with banks collecting the interest on this newly-created money. The business model that allows them to collect this hidden-subsidy is so unstable that it depends on a permanent taxpayer-funded safety-net, as we have seen over recent years. There is no good reason why this privilege and benefit should go to private corporations rather than being used for public benefit.

Benefits of Full-Reserve Banking

The following is a very brief outline of the benefits of switching to full-reserve banking. The real benefits are profound and affect the whole economy.

8. The money supply will now be stable and adjusted according to regulate inflation, rather than increased by the profit-seeking activity of banks. This should lead to much greater economic stability.
9. Banks will be more stable, as full-reserve banking makes it much easier for them to predict future cash-flows and makes them almost immune to a run on the bank.
10. Moral hazard would be reduced as the risk of investments would stay with the bank and the investor, rather than being passed on to taxpayers via government guarantees.
11. Toxic banks could be allowed to fail with no cost to the taxpayer.
12. The inwards-and-upwards redistribution effects of fractional reserve banking would be greatly reduced, reducing inequality and poverty in the UK.
13. Some of the unproductive/speculative investment made by banks would disappear, while the level of credit for productive investment (i.e. in businesses, shops, factories etc) should remain stable or even increase
14. Newly-created money can be used for public benefit (funding public services or lifting the poorest out of tax completely) rather than being used by banks to fuel asset-price bubbles
15. Because newly-created money would not be created as debt, it can be used to reduce the overall debt burden of the public. This will stimulate the economy and would be a far more effective method of ending the recession than pumping money than trying to encourage banks to lend to an already over-indebted public.

Further Information

The creation of money is poorly-understood and rarely discussed, but it should be central to any discussion of banking reform. The draft Bill seriously neglects this issue. As long as banks are permitted to create the nation's money supply through the business model they use, crises and bank failures will be inevitable, and the costs will have to be passed onto taxpayers.

I would be happy to provide further detail or discuss this issue with the Committee in person.

September 2011

Quoted Companies Alliance (QCA) – written evidence

INTRODUCTION
The Quoted Companies Alliance is a not-for-profit membership organisation working for small and mid-cap quoted companies. Their individual market capitalisations tend to be below £500m.
The Quoted Companies Alliance is a founder member of EuropeanIssuers, which represents over 9,000 quoted companies in fourteen European countries.
The Quoted Companies Alliance Legal Committee has examined the draft Bill and advised on this written evidence. A list of committee members is at Appendix A.
RESPONSE
We welcome the opportunity to respond to this Call for Evidence. We are responding in particular to Question 22 in the Call for Evidence:
22. Does the draft Bill contain any proposals or omissions, not covered by the questions above, which cause concern?
The Quoted Companies Alliance is very concerned about the proposed power for the extension of powers of the Financial Conduct Authority (FCA) in section 166 of the Financial Services and Markets Act 2000 ("FSMA") to listed issuers in the non-regulated sectors ("Non-regulated Issuers").
We believe that the extended power is not required because:

(a) there are sufficient and equivalent powers already in place; and

(b) we are concerned about the potential cost to Non-regulated Issuers.

We do not see any clear need for this additional power and we are concerned that if given, and used by the FCA, it will be costly for the companies involved, with no demonstrable material benefit.

1. EXISTING POWERS AND SAFEGUARDS
The current Financial Services Authority (FSA) already has extensive enforcement powers, but in particular it already has the power to appoint a skilled (competent) person to carry out an investigation equivalent to section 168 FSMA in cases where the FSA as the competent authority suspects that there has been a particular instance of misconduct or wrongdoing (section 97 of the FSMA) broadly with regard to Part 6 Rules (covering the Listing Rules, Prospectus Rules and Disclosure and Transparency Rules).
In expanding its powers over Non-regulated Issuers, the FSA would appear to be seeking to secure the additional power to appoint skilled persons where there are no particular circumstances suggesting an instance of misconduct or wrongdoing under the Part 6 Rules, which does not seem logical or necessary.
Non-regulated listed companies should not be exposed to the inconvenience or cost of appointing a skilled person unless there have been particular circumstances suggesting a breach of the relevant rules.
Finally, a broad power to investigate the underlying business of a firm may be appropriate in the regulated sector where the FSA is responsible for authorisation and ongoing regulation. Outside of this, the FSA is specifically responsible for regulating compliance with the Listing Rules etc., and not the underlying business of the Non-regulated Issuer.

In conclusion, we do not believe that this extension of FSA powers is warranted. In the absence of any evidence that the existing regulation is not fit for purpose, we also believe that the imposition of more regulation is inconsistent with the philosophy behind the Government Red Tape Challenge - the extension appears to be a perfect example of more regulation for the sake of regulation.

2. POTENTIAL COSTS

The actual cost of appointing a skilled person varies hugely depending on the terms of reference in question. The cost might range from tens of thousands of pounds for a discrete review of specified records to tens of millions for reviews of whole businesses. The key factors which concern Non-regulated Issuers are:

(a) The lack of control of the Non-regulated Issuer would have over costs - because the report would be being made by the skilled person appointed by the FSA, there is limited ability for the Non-regulated Issuer to control costs (since any such control be might be seen as an attempt to affect the process or outcome);

(b) The process of appointing a skilled person is very formalistic: terms of reference are negotiated; there will be regular reporting; there will need to be careful protection of independence of the skilled person; and a full report is required. This means that the process is a costly way in which to inform the FSA of a particular, factual, situation.

(c) It is sometimes suggested that the work of skilled person is work that the issuer in question would need to do anyway, even if the skilled person does it to a more rigorous and externally verifiable standard. Whilst this could be true, it is not our experience and generally we fear that the work would be an additional cost for the Non-regulated Issuer. In many cases in the regulated sector the issuer will currently appoint their own expert to shadow the skilled person to protect their interests thus increasing the cost further.

The consultation document, *A new approach to financial regulation: building a stronger system* (published in February 2011) suggests that the extension of section 166 will be cost efficient for issuers as the regime is an intermediate step between the FSA requesting information from the issuer and the FSA launching a full external investigation. We would be interested to see the data on which that statement is based. In our view, the skilled person approach would only be an intermediate step insofar as the FSA is concerned. For the issuer involved, it will be as or more costly than a full investigation. It would be intermediate only in terms of the formality of the investigation and the intrusion into the business in question.
We understand the desire to ensure that the FSA as regulator has a full armoury. However we believe that the extension of the skilled person regime is not consistent with the regulatory objectives relating to Non-regulated Issuers and therefore the potential for extensive costs for issuers cannot be justified.
If you would like to discuss this issue in more detail, we would be pleased to attend a meeting.

The Quoted Companies Alliance Legal Committee
Tom Shaw (Chairman) Speechly Bircham LLP
Gary Thorpe (Deputy Chairman) Clyde & Co LLP

Jai Bal Farrer & Co
Chris Barrett Bird & Bird
Richard Beavan Boodle Hatfield
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Mark Taylor Dorsey & Whitney
Kate Jalbert Quoted Companies Alliance
Tim Ward Quoted Companies Alliance

THE QUOTED COMPANIES ALLIANCE (QCA)

A not-for-profit organisation funded by its membership, the QCA represents the interests of small and mid-cap quoted companies, their advisors and investors. It was founded in 1992, originally known as CISCO.

The QCA is governed by an elected Executive Committee, and undertakes its work through a number of highly focussed, multi-disciplinary committees and working groups of members who concentrate on specific areas of concern, in particular:

- taxation
- legislation affecting small and mid-cap quoted companies
- corporate governance
- employee share schemes
- trading, settlement and custody of shares
- structure and regulation of stock markets for small and mid-cap quoted companies;
- political liaison – briefing and influencing Westminster and Whitehall, the City and Brussels
- accounting standards proposals from various standard-setters

The QCA is a founder member of European**Issuers**, which represents quoted companies in fourteen European countries.

QCA's Aims and Objectives
The QCA works for small and mid-cap quoted companies in the United Kingdom and Europe to promote and maintain vibrant, healthy and liquid capital markets. Its principal objectives are:
Lobbying the Government, Brussels and other regulators to reduce the costing and time consuming burden of regulation, which falls disproportionately on smaller quoted companies
Promoting the smaller quoted company sector and taking steps to increase investor interest and improve shareholder liquidity for companies in it.
Educating companies in the sector about best practice in areas such as corporate governance and investor relations.
Providing a forum for small and mid-cap quoted company directors to network and discuss solutions to topical issues with their peer group, sector professionals and influential City figures.
Small and mid-cap quoted companies' contribute considerably to the UK economy:

There are approximately 2,000 small and mid-cap quoted companies

They represent around 85% of all quoted companies in the UK

They employ approximately 1 million people, representing around 4% of total private sector employment

Every 5% growth in the small and mid-cap quoted company sector could reduce UK unemployment by a further 50,000

They generate:

- corporation tax payable of £560 million per annum

- income tax paid of £3 billion per annum

- social security paid (employers' NIC) of £3 billion per annum

- employees' national insurance contribution paid of £2 billion per annum

- The tax figures exclude business rates, VAT and other indirect taxes.

September 2011

Rathbone Brothers, Brewin Dolphin and Cazenonve Capital Management – written evidence

Evidence to be found under Brewin Dolphin

Reserve Bank of Australia; Consumer Focus; Which?; Citizens Advice Bureau; moneysavingexpert.com; Mr Paul Lewis; Financial Services Compensation Scheme; Financial Ombudsman Service; Money Advice Service - oral evidence (QQ 99-206)

Transcript to be found under Consumer Focus

Reynolds Porter Chamberlain LLP – written evidence

1 Introduction

1.1 RPC has concerns about a specific proposal concerning the law of causation which has been placed before the Joint Committee by the FSA.

2 FSA proposals to the Joint Committee

2.1 In paragraph 33 of its Memorandum to the Joint Committee the FSA comments that '*the FCA's ability to ensure that consumers receive redress is constrained by the general law, in particular by questions of causation. If the breach of rules either did not cause the loss, or was merely a contributory factor, the FCA will not be able to require firms to pay full redress.' The Memorandum continues in paragraph 34: 'If society expects as a matter of public policy that the regulator should be in a position to require greater levels of redress to be paid then the FCA needs to be given a clear mandate and the powers to do so in the legislation*.'

2.2 The importance of this issue for the FSA was highlighted in this year's Mansion House speech when Lord Turner, FSA Chairman, selected an amendment of the law of causation as being one of four key trade-offs that the FCA would need to consider in respect of future mis-selling. '*The natural assumption may be that wherever there has been a breach of regulatory rules and also customer detriment, that 100 percent redress should be available. But general principles of law mean that if the breach of rules did not without question cause the whole loss, then 100 per cent redress is not available. Parliament could decide to change that balance, but that would involve a judgement about another trade-off.*'

3 General law on causation

3.1 As the law of causation currently stands, if a firm breaches FSA rules it is only liable to pay compensation if its breach caused the loss. To impose liability on firms without reference to these causation principles, the FSA would have to secure amendment to the Financial Services and Markets Act 2000 ('FSMA') to disapply them from the regulated sector.

3.2 There are several options for amending FSMA through the Financial Services Bill, two of which are set out below:

Option A: The practical reality within the Financial Ombudsman Service ('FOS') could be formalised in law by simple amendment to the language of s.228 FSMA which sets out the FOS' jurisdiction to decide matters on the basis of what, in the opinion of the individual Ombudsman, is fair and reasonable in all the circumstances. The new Bill would simply have to add words such as: "*regardless of the law of causation*".

Option B: Beyond FOS, to prevent firms from avoiding liability to consumers (including under a consumer redress scheme or similar past business review) the

right to damages under s.150 FSMA would have to be amended, at least, to remove the words "*as a result of the contravention, subject to the defences …*". More likely, express provisions would be required to rule out causation defences.

3.3 If such changes are implemented it will make real the fears first expressed when the predecessor to s.150 was created in s.62 of the Financial Services Act 1986. At the time, the industry was reassured that legal defences would still be available as the loss had to 'result' from the breach. This is clearly illustrated in an article published in The Law Gazette on 28 June 1989, which comments that a 'claim under the section [62] is subject to the defences and other incidents applying to actions for breach of statutory duty'. For any action to succeed under the section it is necessary 'to look at the relevant rules and consider the issues of causation and reasonable foreseeability.'

4 Consequences of change: four case studies

4.1 The impact of these changes is best demonstrated by considering recent cases and FSA Final Notices against regulated firms which either turned on the issue of causation or on which changes to the law would have had a significant impact.

Case study 1: Rubenstein v HSBC
Judgment in the case of *Rubenstein v HSBC*[223], relating to the AIG Enhanced Fund, was handed down on 2 September. Although the adviser was found to have been in breach of his common law duty of care and old COB rules, the Judge decided that the global economic events that caused the loss were wholly outside the contemplation of the bank or any competent financial adviser at the time the advice was provided in 2005. The Judge therefore awarded only nominal damages. But if the wording of s.150 had been different, full compensatory damages would have been payable.

Case study 2: Zeid v Credit Suisse
Similarly, on 4 October, judgment was handed down in the case of *Zeid v Credit Suisse*[224]. Again, although the Judge found Credit Suisse had made personal recommendations and that the later advice given was unsuitable, the Judge concluded that the breach of the rules and negligence did not cause Mr Zeid's losses as he would have made the investments anyway. With nearly US$70m at stake, the case provides clear illustration of the importance of the causation defence.

Case study 3: Final Notice against Credit Suisse
On 25 October, the FSA fined Credit Suisse's UK arm £5.95m for systems and controls failings relating to the sale of over £1 billion in complex structured products to private banking clients. Relying on the current law, Credit Suisse has only promised to compensate customers who suffered loss caused by any unsuitable sales. If every case of breach required full redress regardless of whether the breach caused the loss the compensation automatically owed in this case would have been far higher.

Case study 4: Final Notice against Coutts & Company

[223] Rubenstein v HSBC Bank Plc [2011] EWHC 2304 (QB)
[224] Zaki & Ors v Credit Suisse (UK) Ltd [2011] EWHC 2422 (Comm)

On 7 November the FSA published its Final Notice imposing a £6.3 million fine on Coutts & Company for failure to comply with the FSA's principles of business in the way it sold the AIG Enhanced Fund (which was also the investment featured in the Rubenstein case above). 247 Coutts customers had £748 million invested in the fund and Coutts has agreed to undertake a past business review of all these sales to ensure that customers do not lose out as a result of its failures. Redress will be provided to those for whom sales were found to be unsuitable. However, if the law of causation were no longer to apply, Coutts could expect to pay out substantially higher compensation.

4.2 It is clear from these case studies that a change in the law would have a very substantial impact on all financial services firms. We submit that the Joint Committee and the Houses of Parliament should consider very carefully the significant pecuniary difference between money owed under court judgments and through compensation schemes agreed with the FSA under the current legal framework compared to the amount that would be owed should that framework be changed.

4.3 If causation defences are lost, it would mark a radical change in the exposures of regulated financial services firms. We are concerned that the professional indemnity insurance market would not be willing to insure firms subject to such liabilities or would (at least) require prohibitively high premiums. Ultimately, this could result in less compensation.

5 Concluding remarks

5.1 Lord Turner noted in his Mansion House speech that gaps in legislation governing the financial sector 'will inevitably leave many of the details of these trade-offs to be struck by the FCA itself under the overall direction of its Board.' We submit that a statutory change to the law of causation in respect of the financial services sector represents such a fundamental alteration to the laws of this country that it must be debated in full.

5.2 As the FSA recognises in its Memorandum, '[t]his is a difficult issue that gives rise to real questions as to how far the regulator’s powers should extend'. We agree that the central issue is the extent of the regulator's powers: should Parliament encourage and codify the developing division of the UK legal system, between statutory principles and rules governing regulated individuals and firms, and the traditional general principles of common law that govern all other natural and corporate persons in England and Wales?

5.3 The division matters for regulated firms who will question why in justice they should pay for losses they have not caused. If every technical breach of rules led to compensation, firms would effectively become guarantors of the products they sell.

9 November 2011

Royal Bank of Scotland; Barclays and HSBC – oral evidence (QQ 692-761)

Transcript to be found under Barclays

Royal Bank of Scotland – supplementary written evidence

Thank you for the opportunity to expand on the points raised by Lord Maples as you know, my remarks to the Committee were necessarily general in nature.

As required by the Companies Act 2006 and Article 4 of the European Union IAS Regulation, the consolidated financial statements of The Royal Bank of Scotland Group plc ("RBS Group") are prepared in both accordance and compliance with International Financial Reporting Standards as issued by the International Accounting Standards Board ("IASB") and the interpretations issued by the International Financial Reporting Interpretations Committee of the IASB (together "IFRS") as adopted by the European Union.

Lord Maples's first question appears to relate to fair value accounting. The RBS Group accounts are prepared on a historical cost basis, except as required by the relevant IFRS, the following assets and liabilities are stated at their fair value: derivative financial instruments, held-for-trading financial assets and financial liabilities; financial assets and financial liabilities that are designated as at fair value through profit or loss; available-for-sale financial assets; and investment property. Recognised financial assets and financial liabilities in fair value hedges are adjusted for changes in fair value in respect of the risk that is hedged. This can have the effect of realising either profits or losses during the life of the relevant transaction.

In relation to Lord Maples's second point, RBS Group accounts for commitment fees (i.e. fees paid by a customer to keep a line of credit open or to guarantee that a loan will be available at a later date) in accordance with applicable IFRS. Under IFRS the treatment of a commitment fee depends on whether or not a specific lending arrangement will take place. If a specific lending arrangement is likely, (i.e. where specific drawdown amounts, rates, currencies, cash flows and maturity dates are agreed,) the commitment fee is deferred and when the loan is drawn down, the fee is included in its effective interest rate[225] in accordance with IAS *39 Financial Instruments: Recognition and Measurement.* This results in the fee being recognised as income over the expected life of the loan. Where a specific lending arrangement is not likely, the commitment fee is recognised as revenue on a time proportioned basis over the commitment period as required by IAS 18 *Revenue*.

On the third point, we are not aware of any activity at RBS Group of the type described, either historic or current. I can also confirm that since 2009 we have disbanded proprietary trading desks and exited activities with no customer components.

On several occasions we have looked at our historic transactions and business practices. These include (i) the transfer of assets to our Non-Core division and the process of winding down or disposing of these assets; (ii) regulatory enquiries from the SEC in connection with trades of this type conducted by another market participant and (iii) a survey of our US

[225] The effective interest method is a method of calculating the amortised cost of a financial asset or financial liability (or group of financial assets or liabilities) and of allocating the interest income or interest expense over the expected life of the asset or liability. The effective interest rate is the rate that exactly discounts estimated future cash flows to the instrument's initial carrying amount; this carrying amount will be net of the deferred commitment fee and as a result the fee will be recognised over the loan's expected life.

business conducted on our behalf by a leading law firm in response to a question from FINRA.

Our knowledge of the past cannot be perfect but the work completed and the knowledge that we have gained from this give me a degree of confidence in my response.

8 December 2011

Shelter – written evidence

Summary

- Reckless mortgage lending, permitted by lax regulation, contributed to the scale of the financial crisis and severe detriment to thousands of home owners.
- Shelter is therefore strongly supportive of the government's proposals to strengthen the regulatory framework for financial services. We believe the regulators' new powers will support a much more effective response to poor lending practice.
- We urge the draft bill committee to ensure these proposals are not watered down, and to consider further measures to more effectively prevent future financial crises.
- In addition to providing evidence in support of existing proposals, our response sets out the case for the following measures:
    - Extension of regulation to buy-to-let mortgages
    - Transfer Consumer Credit Act regulation to the FCA to include second-charge mortgages, with some CCA protections extended to residential mortgages
    - Strengthened consumer protection objectives for the FCA.

Why is Shelter interested in the Financial Services Bill?

Shelter is a national campaigning charity that provides practical advice, support and innovative services. We help more than one million people a year via our website, helplines and national network of services.

Shelter is interested in the Financial Services Bill because we know that poor financial regulation led to reckless mortgage lending, with severe consequences for individual borrowers, the housing market and the wider economy. As such, Shelter broadly welcomes the consumer protection proposals set out by the government in the draft legislation, which we believe could help to prevent the scale and the severity of the lending practice we witnessed in the build up to the financial crisis.

Reckless mortgage lending saw many thousands of households leant mortgages that they had no hope of ever paying back, placing borrowers in dire financial straits. The practice of securitisation, where mortgage books were sold on to unregulated third parties who had no obligation to forebear struggling borrowers, led to macro-economic instability and also direct consumer detriment. Over 150,000 households have had their homes repossessed since 2007.[226] Meanwhile, new research by the Consumer Credit Counselling Service finds that 11% of all mortgage accounts are in some kind of financial distress.[227] This has also resulted in high costs for the tax-payer, with each repossession costing the state up to £32,000,[228] as well as high contributing to legal aid costs.

Shelter believes mortgages are a striking example of how poor regulation of lender practice has harmed individual consumers and the wider economy, particularly as residential mortgage lending makes up 86% of all lending to individuals in the UK.[229] Mortgage lending

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226 Council of Mortgage Lenders, Quarterly repossession statistics
227 Consumer Credit Counselling Service, Debt and household incomes report, 2011.
228 Shelter, Policy Briefing: Mortgages and Repossessions, January 2008
229 Bank of England, 2011. Statistical release: Lending to individuals: June 2011.

should act as a powerful precedent when parliamentarians assess the effectiveness of both prudential and conduct regulation set out in the draft legislation.

Shelter is not directly about the full range of financial services regulation; our interest lies in whether the regulatory tools will prevent the conduct and prudential practice of lenders that causes direct detriment to borrowers and wider negative effects on the housing market. As such, our response to this call for evidence will focus on questions relating more directly to mortgage lending.

9. Can Parliament take an informed decision about the proposals for the FPC without details of the macro-prudential tools at its disposal?

Shelter encourages the committee to actively consider the potential benefits of the FPC's mooted tool of setting maximum loan to value ratios for reasons of macro-economic stability. While lenders are generally cautious at present, the effects of widespread high LTV mortgages in the run up to the credit crunch arguably over-inflated up house prices,[230] while leaving borrowers more vulnerable to negative equity if the value of their home decreased.[231] The Bank of England sets out that this can make banks vulnerable where sufficiently widespread negative equity impairs their capital ratios.[232]
It is important to be clear that these measures are no substitute for responsible lending conduct rules, but do offer the FPC strong emergency powers to protect the integrity of the economy. It would also be necessary to ensure that there were safeguards to prevent against any negative consequences, such as all lending temporarily drying up.

15. Are the FCA's primary objectives appropriate? Is significant emphasis given to the promotion of competition?

Shelter believes that a sustainable financial system is one that starts with the best interests of consumers and the wider economy, and we are pleased that the Treasury has highlighted consumer protection as a key principle for the new regulatory framework. Consumer Focus research highlights that the overall culture of a regulator is central to the effectiveness of regulation.[233] We believe this should start with strong principles set out in legislation.

Shelter does not consider the wording of the consumer protection objectives as it stands in the draft bill to deliver on Ministers' ambitious vision. We believe a stronger objective, similar to Ofcom's consumer protection objective,[234] would send out a stronger message to the regulator about the necessary culture shift, and allow consumers and consumer groups to hold them to account against this objective, particularly around protection for vulnerable consumers.

16. Are the responsibilities of the FCA towards the regulation of markets appropriate?

Shelter welcomes the new powers proposed in the draft bill. In particular we support the powers to ban detrimental products and to publicise investigations into firms' practices. We believe these have the potential to be effective in stopping early detriment to consumers as

230 Heitor Almeida, Murillo Campello, Crocker Liu. The Financial Accelerator: Evidence from International Housing Markets, Review of Finance (2006) 10: pp. 1–32.
231 Gudmundur Gudmundsson, Risks in higher loan-to-value ratios of housing. Monetary Bulletin 58, 2005.
232 Bank of England, Quarterly Bulletin 2009 Q2, The economics and estimation of negative equity.
233 Fair enough? A report to Consumer Focus from the National Consumer Federation on the FSA's Treating Customers Fairly initiative. 2011.
234 Section 3(4) of the Communications Act 2003

well as sending out a clear message to lenders that they cannot get away with lending practice that causes serious detriment to consumers.

The power to ban detrimental products could see the removal of products that put vulnerable borrowers at risk of homelessness before they cause widespread detriment and pose significant macro-economic risks.

For example, this could have prevented Sale and Rent Back products from causing significant detriment to consumers earlier, before they were brought within FSA regulation.[235] In this instance, Shelter advisers were seeing significant numbers of cases where vulnerable homeowners were facing eviction after taking out these often exploitative products, but it took two years for the FSA to bring them within their regulatory framework and a further year for sufficiently robust rules to come into play. This caused prolonged and unnecessary anguish for consumers.

We would urge parliamentarians to consider whether the current proposals to only ban products within the FCA's existing regulatory framework are sufficient, and whether a fast-track process could be instigated to allow FCA to bring wholly unregulated products, such as 'Sale and Rent Back', within their regulatory framework. Shelter believes this additional power would further enshrine a more proactive approach for the regulator, and prevent similar problems occurring in the future.

The new transparency powers for the FCA, through naming and shaming reckless lenders, can be a strong support for improving practices, protecting consumers, and changing culture across the financial services sector.[236] It is important that this measure has teeth, although we note that the Treasury has already made significant concessions to lenders on safeguards against undue publicity. We would urge the committee to consider whether the detail of the draft legislation gives too strong a ground of appeal that it will fail to act as a major disincentive to lenders.

17. Does the draft Bill strike the right balance between the responsibilities of consumers and firms? Are the FCA's new powers in the area of consumer protection appropriate?

The examples of sub-prime mortgage lending and payment protection insurance have shown that lenders have targeted vulnerable consumers with complex and risky products that were thoroughly inappropriate for them. With regard to mortgage lending, the apparent insecurity of private renting compared to owner occupation and the shortage of social housing, meant that many households were driven to buy a home when they could hardly afford to maintain their mortgage payments.[237] The factors that push consumers to take out financial products are much more complex than the consumer responsibility argument allows.

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235 'Sale and rent back' or 'mortgage rescue' companies offer struggling homeowners the chance to stay in their homes when they can no longer afford their mortgage. The property is bought and rented back to them by the company. Before the FSA began regulation of the sector in July 2009, some companies took advantage of people's desperate circumstances by buying properties at much less than their market value, putting up rents to unreasonable levels or even evicting tenants from their own home for no reason.
236 Consumer Focus, 2009. Rating Regulators.
237 Citizens Advice, 2009. Set up to fail: CAB clients' experience of mortgage and secured loan arrears problems

Furthermore, consumers are subject to significant asymmetries with lenders. Lenders are technical experts in their products, whereas consumers are generally not experts in financial services and do not, for example, have access to interest rate forecasts. An Office of Fair Trading survey found that only a quarter of consumers will read the small print.[238] While consumer responsibility is important and we support the role of ongoing consumer education programmes through the Money Advice Service, we believe that to address short and medium term micro and macro-economic risks, the principal responsibility should be on lenders to ensure that they do not market and target their products at inappropriate groups.

22. Does the draft Bill contain any proposals or omissions, not covered by the questions above, which cause concern?

Shelter believes the committee should consider whether the proposals in the Bill go far enough to improve the practice of lenders and prevent further consumer detriment and macro-economic risk.

Regulating buy-to-let (BTL) mortgages.

We believe it is important for the Treasury to consider carefully how it defines 'participants at the sophisticated or professional end of the spectrum', particularly where this applies to BTL lending. BTL mortgages have recently been disproportionately subject to arrears and repossession,[239] and the vast majority of landlords are individuals or couples with fewer than 3 properties.[240] This suggests that many BTL borrowers have more in common with consumers than businesses and would benefit from more effective protection and regulation. Meanwhile, a lack of proper protection could place large numbers of tenants at considerable risk of losing their home.

Transfer of Consumer Credit Act responsibilities from OFT to FCA

The Treasury has considered transferring the responsibilities for Consumer Credit Act (CCA) responsibilities to the FCA from the Office of Fair Trading (OFT). Shelter strongly supports this move, along with a transfer of certain CCA legal protections to mortgages. This change would provider greater protection for consumers as well as further promoting culture change among lenders.

The main benefit of this transfer would be bringing second charge mortgages[241] within the same regulatory framework as residential mortgages. At present, the OFT and FSA both seek to regulate the same sorts of issues in slightly different ways. Both existing regulatory systems have different strengths and weaknesses. This can mean a lack of clarity and consistency of practice across the mortgage market, and confusion for consumers. While second charge mortgages were due to be transferred to FSA regulation, this move is how in question by the Treasury.

Second charge mortgages are disproportionately subject to repossession, with analysis of a sample of 452 possession cases in English county courts, 16% of cases were being brought by

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[238] Office of Fair Trading, Consumer Contracts, 2011.

[239] Council of Mortgage Lenders: Table AP7 - Possessions, buy-to-let and owner occupied markets. Published 6 August 2010.

[240] Professor Julie Rugg, The Private Rented Sector: its contribution and potential, 2008

[241] Second charge mortgages or secured loans are when a loan is secured against a mortgage. As the loan is secured against the mortgage, if the borrower defaults on the loan, they risk having their home repossessed.

second-charge lenders.[242] This appears to be disproportionate to the market share of second-charge lenders.

Furthermore, a transfer of some of the more effective CCA regulatory tools, such as Time Orders, would be a welcome tool for challenging hasty repossession by residential mortgage lenders.

There are also small amendments to mortgage law that would close loopholes that allow lenders to repossess a home without obtaining a court order. We would strongly welcome the Government taking sensible action to close these.

September 2011

[242] Turning the tide? Evidence from the free advice sector on mortgage and secured loan possession actions in England in July 2009, AdviceUK, Citizens Advice, Shelter, December 2009

Smaller Businesses Practitioner Panel – written evidence

INTRODUCTION

The Smaller Businesses Practitioner Panel represents the interests of smaller practitioners to the FSA, and is due to become a statutory body representing these interests to the FCA under the new regulatory structure. The details of the Panel's remit, and its current membership is at Appendix 1. We have taken a close interest in the plans for regulatory reform as they have developed. We support the views of the Financial Services Practitioner Panel, which takes a broader view on behalf of all regulated firms. We would like to use this opportunity to focus on those particular points which affect smaller firms.

The Committee has asked if these proposals will prevent another financial crisis, or enable the UK to better handle a financial crisis, as well as deal with bank failure and protect the public purse.

We are concerned that there is no guarantee that these changes will prevent another financial crisis. The vast majority of the regulated community are smaller firms who played no part in the last crisis. Nevertheless, smaller firms are potentially set to pay a high price, both regulatory and financial, for the actions of a relatively small number of larger firms.

1. Is the separation of prudential and conduct regulation into a "twin peaks" system the right approach?

We support the formation of the FPC to consider systemic or macro-economic risk and to help to avoid a future financial crisis. However, we believe that the other changes in regulatory structure will not assist, and may indeed prove to be an impediment. The regulatory divide between the PRA and FCA introduces a new potential weakness into the regulatory structure: business models are influenced both by prudential issues such as capital structure and liquidity, and also by the products sold. From a firm's point of view, there is not always a natural dividing line within a firm's culture between its duties relating to prudential risks and conduct risks. It will therefore be more difficult to hold conversations with regulators who want to see that split. Issues could fall down the cracks between regulators: actions taken in one area of a business will have an impact on other areas, and supervisors need to be aware of this.

Overall, we believe the disruption and cost of regulatory change is disproportionate to the benefits. All small deposit takers and insurance companies will be swept up into dual regulation by the PRA and FCA, with a significantly increased burden in dealing with two regulators, and little commensurate benefit.

4. Are the accountability and governance arrangements for the Bank of England, FPC, PRA and FCA satisfactory?

We are pleased that the Smaller Businesses Practitioner Panel will become a statutory Panel for the FCA as part of the proposed legislation. However, we have registered considerable concern that there will not be a regular statutory forum for debate between practitioners and the PRA. We also believe that the FPC should have more of a clear and regular dialogue with the industry, as its opinions will have a significant impact on the regulation of firms.

We believe that there should be a forum for ongoing dialogue with the industry in the form of a statutory Panel. There are a number of key benefits for having such a Panel for the PRA:

a) A Panel of practitioners representing the wider industry would be able to recognise the *impact of regulation in one sector on another*. Specialist ad hoc groups drawn together for e.g. the purposes of giving input on regulation in the mortgage market would not appreciate the potential impact that same regulation could have in other sectors.
b) A Panel could comment on and therefore contribute to more *effective coordination between different regulatory bodies*. It could monitor how successfully they coordinate and provide feedback on an ongoing basis. This would work best with a Panel that has some overlapping membership or coordination requirements with the FCA practitioner panels.
c) A Panel would have *a 'corporate memory'* and so recognise links and repetitions over time that may not be obvious to ad hoc working groups.

We have set out our views on this in a separate briefing, jointly with the Financial Services Practitioner Panel, and this is attached at Appendix 2 to this document.

We have also registered concern about the current governance arrangements for the FPC and PRA. Under current proposals, the Governor of the Bank of England would have a very broad range of responsibilities and powers, with very little checks and balances. We believe that greater checks and balances are needed, and that this should include a broader membership of the FPC including industry experience, and those able to consider the impact of FPC decisions on conduct as well as prudential regulation.

6. Should the FPC be limited in the actions it can take which might affect the growth of the financial sector?

The Smaller Businesses Practitioner Panel believes the FPC's responsibilities should include a 'have regard' for diversity in size in the UK financial sector. Without this 'have regard', we believe there is a danger that decisions will be taken to control larger firms which pose a systemic risk, but which have a knock on effect on the viability of smaller firms which may not have been considered..

12. Are there any risks in the Government's proposed 'judgement-based' regulation?

As yet, there has been no recognition of the diversity of size of firms in any of the Government's consultations, and 'judgement-based' regulation is one aspect that causes concern for smaller firms.

We believe that there is a risk that judgement-led supervision has the potential to be all encompassing, and overly burdensome on firms. This is particularly so for small firms who may have unlimited responsibilities towards the regulators unless there are clear guidelines in place. Smaller firms in particular need clarity on what is expected of them from the regulator. We believe 'judgement-based' regulation must be carried out in the context of clear and limited policies and guidelines which are predictable and fully aligned with international and European requirements.

We are particularly concerned to ensure that smaller firms are not overburdened with regulatory requirements which are targeted at larger firms, and yet apply to all. We have

yet to see any detail of how the new regulators will adapt their requirements for smaller firms and make them proportionate. For instance, the PRA Approach document refers to baseline supervisory monitoring for all firms and the PRA Approach documents published earlier in the Summer referred to wide data sets, beyond what is normally submitted, being available for PRA supervisors to call upon at short notice. This is the kind of wide ranging requirement which is extremely difficult for smaller firms to be able to prepare for.

17. Does the draft Bill strike the right balance between the responsibilities of consumers and firms? Are the FCA's new powers in the area of consumer protection appropriate?

We are not convinced that enough attention is being paid to consumer responsibility as a key principle of 'have regard' for the regulator. Consumer responsibility was not discussed in the FCA Approach document published in July 2011, and we believe there should be more consideration of how this principle will be applied in practice. Under the FSA, the role of consumer responsibility has been ambiguous: it has never been properly defined how the regulator should carry this out, beyond vague references to *caveat emptor*. The current legislation is an opportunity to set out clearly the balance between consumer protection and responsibility. If the FCA is not to be a zero-failure regime, then it must declare where the responsibilities of consumers, as well as firms, lie.

Overall, it will be important that the FCA balances the views and responsibilities of consumers and industry practitioners when framing its policies and supervising firms. Any regulator should be seen to take an unbiased approach, and not be inherently critical of the industry, as this will not enhance confidence overall.

We also feel that there are dangers in the Government's focus on a single broad definition of consumers for the FCA. We believe this may encourage a "one size fits all" approach to regulation which we have fought hard to encourage the FSA to avoid unless clearly justified.

18. Are the prudential regulatory responsibilities of the FCA towards FCA-only regulated firms given sufficient emphasis and detail?

There was little detail on the prudential regulatory plans of the FCA in the FCA Approach document, and so it is difficult to tell how the prudential regulatory of the FCA will be taken forward as yet. Nevertheless, we are concerned that the FSA's Smaller Firms Division will not be maintained as the FCA moves towards a sector-based approach. Although we can see the advantages of the sector-based approach, we are concerned that some smaller firms may be overlooked and will not have the access to assistance in interpretation of the rules, etc which larger firms will have through their individual supervisors.

19. Will the new regulatory arrangements reduce the risk and cost of dealing with miss-selling of financial products?

It is hard to judge whether the new regulatory arrangements will reduce the risk of mis-selling without knowing what the new regulator's risk appetite is going to be. Our Panel strongly believes the FCA should publish its risk appetite, in order to appropriately set expectations around what its role should (and should not) be, and in order for it to have a yardstick against which its performance can be measured.

It is worth noting in the context of mis-selling that much of the new intervention powers of the FCA have focused on the product intervention powers being proposed for the FCA.

However, we have argued that many products are often correct for their target market, but they are then sold to a wider market, and this is where the sales become inappropriate.

We also believe that the product intervention powers do not provide a simple solution: significant liabilities and pressure could build up on the FCA if the product intervention powers are not used appropriately. In cases where either firms or consumers suffer detriment as a result of the regulator's actions, it is unclear what the regulator's liabilities and obligations would be. There should be a means to hold the regulator to account (and allow it to learn) from making the wrong decisions.

20. Are the proposals for co-ordination between the PRA and FCA clear and adequate? What would be the advantages and disadvantages of having a Single Point of Contact and/or a joint rule book for dual-regulated firms?

The Panel supports the idea of having a Single Point of Contact and a joint rule book for dual-regulated firms. Avoiding multiple information requests and making it as easy as possible to access information for smaller firms is key for smaller firms.

However, we remain unconvinced that enough has been done to ensure coordination at a day to day level between the regulators. This will be vital for the significant number of small deposit takers and insurance companies which are dual regulated, and where the burden of compliance will fall on a small number of staff. We believe that a duty to coordinate should be in the regulatory principles which are referred to on a day to day basis, in addition to the statutory duty to coordinate.

22. Does the draft Bill contain any proposals or omissions, not covered by the questions above, which cause concern?

In the Approach documents for the PRA and FCA, we have seen little reference to the cost of running these organisations and the ways in which the new regulators will be made cost-effective. In the Government's Impact Analysis in the first consultation in July 2010, it said there would be no significant additional ongoing costs for both of the new regulators after the transition costs. It also stated that firms who would remain with a single regulator were unlikely to suffer any significant transitional costs or any increase in ongoing costs as a result of these reforms. However, both organisations have referred to significant new initiatives in their Approach documents. For instance, the FCA's new product intervention powers will require considerably more resources, without a clear identification of areas to cut back.

This also takes place in the context of other cost increases/commitments – such as MAS, FOS and especially the FSCS. Given the recent huge FSCS levies, the Panel wishes to reiterate the point that it is very difficult for smaller businesses to cope with such large, unplanned cost expenditures. Going forward, we would also like to see explicit recognition by the regulator that they need to take account of the FSCS levy on the financial viability of firms. It would make no sense going forward to have a prudential regulator which did not recognise that large FSCS (or other regulatory) levies could threaten small firm viability and lead to many small firms closing.

In addition to concerns around overall regulatory cost increases, we have specific concerns around the distribution of these costs. Smaller firms not only pose smaller risks to financial stability and require less costly supervision, but as mentioned above are also less able to cope with sudden or unplanned cost increases. As such, it is vital to ensure that the

regulatory cost burden on smaller firms does not become so high that only the largest financial sector institutions are able to survive.

We are concerned that this increase in the regulatory burden, along with other current changes in the regulatory landscape, will undermine the viability of many smaller financial services firms going forward. Both the Government and the regulators must guard against a situation where the drive towards financial stability puts so great a burden on firms that only the largest firms are able to survive, and the smaller firms, which are valued by many consumers, are unable to compete.

In addition, the Panel would like to emphasise the importance of not losing valuable existing FSA initiatives (such as TCF) in the move to a new regulatory structure. The industry has spent a considerable amount of time and resources in implementing TCF, and so we do not wish to see the FCA developing and implementing a similar and yet different set of requirements on firms in the future.

In terms of coordination, it is unclear what the duty to coordinate will mean in practice. It is key that the various regulatory bodies cooperate, but it remains unclear what the practical implications of the current coordination arrangements will be.

The Panel would also welcome greater clarity on how consumer responsibility will be defined and interpreted going forward. Whilst welcoming the recognition that consumers need to have some level of responsibility for their decisions, again it remains unclear how this will be interpreted in practice.

APPENDIX 1

ROLE AND REMIT OF THE SMALLER BUSINESSES PRACTITIONER PANEL

5. The Smaller Businesses Practitioner Panel (SBPP) was set up by the Financial Services Authority (FSA) to represent the views and interests of smaller regulated firms and to provide advice to the FSA on its policies and strategic development of financial services regulation.

6. Our members are drawn from smaller firms operating across the main sectors of regulated business.

7. We consider several factors when deciding on the definition of "smaller" businesses and take a flexible approach to the application of criteria. A firm may have – in relative terms – a minor market share or small number of employees in the context of its industry sector. In addition, the firm's financial position and whether the firm is owner-managed may be relevant.

8. We work to ensure that the interests of smaller financial services firms are taken into account and their importance to a healthy, successful and vibrant marketplace are properly reflected in the policies of the FSA.

9. The names of the members of the SBPP as at 01 September 2011 are as follows.

Panel Member	*Position*
Guy Matthews *Chairman*	Chief Executive, Sarasin Investment Funds
Clinton Askew	Director, Citywide Financial Partners
James Bawa	Chief Executive, Teachers Building Society
Dick Carne	Director of Asset Management IFA Limited
Ian Dickinson	Director, The Brunsdon Group
Peter Evans	Chief Executive, Police Credit Union
Sally Laker	Managing Director, Mortgage Intelligence
Fiona McBain	Chief Executive, Scottish Friendly Assurance
Andy Smith	Risk, Governance and Compliance Director TD Wealth International
Ian Templeton	Managing Director, UIA (Insurance) Ltd
Andrew Turberville Smith	Chief Operating Officer and Finance Director, Weatherbys Bank Ltd

APPENDIX 2
THE NEED FOR A STANDING BODY OF PRACTITIONER REPRESENTATIVES AT THE PRA

INTRODUCTION

This briefing is written on behalf of both the Practitioner Panel and Smaller Businesses Practitioner Panel, the current practitioner panels for the FSA. It is based on our knowledge and understanding of the contribution that the Panels make to regulatory policies, and we would like to contribute further to the ongoing debate concerning the need for statutory standing bodies for the proposed PRA. We recognise that these opinions might be viewed as being self serving; however, we do not believe that we have particular vested interests in the Panels continuing: members of the Practitioner Panel serve to make a personal contribution to the regulation of financial services and are unpaid (while the members of the SBPP receive only a small fee) and normally serve a maximum of two terms of three years each.

THE CURRENT PROPOSALS

The White Paper on regulatory reform published in June 2011 ("A new approach to financial regulation: the blueprint for reform") correctly distinguishes accountability (for example, to Boards/Court and Parliament) from engagement with stakeholders (for example, to Practitioners, Consumers). The White Paper is clear on the need for statutory Practitioner, Smaller Business Practitioner and Markets Panels for the FCA. However, whilst the White Paper proposes to give the PRA a statutory duty to put in place arrangements for engaging with practitioners, as drafted there will be no specification of what those arrangements might be. Therefore the arrangements would be at the discretion of the PRA and the Bank of England. The White Paper also indicated that the Government will continue to consider these arrangements in the light of further consultation and PLS.

As the current statutory practitioner panels of the FSA, we wanted to set out what our experiences indicate are the advantages of having a statutory standing body of practitioners

with strong links to the FCA Practitioner Panels, possibly in the form of a statutory Panel, and also what we see as the disadvantages of not having such a forum for the PRA.

We believe that engagement with the industry at an early stage of policy development has significant benefits for regulators as well as firms. The Government has recognised this in the proposed structure for the FCA, but not in the PRA, although the reasons for the distinction are not articulated clearly and the distinction seems to us to be misguided , particularly as each body has the same policy-making functions. We believe that such a structure for industry consultation via a standing body is not relevant only to the FCA: it should also be incorporated into the set up of the PRA.

We do not accept that setting up a standing body for the PRA would increase the risk of "regulatory capture" given the powers and responsibilities of the regulators enshrined in the legislation. In this regard, we welcome the comments of Hector Sants in his speech to the PRA conference on 19 May 2011: "Avoiding regulatory capture does not mean, however, that the PRA will not engage with the firms it regulates. In particular in making its rules, the PRA should do so in full understanding of both their impact and the industry's perspective. It will accordingly set up the necessary consultation mechanisms to ensure the right people in industry are involved. Where necessary this could include standing advisory committees. Furthermore when it makes its rules it will set out their purpose in a clear and straightforward manner."

DISADVANTAGES OF NO STATUTORY STANDING BODY/PRACTITIONER PANEL

We believe that there are distinct disadvantages in not having a statutory Practitioner Panel with strong links to the FCA Panels at the PRA, even if there were to be either standing bodies or ad hoc groups gathered together for specific aspects of PRA regulation at the discretion of the PRA and the Bank. The main disadvantages of non statutory ad hoc groups or standing bodies are as follows:

- Groups drawn together for specific issues will only be focussed on that part of regulation and so may not recognise the impact that such an action may have on other aspects of the system, its interaction with other rules already in place or in prospect or the opportunities for coordination and economies of scale in implementing different changes at the same time. For example, there has recently been considerable debate about the fit between Basel III (and its requirement for banks to lengthen the maturity of their liabilities) and Solvency 2, which may make holdings of bank term debt more expensive, and hence less attractive, to insurance companies. These linkages could well be missed by two single sector groups.

- The division of regulatory issues into Conduct and Prudential at the FCA and PRA, whilst it may be a useful construct for supervisory purposes, is somewhat artificial: from the viewpoint of practitioners (and government), it is the cumulative impact of regulation that matters, especially in regard to maintaining financial stability, protecting consumers and ensuring the UK has an internationally competitive financial services industry.

- The 'corporate memory' of the Panel means that they may recognise links and repetitions that may not be obvious to ad hoc groups, and would be able to look at

the impact of proposals when combined with FCA rules or proposals if there was strong linkage, or even some common membership with the FCA Panels. Although standing bodies might achieve this, we believe that a statutory basis with a link to the FCA Panels would make the standing bodies much more effective.

- Deciding when an ad hoc body is needed or not could result in not having industry input precisely when it could be most beneficial, for example in making the case to the European Union regulatory bodies for regulations which can be properly applied in the UK, given its unique financial markets which is evidenced at the moment in the debate on maximum harmonisation of bank capital rules;

- Setting up various bodies will be time consuming and potentially inefficient. It also runs the risk of "missing the boat" insofar as engagement with EU policymaking is concerned.

REMIT OF A STATUTORY PRA STANDING BODY/PANEL IN THE NEW REGULATORY STRUCTURE

There are particular areas in the PRA's remit which would provide opportunities for engagement with a Practitioner Panel as follows:

- The PRA's future approach documents set out PRA responsibilities in regard to policy making. It says that the PRA will seek to ensure, wherever possible, that its policies and rules are straightforward, clear in intent, robust and support timely interventions. The PRA's policy documents will explain the underlying purpose of its policies and rules. And the PRA will, wherever possible, include clear statements of purpose when setting rules to ensure that firms and the market more generally understand the reasons behind the policy. All these commitments would benefit from a regular and informed dialogue with a specific group of practitioners who also have links to the FCA Panels.

- The PRA's (new) policyholder objective with regard to insurers gives the PRA a broader remit which needs to be considered and may require wider debate on the implications of proposed policy changes.

- The PRA's responsibility for designating Significant Influence Functions (SIFs) would benefit from debate with practitioners.

- The PRA will be the gateway to European and international regulation, and practitioner engagement on negotiating issues could be useful to the PRA.

- The PRA Panel could assist in providing feedback on the practitioner experience of coordination between the two regulators, particularly if it was set up with close links and some common membership with the FCA practitioner panels.

POTENTIAL REMIT REGARDING THE FPC AND BANK OF ENGLAND

The potential for engagement directly or indirectly with the FPC on financial stability issues as they impact on the PRA should also be considered. We believe this is particularly important in respect of the proposed macro-prudential policies. It can be illustrated by considering those in the interim FPC's first minutes of June 2011. The FPC made several recommendations including specific ones on banks' forbearance practices and on funding

structures such as collateral swaps employed by exchange traded funds. In our view, the assessment of the impact of such policies in advance, but more importantly ensuring the implementation of such policies, would benefit from the expertise and knowledge of practitioners, especially understanding the transmission mechanisms and indirect effects, which will be crucial to their success.

In a speech at the British Bankers' Association's Annual Banking Conference on 29 June 2011, Paul Tucker (Deputy Governor for Financial Stability), talked of the broad approach of the PRA. He said that the supervisor will not "... treat firms as islands. They are part of a system. So, at the very least, supervisors will need to look laterally across peer groups of firms for oddities, and stress test firms' resilience against short-term and longer-fuse threats from the environment. They will, therefore, need to draw on market intelligence on industry trends from the Bank's Markets area; insights from the operators and overseers of the clearing, settlement and payment systems; and analysis from the finance and monetary researchers in the Bank. Conversely, the Financial Policy Committee will – and already has – drawn on briefings from the supervisors as well as the Bank's existing staff. In other words, this is going to be about making connections, pulling together a varied range of inputs. A measure of the Bank's success when prudential supervision transfers will be how well we knit them together".

We believe that "pulling together a varied range of inputs" is precisely what the FSA Panels have done over the years and that input from a standing body of senior practitioners linked also to the work of the FCA Panels, would contribute to this market intelligence and industry expertise.

ADVANTAGES TO A PRACTITIONER PANEL

We propose a single Practitioner Panel for the PRA – which would also incorporate the views of smaller firms who will be swept into regulation by the PRA. Such a Panel would have the following advantages:

1. Consideration of practical impact of policy changes

The Panel provides an overview from those who will have to implement any policy changes, and if it were also linked to the FCA Panels, would be able to give feedback in the light of FCA policy debates as well. The Panel would be able to review potential areas for misinterpretation of judgement-based regulation requirements on both sides. It would also be able to help the regulator to understand what is required to implement policy proposals successfully, whilst avoiding any unreasonably detrimental impact or unintended consequences on firms, and so assess costs versus benefits in accordance with regulatory principles. The Panel would also be able to look at how prudential requirements interact with conduct requirements from the firms' perspective and the impact on businesses and consumers more widely. We also feel that, adding smaller businesses representation into a PRA Panel would enable discussions about proportionality of application of rules and requirements across different sizes of firm.

2. Ability to review cumulative impact of PRA and FCA on firms

A vital area of concern in the new system is to see that there is effective coordination of regulatory requirements between the PRA and FCA. The PRA Panel should have a strong

link to the FCA Panels to enable it to provide commentary and appropriate advice on the coordination of regulatory requirements between the two new regulators.

3. A forum with a remit to help the regulator to look ahead

With a regular forum, the members can look ahead to the impact of regulatory developments and initiate its own enquiries of the regulator if it sees a potentially adverse impact or prudential risk. There is no wish to 'capture' regulators through this system, but to provide forward looking advice on issues to look out for. Decisions on how to use these insights are unambiguously for the regulator alone.

4. Well informed and quality membership

If the Panel is statutory, it is given an authority and credibility which enables CEO level people to be persuaded to give up valuable time to become members. Such individuals are more likely to be able to see the wood for the trees than specialists with a narrower focus. Cross sectoral membership provides a focus on effective regulation rather than the sectoral interests of trade associations, which have a separate and important place in discussions with the regulator (and incidentally seemed to support the role of a standing body of practitioners in some of their comments). The members can sign confidentiality requirements, allowing early debate on the pros and cons of new policy developments. They also build up a knowledge of regulatory policy developments through membership over a period of 3-6 years which helps them to bring regulatory perspective to the debates. In addition, individual and high level advice can be given to the regulator on specific subjects through ad hoc sub groups with Panel chairmen and members outside the formal meeting process.

5. Transparency and public accountability

Although we recognise that the Government has said that the PRA's arrangements for consulting practitioners should be transparent, it will be simpler and more practical for a regular Panel to achieve these transparency requirements: the Panel can be required to produce an annual report (as the FSA Panels do currently) and possibly report to the Treasury Select Committee on the PRA (and FCA) engagement with firms. In addition, the PRA Panel could join the FCA Panel in continuing a similar project to the Practitioner Panel's biennial survey of regulated firms which has proved a useful tool for the FSA and provides feedback on perceptions of the regulator's performance against its objectives.

6. Contribution to EU and international negotiations

Such a Panel could additionally contribute to effective EU and international representation for PRA, by providing a means of facilitating proactive and early involvement of the industry in EU developments. Panel members could provide advice on ensuring that EU rules deliver the desired objectives in as efficient and effective way as possible, such as the precise way in which stress tests are conducted, the different options to increase prudential capital or the interactions between the market structure and payment mechanisms and individual firms. Directives and regulations, even on capital and liquidity matters, include a wide range of specific measures on which industry input is extremely useful to ensure they achieve their intended effect and avoid adverse unintended consequence.

CONCLUSION

We believe that it will be crucial for the PRA to have a statutory standing panel of independent practitioners who regularly engage with the PRA in policy formulation and implementation. The group should have strong links to the FCA Panels. An alternative but less welcome structure would be for the FCA Practitioner Panels to have a remit and responsibility to look at certain prudential issues from the PRA.

September 2011

Ms Gillian Tett, US Managing Editor, Financial Times – written evidence

Bridging Mars and Pluto

Four and a half years ago, when the last credit bubble was in full swing, I attended a meeting in the House of Commons to discuss how modern finance worked. That left me profoundly uneasy; so much so, that I penned a column for the Financial Times which lamented that bankers and politicians seemed to live in such different mental worlds that they might have well dwelt on "Mars and Pluto".

More specifically, in early 2007, on the eve of the credit crunch, most politicians (and voters) had little desire to scrutinise how modern finance worked; meanwhile, most bankers had precious little interest in the operations of parliament – or expectation that anybody in society at large could understand what they did, far less control it. Banking, it was widely assumed, was best left in the hands of the bankers, since they alone were skilled enough to understand this complex craft. And while regulators were supposed to be overseeing this system, they were ill-placed to monitor what was going on, or rein in the risks, because they were fragmented in their structure, muddled in their responsibilities – and faced no pressure from politicians, the media or society to act. In short, nobody had much incentive to rock the financial boat since the system appeared to be making the country wealthier – and non bankers had almost no idea what bankers were doing.

Thankfully, these days it is now recognised that it is not good enough to leave banking just in the hands of bankers. Politicians are now pushing for better public oversight, and measures that empower – and encourage – regulators to act. The fact that parliament is now debating this draft financial services bill, and summoned a range of witnesses, should thus be viewed as progress. After all, sunlight can be a powerful "disinfectant", to prevent corruption; more important still, it can also promote common sense and prevent the type of tunnel vision that took hold in the financial system before 2007.

But the bad news is that the process of implementing financial reform and the details of these reforms are still far from perfect. Some of the proposed changes in this bill are certainly positive; however, the key problem is that this bill still leaves considerable issues on the table, such as the question of how to handle bank failure. Moreover, many of the truly critical issues now lie in the hands of international – not national – regulators, and thus are beyond the scope of this bill.

In terms of this bill itself, however, thoughts are as follows:

- I broadly welcome the move to adopt a so-called "twin peak" system of regulation, in place of the old tripartite model, although I recognise that this also poses some risks. This reorganisation presents significant logistical challenges and could be an unwelcome, morale-sapping distraction for regulators. It may possibly create some duplication of reporting requirements for banks, and undermine the ability of UK regulators to collaborate with other international regulators (most of which are not following a twin peak model). However, these costs should – hopefully – more than offset by other benefits. This system offers more clarity of purpose and responsibility,

since the goal of protecting consumers and maintaining financial stability is *not* the same thing; separating this functions could mean that these two goals will each be met in a more effective manner. If there is sensible collaboration and separation of purpose, the problem of duplication should also be minimised.

- I also believe the decision to place the PRA under the authority of the Bank of England is sensible. This should provide clearer lines of responsibility. It should also enable the Bank to take a more holistic – or "joined up" – view of financial supervision. This is badly needed, since a key factor why regulators found it so hard to spot the looming crisis back in 2006 and early 2007 was that the Bank tended to treat monetary policy and finance as separate spheres of activity (and place more emphasis on the former); meanwhile, the FSA was so focused on the micro-level details of banking supervision that it did not try to take a macro-level view about stability, or connect it to the wider economy. It is essential that these different areas of analysis are combined, and I believe that the Bank is probably the better group to lead this. However, the Bank will only be able to fulfil this role properly if it places an equal emphasis on financial stability issues, as monetary policy issues, and recognises that it must invest in its research capabilities accordingly.

- I support the decision to create a Financial Policy Committee at the Bank of England. One benefit of this reform is that this body should be able to take a broad overview of the financial system. Another benefit is that the sheer act of releasing its minutes – and any accompanying statements – could promote more debate about financial stability issues in the media and political circles (in much the same way, say, that the activities of the monetary policy committee raise the level of media and public awareness of monetary policy decisions.) This could help promote more public scrutiny of finance, of the sort that was so lacking before 2007, and thus combat the "mars" and "Pluto" problem I described earlier.

- I also support the move to incorporate macro-prudential tools into the operations of the FPC. These tools have not been extensively used in the Western world in recent decades. Thus this shift will inevitably be somewhat experimental, since there is relatively little academic research into this topic and few well-established conventions. However, it is worth remembering that half a century ago, monetary policy was considered novel too; there is thus every chance that conventions will soon develop; and by adopting macro-prudential tools, the committee should be able to "lean against" bubbles as they develop (or counteract contractions) in a more proactive way.

- I also applaud the decision to adopt a "judgement" based regulatory regime. One risk in this change is that it places more onus on regulators to act wisely (and, by default, on parliament to scrutinise what regulators do). It could make regulation more capricious and less predictable. However, the alternatives are not particularly attractive, given the experience of recent years. The rules-based approach that has been used in America, for example, has spawned a legalistic, box-ticking culture, in which bankers have danced around the rules (or "arbitraged" them) in ways that regulators were powerless to prevent. Meanwhile, the "principles based" approach that was used in the UK before 2007 turned out to be far too passive and vague. Moving to a "judgement based" system will – hopefully – force regulators to take a more proactive, joined up approach, not just in terms of measuring risks but also

- I also believe that it sensible for the FPC to have a remit beyond the regulated banks. The recent crisis showed that non-banks, ranging from special purpose vehicles to insurance groups such as AIG, can create systemic risks. There are already signs today that activity is flowing into the non-banking system as a result of the Basel reforms and the regulatory debate underway in the US and UK. This is likely to accelerate, as banking reform bites. For "judgement based" supervision to be effective, it must be able to watch the entire financial system – and act.

- Lastly, it seems self evident that the financial services bill should be implemented alongside a general increase in minimum capital adequacy and liquidity standards, as set out in the Basel reforms. The standards which were in place before 2007 were clearly too lax. However, it would be a mistake to impose standards in too binding a manner today; some flexibility will be needed since economic conditions may change and activity may shift between different parts of the financial system (say, banks and shadow banks). This is precisely why a shift towards a judgement-based regime is potentially beneficial, in my view.

However, there are other aspects of the specific bill, and reform process more widely, that leave me more concerned. Most notably:

- If there is a long delay in implementing the proposed reforms, this will foster uncertainty in the system. It will also encourage the banks to engage in extensive arbitrage (or to exploit gaps in the rules). This is precisely what happened in the last two decades, when Basel I and II were introduced; precisely because the timetable for implementation was so slow, bankers responded by developing innovative products to exploit loopholes in the rules. This is highly likely to occur again, if there is protracted delay.

- The lack of international harmony is a point of concern, not least because it will encourage the banks to engage in more regulatory arbitrage between regimes. Indeed, there is already anecdotal evidence that this is occurring. There is no easy solution to this, as far as the British parliament is concerned; however, regulators and politicians alike need to be keenly aware of this risk. If nothing else, the British parliament needs to spend more time examining the work of bodies such as the Financial Stability Board.

- One of my biggest concerns is that the question of how to deal with large, failed banks remains dangerously unresolved. The key problem is that different national jurisdictions are taking different policy approaches (eg in Europe there is now a focus on a "bail in" mechanism, while the US is focusing on a resolution regime,) At present, the UK appears to have a system in place that would work relatively well for a small, British-only bank failure. Similarly, in America, the FDIC has a system in place to handle the collapse of a domestic bank. What remains unclear is what might happen if a large cross-border bank collapsed. The British parliament must watch what is happening in international bodies in this respect, and push for more action. It

would also be desirable to implement some deals to uphold mutual recognition between, say, the UK and US, in this respect.

- Lastly, I remain concerned in general about the whole issue of "complexity", opacity and the democratic deficit. Back in 2007, one reason why finance appeared to exist in a different sphere – aka "planet Pluto" – was that financial products seemed so dauntingly complex that most journalists, politicians or voters found them impossible to understand. These days, some of that mystique has disappeared. However, there is now an added layer of complexity: not only are the operations of finance complex, but the reform processes are dauntingly complex too. That makes it tough for any journalist, politicians or voter, to get a clear idea of what is going on. Indeed, the only group in society that have the resources to track this properly are the bankers themselves, and lawyers and lobbyists.

- There is no easy solution to this. If the new FPC and PRA take a proactive, holistic and intelligent approach towards regulation, I hope that this will build a better financial system. But it is important to recognise that this draft bill is only one necessary step in this direction; it is not sufficient. It is essential that action is taken to build a resolution regime, overhaul capital standards and push for more collaboration across borders. But above all else, it is essential that parliament – and society at large – continue to monitor finance, not just when times are bad, but when they are good too. The gulf between "Mars" and "Pluto" – or bankers and the rest of society – must never be allowed to yawn so wide again; otherwise, we will all be the losers.

September 2011

Ms Gillian Tett, Financial Times; Charles Dumas, Lombard Street Research Ltd and Lord Burns – oral evidence (QQ 1-63)

THURSDAY 8 SEPTEMBER 2011

Evidence heard in Public Questions 1 - 63

Members present:

Mr Peter Lilley (Chairman)
Mr Nicholas Brown
Baroness Drake
Mr David Laws
Lord Maples
Lord McFall of Alcluith
David Mowat
Mr George Mudie
Lord Newby
Mr David Ruffley
Lord Skidelsky
Baroness Wheatcroft

Examination of Witnesses

Witnesses: **Charles Dumas,** Chairman, Lombard Street Research Ltd, and **Gillian Tett,** US Managing Editor, *Financial Times*, examined.

Q1 Chairman: Welcome to the first public session of the Joint Committee of both Houses on the Financial Services Bill. I extend a particular welcome to our first two witnesses. The Committee in its earlier internal session decided that it would like to begin its investigation and discussion by considering the background to the present crisis which has given rise to this legislation, so we have invited both Gillian Tett and Charles Dumas. We are grateful to both of you for your written evidence and taking the trouble beforehand to help educate us by writing books, which a surprising number of members of the Committee have read. If you will forgive me, I will not ask you to make any opening statements. If it is all right with you, we will go straight into our questioning. I wanted to ask a question of both witnesses. If we had had a perfect system of regulation, even better than the one we are considering, would it have enabled the authorities to prevent the crisis occurring in this country or, had it been adopted worldwide, worldwide?

Charles Dumas: As I see it, the source of the crisis was imbalances driven originally by an excess of saving, and mispricing of currencies among the second, third and fourth largest economies in the world, China, Japan and Germany, on the one side, and the United States, Britain and a few other borrowing countries on the other. That imbalance is obviously not

something about which British regulation could have done much, but the expense of the crisis to the British was obviously very substantially enlarged by the activities of various British banks outside Britain in an international context. I suppose it follows that, if regulations had been in place that would have enabled regulators to check some of that activity, the scale of the false and unwise activities would have been much reduced and, therefore, the expense to the British public likewise.

Gillian Tett: I would echo what Charles says. I do not think the regulators are there to prevent all asset price swings, markets and price signals. There were, and still are, very big imbalances in the global economy. In a recent issue of the magazine *Foreign Affairs* there is a fascinating piece by Nassim Taleb, the man who wrote about the black swan. He pointed out that if regulators or governments try to impose perfect stability on any system they risk creating more instability in the long term by not letting systems adjust. However, I think that if you had had a better system of regulation in place you would have had a less dramatic bubble in the upswing. If regulators had stepped in, say, in 2005 when there were already signs of problems developing, much of the resulting damage would have been prevented. More importantly, if regulators had been better organised in the crash there would have been less panic. One of the questions posed in our pre-material was: how do we define "financial stability"? To me, the essence of financial stability is a system of trust. Tragically, the failure to handle regulation widely, particularly during the crash or the downturn, essentially led to a collapse of trust in systems, banks and regulators.

Q2 Chairman: In essence, part of my question is: if there was the flow of finance and credit that Charles describes and that is key to his analysis, and regulators had stopped it going into sub-prime, would there have been less credit, or would it have gone into something else? Would that something else have been worse, like sub-sub-prime, or better?

Gillian Tett: People have often asked me whether all the newfangled products, the CDOs and CDSs, create the crisis. I answer that they did not create the crisis, because there were significant global imbalances about which Charles has written, and which were absolutely fundamental. There was too much liquidity in the system. But what people need to realise is that the presence of these complex instruments created a system of opacity which meant it was very hard for anybody outside the banking world, or even inside it, to understand, first, the scale of leverage in the system, and second, the degree of risk taking. It was that opacity and complexity above all else which concealed the distortions building up and made the problems that much worse on the way down. It was in that, above all else, where regulators could and should have intervened.

Charles Dumas: Stepping back a little, I completely accept the point about opacity. What you might call the Zeitgeist at the time was one of light regulation and that aspect was closely connected with the altogether too free-booting approach to how the economy should be run. I do not think there was any likely implementation of regulations which would have worked. You have to remember that, if the regulations that did exist had been properly administered, for example, in the mortgage market in the United States, a large quantity of the bad loans would not have been made. They were made because the regulation was light, and the light regulation was part of the overall mood.

It is worth remembering that, when running monetary policy, people have other things on their mind than just whether people are making bad loans. For example, in the United States,

between the end of the last recession in 2001 and the end of the boom period in 2007, the average growth rate was only 2.75%, which is a long way below their long-term average, including recessions. They had a bad upswing in that particular cycle, and the inflation rate was less than 3%. The core inflation rate that they like to look at, excluding energy, was only just over 2%, so in terms of what they were trying to achieve they did the right thing. The only problem is that to achieve that they had to have a huge upsurge of borrowing. There were incompatible goals inherent in the situation largely because of the gross excess of saving flooding out of these countries which were maintaining artificially cheap exchange rates.

Q3 Mr Laws: I want to ask a question that follows on from the Chairman's first question. He asked, if we had had a perfect system of regulation, to what extent could we have avoided the problems in the financial crisis? My question is: if we had had the system of regulation proposed in the Bill, how much more successful, if at all, would that have been in your view either in avoiding or in moderating the nature of the crisis?

Gillian Tett: I think it could have potentially helped, for two reasons. First, I think that the creation of an intelligent brain at the centre of the regulatory process, which essentially is what is being proposed through the creation of the FPC, is very important. You need one nerve centre, if you like, to look across the entire financial system and try to take a proactive approach, and, above all else, not so much fight the last war, which was the direction of so much of the regulation before—a kind of box-ticking culture—but to look forward in a flexible and, dare I say, imaginative way. It is absolutely essential that monetary policy and financial regulation be brought together in terms of vision.

I was deeply influenced by being in Japan in the late 1990s. It was very clear to me from experience of the Japanese banking crisis that it was absolutely nonsensical to think that you could look at the money flowing around an economy like water without looking at the pipes through which it flowed, i.e. the financial conduits. It was clear to me back in 2005 and 2006 from that Japanese experience that the way the Bank of England and the FSA were looking at financial regulation was ridiculous, because you had monetary policy examining the water, and the FSA looking at the micro-level details of the pipes, but there was very little attempt to try to bring that together. Obviously, splitting the FPC and MPC risks creating a division, but I have some confidence that, so long as it is clearly recognised that there needs to be a lot of collaboration, overlap and a single financial brain, the new FPC will have more chance of taking a holistic oversight than the system which was in place before.

Charles Dumas: I think that, in terms of future effectiveness, adequate capital will always be the most important aspect of regulation. Without getting into the issue of firewalls between commercial and investment banking and all the rest of it, I think the key thing is that the capital should be actually located in the entity that is taking the risk in question. Of course, that will possibly solve one or two of the taxation problems that exist in the international system. This requires that regulation effectively cover both the global activities of banks that the British will have to bail out in the event of a crisis—in other words, banks located here—and also the British activities of international banks that may get us into trouble domestically, whatever their home regulators are doing or saying.

Q4 Mr Laws: I read those answers as saying that Gillian is optimistic that the new system should have made things better. Charles, I think you are mildly supportive but point to other factors that are almost more important than the domestic regulatory system. Perhaps I may ask both of you another general question before moving on to other colleagues. It is quite a big question, and if you can manage a short answer that will be helpful to other colleagues, but it will at least guide us as we think about the other questions that we should be asking. If you are giving a qualified thumbs up to the Bill, which in a way I read you as doing, could each of you mention very briefly the two primary deficiencies in the Bill that you would worry about and that you think we should be focusing on in our deliberations?

Charles Dumas: Obviously, what we are trying to do here is make sure that what went wrong last time does not happen again. If we look at the Bear Stearns rescue, the Lehman debacle and the subsequent AIG rescue, which in some ways is the most important part, it became clear that what was really driving the whole thing was the cat's cradle of interconnected derivative contracts on a global basis, by which the collapse of even relatively small entities like Lehman could drag down the entire system. I am not sure that it is within the scope of British regulation to take care of that problem, but I think that was the fundamental driver of the crisis. Maybe it is beyond the scope of regulation and it is a fire-fighting activity.

However devious and venal you may think the banking community is, it is unlikely to attempt within the next 10 or probably 20 years the kind of idiotic activities that were going on between 2004 and 2007, so the next crisis, if there is one, in the reasonably near term, will be of a totally different character. It may be the FPC has the imagination, to use Gillian's word, to anticipate it, but it will always depend upon accurate diagnosis of what is going on in a world in which there is not necessarily all that much.

Q5 Mr Laws: Gillian, a couple of defects?

Gillian Tett: There are two details. First, I am profoundly concerned about the question of cross-border arbitrage and the fact that this Bill is addressing some very sensible measures, but it is very limited in what it can do, partly because the British Parliament is very limited in what it can do in the international financial system. I think that cross-border arbitrage will be a very big issue going forward. Secondly, I am extremely concerned about the resolution regime. It seems to me that, although there are good systems in place for medium and small size institutions on both sides of the Atlantic, what is going to happen to a large institution with cross-border activity at the moment remains utterly resolved. Again, there is a limited amount of stuff that the British Parliament can do on this, but I think that pushing for some kind of mutual recognition treaties would make sense; keeping a very close eye on what the FSB is doing would make sense; and, above all else, recognising that that issue is not resolved, and as long as it is not resolved the "too big to fail" question remains very pertinent.

Chairman: I think it would be logical to move now to Robert's questions on the nature of the proposed reforms and the issue of opacity.

Q6 Lord Skidelsky: Gillian, in your written submission—you repeated it—you were very concerned about the fact that the financial systems become so opaque and

complex, in particular with the new derivatives, that it is beyond the capacity of anyone, even most people in the banking system, to understand what is going on. How would you simplify it? If people do not understand the likely implications of what they are doing, how will they regulate it? How are Parliament, the media and all those other informal regulatory devices on which we rely to stop abuse going to understand it?

Gillian Tett: It is an absolutely fundamental question and is one of the reasons I highlighted it in my submission. A number of steps can be taken. First, some of the moves afoot in the US right now to have an Office of Financial Research, which would force banks to have a much more proactive and timely system of reporting activity, would be very interesting. In an ideal world I would be putting money into trying to create some kind of international system for reporting bank positions and capital flows. As to bank shareholders and managers, boards need to become much more active in demanding information about what is going on. I think risk managers inside banks need to be empowered and, frankly, paid more relative to traders than they have been in the past. These sorts of internal dynamics of what is happening in banks are absolutely crucial. But there have to be ways to encourage scrutiny of banking on a more regular basis, not just in a crisis but when times are good. Almost a cultural shift needs to happen. One of the reasons why I think the creation of the FPC is interesting is that, just as the media at present report on the Monetary Policy Committee—it is a bit like a soap opera—in a way that spurs some kind of public debate about the conduct of monetary policy, just maybe the release by the FPC of its minutes or statements will also keep alive the sense of scrutiny and debate about the direction of financial policy.

Q7 Lord Skidelsky: So you are relying on a lifting of the general level of understanding in order to make sense of the financial system.

Gillian Tett: I think that more external scrutiny would be a good thing because it would help break down some of that tunnel vision. It will never be perfect, but I think that, if the bankers themselves had been forced to explain themselves more pre-2007 and there had been more media and political interest, they would not have been in such a tunnel. I remember clearly back in early 2007 talking to people in the industry about complex products and telling them that there was a burning need to explain what was going on and this revolution to people. Somebody said to me, “Well, at some point we’ll get SIFMA, one of the industry bodies, to do a study or something, maybe in 2008.” There was absolutely no sense of urgency.

Charles Dumas: What we had—and have, of course—was that the employees in the banking industry were about the most brilliant capitalists in the history of the world and the shareholders were relatively unsophisticated. Following on from what Gillian said, I think measures to strengthen the governance procedures and stock market responsibilities of managements and banking employees in general vis-à-vis the shareholders could go some way towards rebalancing towards a longer-term view of the interest, rather than the whole thing being driven by a bunch of people operating behind obscure walls and taking the money out in the form of bonuses.

Gillian Tett: The information asymmetry in finance is not dissimilar from, say, the pharmaceutical industry, in that you have profit-seeking companies in control of information that most people do not understand, and very complex processes. They are doing things which have the potential to affect the wider public good and yet they are also trying to make money. But in the pharmaceutical industry there is a well-recognised trade-off between

speed of innovation and safety and cost and safety. Again, I think looking to the pharmaceutical industry for some parallels and indications about what is possible might be useful if we are looking also at finance.

Q8 Lord Newby: I want to make a brief intervention on something about which I have a bee in my bonnet. In the pharmaceutical industry there is a whole cadre of medical writers, i.e. people who are very bright and attempt to make sense of extremely complicated stuff that most people cannot understand. In its simplest form, you get a little thing on a packet of aspirin. It seems to me that the financial services sector is almost devoid of specialists whose job it is to make sense of what is going on and describe it to consumers of the products. Do you agree with that view?

Gillian Tett: I am often asked about the media's track record in covering finance. People sometimes criticise what happened after 2007. To me, it is lamentable how little attention and interest there was across most of the media in what was going on inside finance before 2007. Sometimes I liken the financial system before 2007 to an iceberg. I used to write about this as memos in the *FT*, not because I thought we were like the Titanic heading towards an iceberg but because there was a tiny piece of the system poking above the water, which was the equity markets, and most of the rest of it was concealed under water, if you like, and simply not written about. I agree with you that it is incumbent on journalists to recognise that, frankly, we need to do a better job at illuminating finance, not just because it is a great story but also because there is a wider public good.

Q9 Lord McFall of Alcluith: On the element of complexity, I well remember that a number of years ago the architect of split capital investment trusts came before a parliamentary committee and admitted he did not understand what the effect would be in the real world. I am not surprised now by the implications of complexity. One question I asked regulators a number of years ago, which seemed to be absurd to them, was whether in future they would regulate only products they understood. Is that the key to it? We have CDOs and derivatives at the moment. If there is a CDO with 300-odd pages behind it and a CDO squared with 500, 600 or 700 pages behind it, who will understand it? We will still be walking or dancing in the dark in future if we do not tackle that issue of complexity. How do we do that? Is it product regulation?

Charles Dumas: If we look at the flows that underpinned all of this stuff, the investors cannot be absolved of some responsibility. If you buy something that you do not understand and lose money on it, there is a part of me that says it serves you right. A very large number of institutions in places on the continent and here, but not, oddly enough, in Japan, for example, where they also have a large surplus, just blithely walked into this folly and suffered the consequences. Investors are remarkably careless. I do not think that in a free market you can really disqualify complex products, but, as Gillian says, there has to be adequate disclosure and after that you depend upon investors to look after their interests.

Gillian Tett: I have three quick comments. First, I think it is very important that regulators and supervisors invest in people and systems that try to track finance. It will be very important for the Bank of England to invest equally in the financial stability parts of functions as the monetary policy side. Unfortunately, regulators will probably have to be paid more

simply to make sure they have the calibre and skills to monitor the people in the financial industry.

Secondly, I think that regulators can and should stand up and speak very clearly about the risks of investors buying products that are too complex to understand. They could have stood up in 2005 and 2006 and said it is entirely ridiculous to have a financial system that sells products that are not merely too complex to understand but too complex to trade in many cases. The madness of the so-called free market system was that these products were designed with the goal of creating free markets but they were barely tradable and so were marked according to model prices.

Thirdly, what really worries me right now is not merely the complexity of the financial flows and products but what I sometimes call "complexity cubed". You have complex flows and products right now; you have fiendishly complex reform processes. At least this financial Bill is only 200 pages; Dodd-Frank is 2,600 double-space pages. It is very hard for newspapers right now to understand what on earth is going on with financial regulation. It is one of my biggest nightmares. There are also very complex reform aims. Therefore, there is complexity on three levels right now in terms of the financial system. As a result, the danger of a democratic deficit in terms of people not understanding what is going on in some ways is magnified.

Q10 Lord McFall of Alcluith: In your paper you mention that you welcome the judgment-based approach that the regulator will have in the future. They had a principles-based approach. I can understand none of them. Can you help me?

Gillian Tett: The principles-based approach?

Lord McFall of Alcluith: It was largely hot air. What is the difference between principles and judgment?

Gillian Tett: I interpret "judgment" as being the use of an intelligent, flexible brain, above all else, and a recognition that it will have to be adaptive. I think that "principles" is basically a sense that as long as it is good for boosting London as a financial centre and it is not seen to be doing immediate harm it should be okay. That was the broad financial point, roughly. But the reality is that a judgment-based approach is a gamble; it won't be perfect. Clearly, I am aware that all of my comments about the future are "could" and "should"; they are all hopeful rather than definite, but the rules-based approach, having seen it up close in America, is very flawed, and the principles-based approach is also very flawed.

Q11 Lord McFall of Alcluith: Is it unfair if I sum up your paper by saying that the legislation we are enacting is worthy but it will be ineffective at the end of the day because we do not tackle the cross-border issue, and in terms of resolution we are dealing with firms that have interests overseas so we alone in Britain cannot deal with that? Until we really get a handle on both the cross-border and resolution issues, the question of "too big to fail" is still out there loud and clear for us to tackle?

Gillian Tett: Essentially, yes. Journalists are paid to be professional gloomy cynics. I am quite encouraged by the direction of this Bill. I think it is pretty good as far as it goes. Unfortunately, it goes only a certain way, but it still has good, positive elements. Above all

else, I think that the creation of an intelligent flexible brain and an attempt to change the culture of regulation is crucial, because at the end of the day a cultural shift needs to occur as much as anything else.

Chairman: This probably moves us naturally to the complexity of the whole system and the shadow banking system which David wanted to raise.

Q12 David Mowat: Gillian, in the past you have written about the need better to regulate shadow banking. That was one of the problems that occurred last time. I am not totally clear from what I have heard so far this morning whether you think we are making much progress in that regard here.

Gillian Tett: I think it is very important that the regulators and supervisors have the ability to look across the entire financial system. It is important people recognise that one function of the intense focus on regulated banks and bank capital standards and things is that there is already evidence of activities moving outside regulated banks to non-banking institutions. I have seen this particularly clearly on Wall Street where you have private equity firms, hedge funds, REITs and all manner of financial vehicles stepping in to provide credit services that used to be provided by the banks, specifically because they are not regulated under the Basel rules. It will be crucial for the supervisors and regulators to watch the shadow banking world in a joined-up way. If the FPC does that—I underline "if"—that would be a good thing.

Q13 David Mowat: But if we have created a shadow banking world that is about the same size in terms of balance sheets as the banking world and we are regulating only the banking world and they are free to arbitrage it in the way you said, that must be a huge flaw. It is hard to see how we can fix it, and the FPC is only a UK-based body, is it not?

Gillian Tett: Exactly. It is potentially a big risk and something which the Americans are debating in terms of the FSOC. There is more hesitancy on the part of American regulators at the moment to reach into the hedge fund, private equity and REIT world. Everything will depend on whether the FPC and PRA not merely monitor the shadow banking world but are enabled to step in and impose some form of control on that.

Q14 David Mowat: You called the FPC an intelligent brain. I think that is a good way of thinking about it. For shadow banking do we not need a globally intelligent brain? We need a global FPC and without that it is quite hard to make progress.

Gillian Tett: It is one of many things on the "to do" list for regulators. I have spoken to the FSB quite a few times about this. There is now a body of opinion, particularly in New York, which argues that by focusing so heavily on the Basel rules for banks the FSB is encouraging this flight of activity into the shadow banks. What the FSB tells me—again, I have been at recent banking conferences where it has been challenged on this—is that it is really an issue of sequencing. It wanted to get the rules in place first for the banks, talk about capital and liquidity, and now it is coming on to the shadow banks. As I understand it, there is a lot of work and debate going on right now in that respect. Watch this space. I just hope they recognise the problems, because the number of conversations I have had in just the last two weeks alone with people on Wall Street about how activity is moving to private equity firms, hedge funds, REITs and other vehicles is very striking.

Q15 David Mowat: Charles, do you want to add to that?

Charles Dumas: I am less concerned about this than Gillian because I don't think this is where the next crisis is coming from in any kind of foreseeable future. The hedge fund industry, which was much abused in 2007 and 2008, came out of the whole thing quite well, considering. Most of these guys are pretty intelligent investors and don't necessarily make quite such big blunders as the short-term, in-out-type banking arrangements that persisted at that time. If we look at where the crisis is coming—it is coming soon, next year if not this—to the extent it affects banks at all, it is to do with holdings of government debt. The problem in the immediate future is nothing to do with this sort of regulation. I completely agree with the idea that in principle many credit-giving entities above a certain size should be within the purview of regulators, but as a priority in current circumstances it does not come high for me.

Q16 David Mowat: In an earlier answer I think you mentioned we had £4 trillion or $4 trillion worth of derivatives. Is there a danger posed by that in terms of it not being understood or its systemic risks that this Bill is addressing? Could we do more?

Charles Dumas: I am not quite sure how this Bill addresses derivatives, but there is in the region of 3 or 4 trillion of over-the-counter derivatives recorded by the Bank for International Settlements in a manner that probably records both sides of each position and therefore doubles the actual volume. Obviously, that is huge and substantially larger than the derivative positions on the public exchanges, so in that sense this is the real market. Half of it is oil. At the peak of the oil price in the middle of 2008 the number was 12 or 13 trillion. It came down very sharply because the oil price came down. The interesting thing is that, when the oil price came down to $30 or $40 by December 2008, it came down to about 4 trillion and did not go back up again when the oil price returned to the three-figure level as it has. That particular form of activity relative to the volumes in the market has declined a little. I am not so concerned about that. There is a bubble in commodities, but I think that derives from the fundamental bubble in the world which is the Chinese economy with an investment rate of 48% of GDP, which is insane, unprecedented in history and is bound to cause enormous trouble as it deflates in one form or another over the next several years. Of course, behind that investment lie terrific inflows and inventories of metals and to some extent energy, so when that thing comes off the boil there will be very violent fluctuations in those markets. I think that is a much more important source of future instability, together with the sovereign debt problems, than the issues that one is addressing in dealing with the banking crisis we had before.

Q17 David Mowat: To go back to the question I put, your judgment is that that 4 trillion worth of derivatives is not in itself the major issue for us.

Charles Dumas: What you have in place here is okay for the time being. In 10 years there may be a different problem and time for a different approach.

Q18 Mr Brown: You say that the hedge funds collectively have emerged from the turmoil in reasonably good shape. Am I right in understanding that a principal reason for that

is that the American Government bailed out AIG and insisted that it pay out its obligations to a number of hedge funds dollar for dollar, and therefore the hedge funds emerged unscathed? Is it correct that had it not been for that large bail-out by the American Government they would not have emerged in good shape?

Charles Dumas: First, to be quite frank I do not know. Certainly, the American Government paid out a huge amount. As we know, a large quantity of it went to Goldman Sachs, which was very convenient for Goldman Sachs, and I have no doubt a lot of it went to the hedge funds. All I am saying is that the hedge funds for the most part did not emerge in too bad shape. Had they taken more of a beating because of not being bailed out by the American Government via AIG they would have lost some money, but that is what hedge fund investors risk when they buy hedge fund investments.

Q19 Mr Brown: My point is that it is not much of a risk if the poor old taxpayer has to bail it out.

Charles Dumas: You did not have to come in and bail them out; the American Government chose to do so because of the system, not the hedge funds. If it had been just hedge fund potential losses, the American Government might well have said, "Tough."

Q20 Mr Brown: They did immediately afterwards with Lehman Brothers, did they not?

Charles Dumas: Yes; and three days later with AIG they realised just how much it was.

Gillian Tett: The AIG bail-out was a pretty dirty, messy story. It was not so much that the hedge funds necessarily benefited; it was a range of banks, including not only Goldman Sachs but a range of French banks as well. It is worth bearing in mind that as far as concern hedge funds a number of them have failed in the last few years. In any given year in the hedge fund world there is a large number of failures and start-ups. The beauty of hedge funds, if you like, is that for the most part they are small enough to fail without taking down the system. In some ways they offer more diversity and variation than the banking system. One can almost argue it is a better model. The issue at stake with shadow banking today is not simply about hedge funds but about whether we are moving credit-creating facilities into the shadow banking system rather than the banking world. There needs to be credit creation. One of the things that the flexible brain of the FPC will have to think about is not simply whether it needs to lean against bubbles but against contractions too, which is a very important point, and whether in future there will be so much pressure on the banks. They cannot lend and they will have to rein back their operations that way. It is really the credit-creation function of the shadow banking world that needs to be monitored, and in that respect things like money market funds arguably are more important than hedge funds.

Q21 Mr Mudie: I am glad that you are taking a more worried view than Charles, but can you tell us the scale of the money markets in the shadow banking system? You refer to an intelligent brain. It is very good that we are having this with the FPC. You cannot have good judgment and a good brain working out solutions to problems if you cannot see the problem and you don't have all the information. Is it not worrying that the scale of the shadow banking world dwarfs the formal regulated system? As you have said, if you regulate

too tightly it will go down there? You referred to "looking at it"; Lord Turner at the FSA refers to it as "oversight of it"; nobody talks about regulating it. Why?

Gillian Tett: First, the scale of the shadow banking system has declined since 2007.

Mr Mudie: It is still massive.

Gillian Tett: It is still very large indeed. I wish that bankers would use some of the amazing innovation they have, not in terms of financial arbitrage but information technology systems. It has long been baffling to me that a country like America, which has an incredible dynamism on the west coast in creating internet companies that can track instantly what everybody is doing all over the world, cannot at the same time inject some of that innovation and dynamism into the east coast financial system to track what bankers are doing in real time. A tremendous amount could be done to get better data from the banks in real time and to get their back offices more co-ordinated so that people can monitor it much more closely. That is something which the OFR and others are trying to do at the moment, and I think the UK should be collaborating with the US on that front.

In terms of regulating the shadow banks, there is a strong case to be made for better oversight and the ability to rein in some elements of activities when they become dangerous, but then you run headlong into the problem of cross-border arbitrage.

Chairman: That brings us naturally to Jean and the international dimension.

Q22 Baroness Drake: If I may put a question to both of you, given the role of the Bank of England and the intelligent brain, which is a wonderful phrase, that is anticipated in this Bill, in your view which key aspects of financial stability are open to influence and control by the UK Government, and which are not?

Charles Dumas: Let me tell you what I think are the elements. I give ball park-type figures of a stable system. You asked how each of us would define financial stability as a starting point. I have got down here debt ratios: household debt should be less than 110% of disposal income, which probably runs to about 80% to 85% of GDP; net non-financial company debt should be less than or equal to 70% of GDP; net Government debt should be less than or equal to 75% of GDP, and the total of those three percentages together should be less than 200. Inflation: it should be less than or equal to 3%; current account, plus or minus 3% of GDP; and the Government balance should be not more than 3% of deficit, which leaves you with a private sector typically in the 0% to plus 6% financial balance. To me, those are the elements of a stable system. We won't get anywhere near there in the near term, and that is the biggest policy challenge, rather than worrying about people borrowing money, because people have borrowed too much money. I am bound to say that all this concern about too much debt, particularly private sector debt, seems to me a classic example of closing the stable door after the horse has bolted. The private sector and Governments are deleveraging and will have to continue to do so for quite a long time.

What is open to influence and control by the UK? Obviously, the foreign exchange rate is affected by monetary policy, so getting monetary policy right in relation to the rate of inflation is crucial. The conditions surrounding mortgage debt seem to me to be a fundamental area that should be addressed, and that is related to my point that household debt should be less than or equal to 110% of disposal income at normal interest rates,

bearing in mind that right now the number is about 160%. The whole British household sector is fundamentally being subsidised by the policy of zero interest rate, which soaks the saver in favour of the borrower. The world is very kind to borrowers at the moment, because there are too many savers. The world's savings rate was at its all-time high in 2007, contrary to people's assertion that there was not enough saving, because of excess savers in Germany, Japan and China. It is now at the 2007 rate and it is supposed to be higher next year, which is why there will be a crisis, because there won't be the possibility of investment to match it. So you have a household sector which is solvent because of entirely artificial and highly negative real rates of interest. Clearly, the conditions surrounding the advance of mortgage debt should be in some sense set to ensure that people cannot just run household debt up to 160% of GDP. I do not know exactly how you do that, but to me that is something regulation might be concerned with.

Obviously, fiscal policy is directly concerned with the Government side of things, but that is not what we are talking about here. Apart from that, I think the most important thing is something which Gillian has hinted at. We need major co-operation with the United States, because the two great financial centres are New York and London, and getting things right between New York and London on an agreed basis would create an axis of rock solid stability in the centre of the system around which stupidity in places like the Cayman Islands and elsewhere would be less significant.

Gillian Tett: I would echo much of what Charles says. I think that what financial regulators in Britain need to do is watch carefully. That is what they were not doing before. They need to educate people. Above all else, they need to foster a climate of prudence through both regulation and speaking out and talking to people. That idea of fostering a climate of good old-fashioned prudence needs to occur at the consumer level. For example, if the Bank of England and the FSA had spoken out back in 2006 more clearly about the danger of taking out excess mortgage debt, that would have been sensible. If the UK had a system like Canada where there are LTVs—loan-to-value ratios—in place for mortgages, again that would have been very sensible. There are practical things you can do in shaping mortgage behaviour. As to the banks, if regulators were to speak out more clearly when they see banks or non-banks taking financial risks, that would be helpful. There was a kind of cultural excuse for those who bought complex products they did not understand back in 2006. If the Bank of England or FSA had spoken out about the dangers of that, it would have forced, say, pension funds to think a bit more. Again, through things like capital and liquidity ratios you can also actively impose more prudence on the banking sector.

Q23 Baroness Drake: Taking forward those views in terms of regulatory policy, in your view how important is it that the UK has a regulatory framework or conditions similar to those applying in the EU? If the UK seeks to set tougher requirements, what would be their implications in terms of UK interests? I am trying to understand the balance between adhering to the EU framework but imposing greater stringent and prudent measures in the UK.

Gillian Tett: I think it is incumbent on politicians and financial bureaucrats to state clearly that the public needs to make a choice right now. You can have a safer and more costly system where the cost of capital goes up and some of the financial business that is currently in London may flee, or you can have a system where the cost of capital appears to go down for periods of time and London flourishes as a financial centre but it may create greater

costs over many years. Once again, I think the parallels with the medical industry are interesting here. People accept that there is a trade-off in the public interest in creating safe drugs but you may have slightly less innovation, and maybe some of the pharmaceutical companies do not make as much money or do not choose to base their activities in a certain jurisdiction. I think the trade-off between cost and safety has not been clearly spelt out to the British public. It needs to be accepted up front and, frankly, one should try to steer for a middle ground. It would be a mistake to drive all business away from London. At the same time, if you try to have a race to the bottom, as jurisdictions were doing before 2007, that is also a bad idea.

Q24 Baroness Drake: If the Bank of England was trying to set this trade off and it was deploying its new macro-prudential tools, in your view where would be the main constraints that the EU regulatory framework would impose on the deployment of those tools? Where would the tension be there?

Gillian Tett: There would be immediate tension on derivatives activity and the more mobile aspects of wholesale banking. If, for example, the FPC further down the road decided, as has been the case in places like Singapore or other parts of the far east, that, say, the mortgage market was getting out of control, and it imposed some kind of LTV ratio on mortgage borrowing, or something like that, there would be less likelihood or danger of a flee. It is really the wholesale activities which potentially would be able to move.

Chairman: We have 10 minutes to do the two remaining groups of questions, both of which are very important: first, the interaction of monetary and financial policy; secondly, the structure of banks. Richard and Patience have questions on the first; and Patience and John Maples on the second. Richard, would you like to start off on monetary and financial policy?

Q25 Lord Newby: Gillian, you said that monetary policy and financial regulation should be brought together in terms of vision, but there is a question about bringing them together in terms of practice. We have the existing MPC and the FPC, which is a new body. First, how far do both of you see potential conflict between what those bodies may wish to do? Secondly, how far do you think the existing provisions both in the Bill but also in the guidance being drawn up by the Bank of England are likely to resolve those kinds of conflicts?

Charles Dumas: I don't see all that much conflict except through lack of communication more than anything else. If we go back to 2007, and what I think was a legitimate sense that the then Mr Mervyn King was not quite sufficiently aware of the risks to the system, the fact that the FSA was a totally separate organisation and clearly dropping the ball relative to Northern Rock, for example, was the primary point. If the whole thing had been under one roof at the Bank of England it is unlikely that the Governor would have been quite so distanced from proper information about the state of the national markets. But the deeper point here is that the academic economic profession has supported a large number of people over the last 20 or 30 years who have produced all their models and views with complete disregard to the operation of the banking and financial systems. We have had a whole bunch of people coming out of the thing thinking that, to take Gillian's analogy, the level of the water is the only thing that matters and the pipes are not important. Quite clearly, that will change. As long as the communication is there, it is fine. The only time it will actually need to interact or affect monetary policy because of a situation in the financial system will be a

crisis, but, to the extent there is proper communication, the ability to do so in time should not create any serious conflicts.

Gillian Tett: Wherever you draw the boundary between the different institutions, you create the risk of overlap or duplication or things falling between the cracks. That is just a reality that should be recognised up front. I think the fact that people are talking about how to get the FPC and MPC to co-ordinate their activities is important, and people need to keep asking that question. One of the interesting things about the FPC is that adopting macro-prudential tools will give a wider range of weapons in the toolkit than at present. Monetary policy in some ways is incredibly crude. The use of macro-prudential tools is a gamble. There is not a body of literature or conventions out there. They have been using developing market jurisdictions but they have not been used extensively recently in western jurisdictions. But the reality is that whatever regime is put in place and whatever system is adopted will have to be constantly revisited. People will take wrong turns; it will be experimental, but it is better to have a system where people recognise up front they need to keep trying lots of small things and monitoring it and debating it than have people thinking, as they did pre-2007, that they had found the perfect way to run a monetary policy for ever; that central banks were now the maestro, in the case of Alan Greenspan, and that no more debate was needed.

Q26 Lord Newby: I have a quick question following on from that about bubbles. If you go back a decade, the Governor said that the role of the Bank was not to worry about asset price bubbles and he could not do it. I think there is now a view that that was a dangerous view. I think you have partly answered the question I was going to ask. To what extent do you think, first, that bubbles need to be regulated or watched more carefully in future; and second, to what extent do you need a balance of both monetary and macro-economic tools to tackle bubbles? You cannot do it just by monetary policy and macro-economic activity prudentially.

Gillian Tett: This is one reason why I think that macro-prudential tools could be useful. I take two tangible examples: first, mortgage markets and house prices. If house prices spin completely out of control, monetary policy is not the only weapon; maybe things like LTVs can also be used. Secondly, if you look at what happened in, say, the CLO market before 2007, you had junk bonds and leveraged companies getting crazy amounts of money, even though interest rates were going up, because the creation of the CLO market effectively changed the way the pipes operated very significantly. There could have been a role for the Bank of England, FSA or other supervisors to speak about the dangers of the CLO market and look at potential macro-prudential regulations there as well.

Chairman: We had better move on to the issue of the structure of banks. I don't know whether Patience or John would like to lead off.

Q27 Baroness Wheatcroft: Because we are running out of time, I will keep it very brief. On the structure of banks, I would be intrigued to know whether you both feel that ring-fencing, as we have seen proposed by the interim Vickers report, would be effective or whether clever bankers might find ways of breaching ring fences.

Charles Dumas: I am not a keen fan of ring-fencing. The nature of modern banking since really the interest rate swap invention in the early 1980s, and arguably the move of

commercial banks into foreign exchange in the 1970s, has been such that almost inevitably you have an integration of various derivative-type activities with the primary loan activity. They are almost bound to be connected up and likely to be inside a specific organisation. You can ring-fence a conventional safe bank, or whatever it may be, with certain rules about the kind of things it can do and its deposits. I would certainly be in favour of any entity having the requisite capital in the entity rather than somewhere else in the broader group organisation so as to make sure that, if something goes wrong, the capital is where it belongs rather than maybe in the Cayman Islands or somewhere like that. But, beyond that, I don't see much point, because in a real crisis you have to come in and bail out the overall system, as we have seen. Therefore, it is fine to say that it is ring-fenced and so you won't deal with it, but actually you will deal with it.

Gillian Tett: The benefit of ring-fencing is that, first, it prevents banks from using cheap capital from savers to finance risky gambles or incorrectly price that capital and flash their returns; and secondly, it ensures that if there is a crunch you have enough money in the system to protect bank deposits. Ring-fencing is not the only way to do that. It is one way to do that, but it does come at a cost, particularly if the UK is the only country that does it. To my mind, it is still very unclear what would be on either side of that ring-fencing. We are waiting to see what the Vickers report suggests. The key question is: what is going to happen to commercial banking? What is going to happen to corporate lending? Until that is answered, it is hard to come up with a sensible cost benefit analysis.

Baroness Wheatcroft: I think that must be true.

Q28 Lord Maples: The whole discussion goes to the heart of something that you have both written about: the behaviour of bankers during the crisis. These seem to be institutions that do not owe loyalty to their customers. They sell a product out of one door; their proprietary trading desk shorts it out of the back door knowing that what they have sold is rubbish, and they pull the wool over the regulator's eyes. Lloyd Blankfein had great difficulty describing to the Senate Finance Committee what the concept of a customer meant to Goldman Sachs. We talk a lot about the structure of regulation and relatively little about the structure of banks. Would it not make sense to say, for instance, that we will split retail banking and investment banking and ban proprietary trading by banks? If you want to run a hedge fund, set it up as a completely separate entity with completely separate capital and shareholders, because you cannot take naked positions in derivatives. As I cannot bet on your life expectancy, why should I be able to bet on your ability to repay your debts if I don't hold any of your debts? It seems to me there is a whole series of things we can do about what banks can and cannot do, and their structure, so that not only do you have the separate capital in the entity that Mr Dumas talked about but it is actually a completely separate organisation. Therefore, the bit we have to step in and bail out is smaller, hopefully less risky and, when you do have failures, it will be easier to handle. We are told that we pay a high price for this in cost of capital, but I rather suspect the cost of capital in commercial banks will go down and in investment banks it will go up. I am not at all convinced that the aggregate would be worse. Would both of you like to comment on what is a pretty fundamental thing about the behaviour of banks?

Charles Dumas: All I can say is that when it came to the point we felt we had to bail out the whole system, because it is all interconnected through these derivatives. I suspect that will continue to be the case. When it comes to the business of separating out trading or

positioning activities from market-making activities, it is not so easy to do. About 20 years ago I spent a long time on the trading side of J P Morgan. In the Government bond market, which after all is the primary flow of lending in the world today and therefore easily the most important market around, it is absolutely essential to be able to position yourself if you are to bid an offer on the screen and enable people to trade with you in suitable volume; otherwise, market makers will get completely murdered if they are not in a position to take a view and hold a position. Therefore, in very important aspects of trading activity, which are vital from the standpoint of the operation of the whole system, you have to let these people hold positions. You can say that all kinds of bread and butter consumer banking, maybe a small business, should be in an entity that is separately and properly capitalised and ring-fenced in that sense, and that trading activities and the riskier forms of wholesale banking should be at holding company level. Therefore, it is more vulnerable and in principle you make the shareholders suffer if something goes wrong, but the idea of saying that you cannot do any of this stuff if you are a bank will just drive the business out of the country. I don't think for a moment that it will stop people finding a way round it.

Gillian Tett: I would echo some of what Charles says. Pure prop trading is probably best handled by hedge funds or an entity in a partnership structure. There is a case to be made that retail deposits should have some utility aspects to them. But the questions I would really urge the Committee to think about are where they want commercial lending, risky corporate lending and small and medium size business lending. That is a crucial question people need to ask. If it ends up sitting purely within a utility function there is a danger that any risky lending will get cut off; if it ends up sitting on the investment banking side, again it gives the issue a new perspective, but to my mind that is a key question people should be looking at.

Q29 Lord Maples: Do you think a split is impractical?

Gillian Tett: It could be done, but it would be very difficult. I think it is more practical to look at ways of subsidiarisation and capital backing specific operations. Some form of ring-fencing is more practical but it does come at a cost which should be recognised; or, better still, get a proper resolution regime in place which is able to handle bank failure, because that really is the 800-pound gorilla in the room that people are not yet talking about properly.

Chairman: We are intending to discuss it later, so we recognise that gorilla. Thank you both very much indeed for the lengthy and extensive grilling that you have put up with, and the contributions you have made both before and during this session. We are extremely grateful to you.

Witness: **Lord Burns,** non-Executive Chairman of Santander UK plc and Alliance & Leicester plc, examined.

Q30 Chairman: Thank you very much indeed for joining us, Terry. I am not sure how many hats you are wearing here as a banker, a former Treasury official, and the person who chaired the first ever pre-legislative scrutiny Joint Committee of the two Houses which considered the Financial Services and Markets Bill back in 1999. Perhaps I may start the questioning by asking whether in the light of your experience in giving some scrutiny to that legislation you have any advice to this Committee, or any lessons that can be drawn from what was and what was not considered at that time.

Lord Burns: Chairman, thank you very much. I thoroughly enjoyed my experience on that Joint Committee. I think the view generally held at the time was that it had worked well. There was a lot of expertise from both Houses, which is obviously being repeated on this occasion. The main lesson and value I personally got from it was that, after some general hearings at the outset of the kind you are having now, we moved into a style of operating where we had chosen some major generalised topics. We had panels of witnesses; both the head of the Treasury Bill team and the deputy counsel of the General Counsel at the FSA were present, and we sought to get all of them involved in the discussion of the issue. There were, in a sense, quite rapid iterative conversations. One of the frustrations that the private sector has in dealing with government is that it puts in its comments or asks a question and after a long delay it might get some kind of response. The whole process works extremely slowly. I think we succeeded in speeding it up a great deal. Both the representatives of the Treasury and the FSA did extremely well in trying to help guide some of the witnesses, for example, as to where issues had been covered, or why they were specified in a particular way. To some extent it became almost a parallel to what happens in the Chamber where very often the points that people are raising have been covered somewhere else in the drafting or not covered because they are in some other document or legislation. We spent a lot of time on that once we had sorted out the major issues.

Secondly, I think people generally found the real value of those sessions was not in going through the drafting or doing the detailed work that subsequently had to be done, but trying to identify the major issues and having a good Second Reading debate about them and getting input from the official side as well.

The third point is that it was in the early days of the internet, but we tried very hard to get all written and oral evidence published as quickly as possible so that people in the outside world could keep track of what was happening and see where the discussion had reached, because very often there is a lot to do in quite a short time. We dealt with quite a lot of issues then in terms of fear of excessive regulatory burdens on the industry and the disciplinary and enforcement processes, which I suspect will not figure quite so significantly on this occasion. But there are quite a lot of very important issues to do with the objectives, remit, accountability and governance of the FPC; for example, the way in which separating the FSA into the PRA and FCA has implications for how the objectives are set. It is a question of finding the mechanism which enables interchange to take place between the people who come to give evidence and the Committee such that as much clarity can be obtained as quickly as possible. I have sat on both sides of these Committees. Sometimes they can be really long drawn-out procedures and they work at a rather slow pace, whereas I think one wants to move pre-legislative scrutiny at a reasonable pace.

Chairman: That is very helpful. Talking of pace, Nick has a pithy question to open the bowling.

Q31 Mr Brown: My question is not about the regulatory structures but what we as parliamentarians should expect a regulator to be able to do. In an ideal world, if we had a blank piece of paper, what should we require or at least hope the United Kingdom regulator could do? How would the regulator get under the skin of those who really do not want to be regulated and whose operations, which have a big effect on the United Kingdom, are taking place in other jurisdictions, principally the United States?

Lord Burns: If you are saying that regulation is difficult—

Mr Brown: I am certainly saying that.

Lord Burns: I agree with you. In our kind of economy the way we try to control most entities is through market processes: the process of competition and transparency of governance - the people who sit on boards and the accountability they have to their shareholders. I wholly agree that there are lots of industries, including the financial services industry, which because of their characteristics need regulation. Many of the products are sold over long periods of time; there are all of the systemic issues that are talked about that are enormously important. Of course, the costs of it going wrong are huge, as with many utilities if that were to happen. One has to be quite realistic that regulators will never be able to see that future in some extraordinary way that other individuals or markets cannot. One can give them a remit that asks them to scrutinise things and take particular things into account; one gives them resources to conduct supervision that maybe individual organisations do not wish to do themselves; and, above all, one hopes they can get a "system" view of what is happening rather than with individual sessions. But in various industries and activities in which I have worked I have tried to ensure all the time that people do not have over-optimistic expectations of what regulators can do.

Q32 Mr Brown: What precisely and specifically should we expect them to do?

Lord Burns: We have to be very careful. I hope this is what you are getting at. We have to set them objectives that they can reasonably be expected to meet with the resources they have at their command. What I hope they will do is to be able to take a position and analyse things in a way which individual firms cannot so they can see the impact on the whole system. They can also take into account other stakeholders, and they try to correct basically for those areas where market pressures are not as effective as they might be - either because of the structure of the industry or whatever.

In the case of financial services there are two broad areas where we have been looking to the regulator for help. One has been the whole area of prudential supervision. It is very important to have people who look at this from the point of view of system rather than simply the view of an individual bank. The second broad area has been conduct of business. If we take the particular characteristic of financial products which very often are sold to people who do not fully understand them, they have effects over a very long period of time. They are often very complex. One wants to have a set of arrangements to ensure the customers are being treated fairly and people go about their business in the right way. It is a balance between being over-regulatory or not sufficiently regulatory. By and large it is done reasonably well. There is a tendency for over-regulation, but I think we are broadly well served by it.

The prudential side is much more difficult because, when you get it wrong, it is because very often you have not foreseen the future. As we know, foreseeing the future in most walks of life is very difficult. Some people do it better than others. Just as in the setting of interest rates, there are some periods of time when it is done better than at others. But prudential regulation in relation to prevention of financial crises is a very difficult thing to do. Prudential regulation from the point of view of making sure that individual firms are behaving correctly, that - they are not up to some kind of deceitful activity, or getting themselves into trouble in a way they are trying to disguise from shareholders, is easier to do.

Q33 Mr Brown: For completeness, how do we protect our country from these very large deals that are taking place outside the jurisdiction of the United Kingdom and in the shadow banking system in the United States?

Chairman: Nick, you are now moving to another section which I would like to take later. Perhaps we can move to the tripartite and twin peaks issues which David is going to deal with, followed by John Maples.

Q34 Mr Laws: I want to move to some fairly predictable questions, if you will excuse me, which are nevertheless quite important ones. Our briefing paper credits you as being one of the people who was instrumental in establishing the existing tripartite system we are now trying to get rid of because people think it has all sorts of weaknesses. When you look back from today's vantage point, having had all the financial crises occur, do you think, boy, we have made some big errors in the way we set up all of this and there are lots of deficiencies, or do you think that this is all very unfair, there has been a crisis and this is just a "something must be done" response?

Lord Burns: I think it is an unfair description of my role. I was not a designer of the system; I was engaged in helping people who had designed it to put it in place.

Q35 Mr Laws: You can be even more candid than that.

Lord Burns: In particular, over the period 1997-98 I was trying to get the various parties together to get a solution to how all these various pieces fitted together. So I was certainly actively involved and I saw a lot of it. This has been well written about. At the outset, when the new Government put in place the arrangements for the MPC and gave the Bank of England operational independence as far as interest rates were concerned, we were immediately into a big debate as to what should then happen to the role of the Bank of England as far as concerned banking supervision. It is well known that I was very cautious about moving banking supervision away from the Bank of England at that stage and wanted to see the system settle down before moving to the new arrangements. But the decision was taken very rapidly to move banking supervision out of the Bank of England and to create the FSA. I then had a role in trying to negotiate the arrangements among the new FSA, the Bank of England and the Treasury on a number of quite delicate issues about what remained with the bank and what moved to the FSA.

If you ask what went wrong, they were all areas that we knew were sensitive. I think the end result, as previous speakers and many others have observed, is that there was in the new structure created insufficient attention given to the prudential aspects of financial stability;

particularly with respect to capital adequacy and liquidity management. The FSA was given the job of supervising and regulating the banks. The Bank of England was left with a general objective about financial stability; indeed, a new deputy governor post was created to look after financial stability. But the Bank of England had no weapons as far as that was concerned.

My interpretation is that we went through a period when the bank paid much more attention to the MPC and rather less to the issues of financial stability. For one reason or another the FSA, partly because we seemed to be living through a very stable period, paid more attention to the conduct of business issues in terms of its remit than to the prudential aspects. Therefore, the prudential part of this ended up being under-examined. And the crisis that blew up in 2006-07—of course, it was not a UK but world issue—was really focused on the prudential issues.

Q36 Mr Laws: From that statement, would it be fair to say that you more or less share the Government's view of the deficiencies of the existing system?

Lord Burns: I do.

Q37 Mr Laws: Do you feel that the Government have got the new proposed structure more or less right, or is there anything in the solution that is being brought forward in relation to the overall regulatory structure that you think is deficient?

Lord Burns: Before I answer that, there is one other issue which I knew would certainly cause trouble at some stage; it was only a matter of when. That was the tripartite arrangements to deal with a crisis and issues of lender of last resort. There was a very elaborate MOU which was never really tested until the moment it really mattered. I think everyone agrees that when the moment came it fell short. To go back to your point, I fully support the notion of having the FPC and a body that is charged with looking at macro-prudential issues. I think it will strengthen that whole area. We will never get it completely right because, as I said to Nick, a lot of times getting it right involves being able to see things which are very difficult to predict. But I think that it will strengthen our hand. I also think that separating the prudential side and conduct of business side will mean more attention is paid to the prudential side, because that organisation then cannot go to sleep because it thinks everything is well and pay all its attention to the conduct of business side.

We also have to recognise, however, that you create another set of overlaps, or under-laps, to which Gillian Tett referred earlier. Every time you create a new structure somewhere you will come across boundaries with jagged edges. Although I see great strength in the new system's concept, we will have to be very careful about the way the FPC interacts with the two regulatory bodies and the two regulatory bodies interact with each other; what the Treasury's role in all of this is; and the extent to which there are remits which are clear so there is proper parliamentary accountability for the activities. Of course, I observe that the FPC is gaining a greater degree of independence than was probably the case before. There are still plenty of issues to be resolved. But, as long as we do not hope for too much from it and think that it will solve all problems in all circumstances, it does tackle the issues that were certainly at the centre of the problems in the crisis that happened.

Q38 Mr Laws: If we had had this architecture in place from 1997-98 rather than the tripartite structure—I think you are hinting that there were some obvious deficiencies in the tripartite structure from the beginning—are you relatively optimistic that we would have been more successful in preventing or moderating the financial crisis of 2007-09 than with the existing tripartite system?

Lord Burns: We would not have avoided it. It was a crisis that affected the world; it affected everyone. The only question was the extent to which it affected us. I do not know of any clear evidence that we were worse affected than we might have expected to be given the size of our financial sector. But I suspect that we were.

Q39 Mr Laws: My question is: if we had had this system could we have been more or less successful?

Lord Burns: I think that if we had had this system we would have been more successful; in other words, we would have been less severely damaged. The second part of it is that measures have been introduced since. One of the problems was that we had no resolution regime. A lot of work has already taken place on that. We know from Alistair Darling's memoirs that the whole process of the tripartite arrangements at the early stages of this crisis really did not work very well. All of that came as quite a severe challenge. The only danger is that this is quite clearly a response to the crisis we have just had. Almost by definition, it addresses the things that went wrong in the crisis we have just experienced. It would be a terrible thing to think that we were creating something that would not have coped better with the crisis we have just been through. A much bigger issue is whether it will deal with the next crisis, because we do not know where that will come from or what the sources of it will be.

Q40 Lord Maples: What some of us are deeply sceptical about is how moving exactly the same people who are running the FSA and the Bank of England into a new structure will make regulation better, because it is not about structure but about the quality of the regulators and what they do. I would ask you for a couple of thoughts about that. First, you said it was important to look at system failure, but system failure arises because banks stop trusting each other, so it is really due to the failure within an individual bank. People think that they do not have the liquidity; they are borrowing too much money in the short-term money markets; their assets are not as valuable as they say they are, and so they stop lending money to them. The system fails because individual components of it look as though they will fail. Secondly, you said that we are always very focused on the previous crisis, which is true. I am sure that the regulators and the bankers will make sure that this crisis does not happen again. They will sure as hell be stirring up a new one in eight to 10 years' time. They all have a common theme, which is that, as the credit cycle progresses, they start to lend money to people who cannot pay it back. They are worse and worse credit risks; they mis-price them and they get a crash. It seems to me that if you have good people focusing on where credit is growing too fast and trying to do something about it sooner, which may also be partly a function of monetary policy, that will be rather more valuable than the structures or what buildings they sit in, or indeed the names of the people.

Lord Burns: Broadly, I agree, but surely what this legislation is designed to do is ensure there are bodies of people whose job is to do exactly what it is that you describe.

Q41 Lord Maples: But it is exactly the same people who got it wrong last time.

Lord Burns: Yes, but they have been given a remit which is rather starker in terms of the things upon which they have to concentrate. I think a lot fell between the cracks under the previous regimes. We had one body that was doing both prudential regulation and market conduct. You had another body that was supposed to be looking after financial stability but did not have any tools. Therefore, we have moved the body with the tools in with the people who have responsibility for financial stability. That should help on that side of things. I agree with you that almost all booms and financial crises have their origins to some degree in over- lending or asset price bubbles, though for various reasons people think that this time it will be different and there are reasons why we can put up with it this time.

If you remember, all the stuff that was being written throughout the 1990s and into the 2000s about how we had managed to distribute risk around the world into different companies through different products. We had managed to have a lot more credit and yet we had a much safer system. That became a very prominent view. Let's call it the Greenspan view, but it is not fair to say that it was only his view. When a particular set of circumstances came together, that view turned out to be wrong because of the interconnections. We had not, in a sense, defused it; we had hidden a lot of it. When the match was put to it, they were all connected in such a way that it turned out we had not really distributed the risk. That was a mistake. Obviously, some people were worried about it, but, on balance, it was a mistake made by the industry and regulators around the world. What is the protection against that? It certainly is not institutional and structural change, but I think we could have done better here, even faced with all of that. The carnage in our banking system is not something that looks very clever, even when you compare it with other countries that had their own problems.

Chairman: One of your many hats is the Spanish position. I think Robert wants to question you about the experience that may give us.

Q42 Lord Skidelsky: Just before that, what is the protection against the mistakes? Would you say that one of the protections is better academic theory? There was a theory that presupposed the absence of such mistakes. That is not the main point of our inquiry.

Lord Burns: But the professions and the academics did not do terribly well on this in this period either, did they?

Q43 Lord Skidelsky: No. I think they influenced the way the regulators felt about it. I want to ask about how effective you think additional dynamic provisioning would be in preventing such a thing. It seems to me that you run into the same problem. One is assuming that one has enough knowledge about the dynamics of the economy to be able to specify the right levels of reserve provisioning, whereas we do not. One knows that governments ran into terrific trouble trying to time the business cycle, and it also allowed a lot of cheating. How can a regulator know what level of provisioning is appropriate for what period of time?

Lord Burns: I have a general view that in this area it is better to try to find automatic mechanisms which respond to the cycle of their own accord rather than put too much emphasis upon the discretionary behaviour of regulators to be able to identify them. I do not

want to give it too much credit, but one of the great benefits of the Spanish system of dynamic provisioning was that it was fairly automatic. Instead of having provisions for bad loans when they took place, you had to set aside a proportion of all loans on the basis that they might go wrong based upon the experience of previous cycles. Therefore, you were setting aside provisions as your lending expanded; you were not waiting until the loans had gone wrong to have provisions. As we know, the period when lending is growing most rapidly is not when the loans go wrong because that is when the whole economy is doing extremely well, or so it appears. During periods of rapid growth of lending you build up provisions which then give you a cushion in the early stages of the unwinding of the cycle. When the loans start to go wrong you have already got the provisions in your back pocket. To a degree, I think that has helped a lot and has worked well. It is well designed. It does not deal with everything, but it certainly helped to get the major Spanish banks through the first stage of the crisis.

They did two other things in Spain. They patrolled the whole question of the perimeter and controlled off-balance-sheet vehicles very closely; indeed, they had capital requirements to be involved in them which meant that they were uneconomic to engage in. The result was that they were not exposed to those off-balance-sheet vehicles in the shadow banking system in the same way as other countries.

Spain has a very interesting distinction. They distinguish between regulation and supervision. They talk about the regulatory process but they also concentrate a lot upon what they call supervision which is just an intensive monitoring of what the major banks are doing; to whom they are lending and in what products they are getting involved. Each of these is borne out of experiences of previous banking problems.

Q44 Lord Skidelsky: But that is exactly the point, is it not, Terry? Your answer presupposes the existence of relatively stable parameters. You are drawing on past experience of cycles in order to have these particular requirements.

Lord Burns: Yes.

Q45 Lord Skidelsky: But suppose the parameters shift.

Lord Burns: It won't catch them, but it performs better than simply waiting for the problems to arise. I am biting my tongue, but I don't think there is anything that can cope with dramatic changes. If the whole views of markets and academics is wrong and the interpretation of how the economy is behaving is wrong, it is difficult to think of any system that will completely protect you from that. The question is: can you do better than some other ways of doing it? Dynamic provision undoubtedly helped. I think that the control of off-balance sheet vehicles was another crucial part of this. I hesitate to say this because it just means more people around our building, but the supervisors just have to spend more time looking at what is happening in order to improve their understanding of the innovations that are taking place and where there might be problems. All I can say about that, as I have about these proposals, is that things like that do help. But the world has had financial crises since we have had banking. Obviously, they occur at erratic intervals. I think it is very optimistic to imagine that we will eliminate them.

Chairman: We move from other countries to international issues more generally.

Q46 Baroness Wheatcroft: Terry, you just mentioned mark to market. Before I go on to the broader international issues, I would be very intrigued to know to what extent you think the accounting systems in place had a major role in what has taken place. Banks were given perfectly unqualified accounts and there was very little hint from a set of bank accounts as to what lay just around the corner which cannot help the regulators, can it?

Lord Burns: No. This has some very difficult aspects to it. It is very important that regulators should have full access to the information they need. They must be able to understand what it is that banks are doing because, as you rightly say, bank accounting is very difficult. The whole issue of when you should mark to market and when you have a product that you are holding over a long period of time has its own issues. Mark to market can itself create a certain amount of instability within a system and one has to be quite cautious about it. Banking supervision is complex. We have an enormous number of auditors who go through the whole banking accounts, and they spend a significant amount of time with us. We also have supervisors who do it. One hopes that one will have a regime, in which there should be sufficient transparency that one can get to the bottom of some of these things. But, above all, one hopes that one can spot some of the issues as they arise. I do not want to say this too often, but there are all sorts of circumstances where products are designed and they are working in an environment where everything seems to be perfectly okay. It is about distribution of risk. You operate a business so that it is taking care of 90% or 95% of the distribution of the risks, but there are tail risks in most of these activities. If you then come across circumstances where they come into operation you will have difficulty. But you cannot eliminate risk altogether, and I think the same is true of auditors and supervisors.

Q47 Chairman: That may be a bit beyond mark to market.

Lord Burns: Yes.

Q48 Baroness Wheatcroft: On the international front, UK regulators are going to find it quite difficult, are they not, to regulate UK branches rather than subsidiaries of banks? I gather the bank is very keen that international banks should create UK subsidiaries but international banks are not all quite as well disposed towards that idea. How effective do you think UK regulators can be in that situation?

Lord Burns: The Santander group model is that they are all subsidiaries. Indeed, my memory is that it was really required when Santander bought Abbey National. I think there would have been a lot of difficulty with it if they had wanted to run it as a branch anyway, but, as it happens, it is the way they operate throughout the world. Santander UK is regulated in exactly the same way as any other British bank. I am a strong believer in the subsidiary model of dealing with banks. It ensures that you have got well identified capital and liquidity in the entity in the UK, and it can be ring-fenced against risks that emerge elsewhere in a group. It avoids in a sense some countries being left holding the baby, as happened during this crisis with some of the banks who had branches. People who are involved in a large amount of trading find the subsidiary model quite difficult. That itself may be a reason why the whole question of how much trading retail banks should have associated with them becomes an issue. But for a business like ours, which is effectively a retail banking business

with treasury functions that are limited to dealing with our customers rather than trading on our own books, the subsidiary model works very well. We have constant discussions with the FSA to make sure that the ring fence is working well. Any transactions between the parent and the UK subsidiary are well known to it and identified and it can monitor what is happening.

Q49 Baroness Wheatcroft: Would you say that your structure effectively provides a blueprint for what we might look to ring-fence in other banks, if that is the way the Vickers report goes?

Lord Burns: Yes. I strongly believe that as far as concerns retail banking it should be run on a subsidiary model. There are some that are small and then you run into issues of competition. I don't want to get into territory about which I know less, but certainly the model we have been operating works well. It also means that, should there be a problem, the resolution is much more straightforward than if you have a branch-based system where issues arise as to the country in which the assets and liabilities are.

Chairman: We have only a quarter of an hour left, so I appeal for pithy questions and answers. Maybe we should move on to the related subject of Europe.

Baroness Drake: I have two questions on consumer protection, each on a different subject. I shall try to make both pithy.

Chairman: I would rather you dealt first with Europe.

Q50 Baroness Drake: You were probably sitting here when we were speaking to Gillian Tett. How similar should financial regulation in the UK be to the rest of Europe? If the UK seeks to set tougher requirements, in your view what would be the implications for UK institutions and possibly economic growth?

Lord Burns: There are two competing principles at work here. One is that, obviously, one wants to have requirements on individual businesses which reflect the degree of risk in those businesses. On the other hand, I am a very strong believer in the whole concept of a level playing field. We want banks throughout Europe to be regulated in a very similar way, certainly with regard to capital and liquidity requirements. If we do not, we will simply find that the business moves from one country to another and we see people engage in regulatory arbitrage. As far as concerns issues of conduct of business there is more scope for differences. Different countries have different retail systems; they have different products that are very popular; they have different ways of dealing with their customers. Some are more branch- based, some more telephone-based, etc, and different products emerge. You can have quite a lot of difference as far as concerns that side of the regulation, but when we come to the prudential side I think we have to aim for something that is very close to a level playing field; otherwise, we will have difficulties.

Q51 Chairman: I was under the impression that continental banks have operated with a far lower level of capital and a far higher level of gearing. I am not aware that that has

led to any regulatory arbitrage between the UK and the rest of Europe.

Lord Burns: No, but London has many special advantages in terms of the way of doing business. Retail banking by definition tends to be more locally based as opposed to the trading and investment banking side. If there was a general requirement on our banks to have much higher capital requirements than in other countries, you will set up pressures to grow more in those countries than here. As far as concerns the retail side, obviously that is fairly restricted. If we require that all retail banking should be done by subsidiaries and the local regulator supervise them, you cannot bank people easily from offshore in terms of mass markets. But on the non-retail side over a period of time I would expect to see movement of people. We have seen hedge fund business move. People will move if taxation and regulatory systems are very different. In this country we have had a fairly liberal view as far as concerns the investment banking side, and of course we have a huge industry.

Chairman: The taciturn David Ruffley.

Q52 Mr Ruffley: Referring to the Financial Policy Committee, the draft Bill tells us that the court of the Bank of England will set the overall financial stability strategy. Do you think the court as it is currently comprised is up to the job given its track record for oversight over the last few years?

Lord Burns: I do not know it closely enough to be able to judge that.

Q53 Mr Ruffley: Then that is a no.

Lord Burns: But, if there is any part of this set of proposals that concerns me, it is probably to do with the governance of the FPC in relation both to its accountability to Parliament through the Treasury and the extent to which it can be defined as "independent". We set up the MPC arrangement whereby there was a very clear objective for monetary policy addressed in terms of an inflation target. The Bank of England was then given the remit and operational independence to achieve that target. Incidentally, the court does not have any role to play in that other than in terms of pay and rations and ensuring that they are doing the job reasonably well. If this is to work well, this is a topic that has strong similarities to the MPC because you are dealing with business cycles and trying to interpret the way the market is working. Is the economy overheating or underheating? Yet we have a completely different set of proposals. One of the problems is that measuring financial stability is a good deal more complex; even the concept is rather more difficult than that of inflation. Inflation is measurable; financial stability really is not measurable in terms of a single index, so accountability for all of that will be quite difficult. Therefore, it is quite difficult for the Government to set an objective that is terribly precise. I look forward to the exchanges that will take place in years to come on whether or not the remit on financial stability has been met when the FPC reports both to the court and, I guess, the Treasury Committee. There is a collection of issues—I am now crossing the floor—which I think need quite a lot of investigation in this inquiry.

Q54 Mr Ruffley: As you have indicated, defining fiscal stability will be extremely difficult, but whatever definition is arrived at, it still seems to many of us that the disparate

expertise of the court, which explicitly in the legislation will be overseeing the FPC—the FPC is a committee of the court, unlike the PRA, which is a full-blown subsidiary of the bank—will not be up to the job given its track record, and I am glad you confirm our concern about this.

Lord Burns: Another big issue is the role of the Treasury and, through the Treasury, Parliament, and what part they play in setting the remit and the accountability mechanisms.

Q55 Mr Ruffley: There are confusions. The Bill says that the court will review the overall strategy every three years but the Treasury's remit which sits alongside that will be reviewed annually. It seems a bit of a dog's breakfast. I move on to a second question on governance. Under this Bill, the Governor of the Bank of England will chair both the FPC and the MPC. Is that too big a set of responsibilities for one person? If it is, what mechanisms do you think can be put in place to allow the next Governor of the Bank of England, he or she, to chair both of these huge policy areas at the same time?

Lord Burns: I am not quite so worried about that. If anything, my fear is that these two bodies with separate objectives and governance arrangements are to some extent mirror images of the same thing. So more rather than less co-ordination between them is required. Therefore, having the Governor chair both of them is not something that causes me great anxiety. Indeed, if he was not involved closely in both of them, I would have some anxiety. That is not the bit that concerns me. The bit that concerns me is his accountability mechanism in terms of whether the remit is sufficiently clear, how it will then be held to account, whether the court is the right body, and above all, what happens in a crisis when the Treasury becomes involved as the paymaster of any rescue that may be required. What are the override powers of the Treasury in terms of its interest in the broader economic stability agenda which, in addition to this, covers a number of other things? If I recall, in the MPC legislation there are quite clear circumstances in which there is a Treasury override if the situation allows it. I would not be worried so much about whether the same person can do both. But it seems to me that as far as possible they should be constructed along similar lines rather than the very different lines that seem to be suggested at the moment.

Q56 Lord McFall of Alcluith: My point is: do we know what we are about in financial stability? I think you have given us a fair idea that we really do not. Philip Stephens in this morning's *Financial Times* makes the point that Vickers and the legislative changes here make only a glancing blow on financial stability. He gives three reasons: the economic head winds; the lobbying we have had; but, maybe more than anything, the international disinterest in the changes. He suggests that we need global banking reform yet, particularly to solve the "too big to fail" issue. Would you agree with those views?

Lord Burns: I think that arrangements that can be agreed upon by the major countries have a much better chance of success than arrangements designed by individual countries, partly because of much of the discussion that took place in the early session about shadow banking, regulatory arbitrage and things moving to jurisdictions which are a lesser burden. One of the concerns about the proposals that we will be hearing about at the beginning of next week is whether, if they are not mirrored anywhere else or they are very different from anywhere else, that will be an advantage or disadvantage to us. I agree on the importance of the global side, because, although retail banking can be a local issue and you can to some degree regulate it differently in different countries, when you come to wholesale banking and fund

management it is very much an international business. Even within retail banking it depends where you draw the perimeter, but large corporates are also very much international bodies that require international services. Clearly, the more progress that can be made on the international stage in this respect the better.

Chairman: One issue you raised earlier, which I said we would come back to, is handling bank failure and resolution.

Q57 Baroness Wheatcroft: I think this came out when we were discussing subsidiarity. From what we have seen so far in the Banking Act 2009, are you confident that the resolution regime will be effective, and what more needs to be done?

Lord Burns: Going back to the individual circumstances, I think it was clear that by the time we got to the situation of Bradford & Bingley things had moved on a lot from the position as it was with Northern Rock. We were quite heavily involved in that because in the end we bought the savings business of Bradford & Bingley. I thought all of that was handled by the Treasury very smoothly. One or two things have happened subsequently. The key thing is to be in a position where one knows what the exposures, balance sheet and everything of an entity looks like. And where the money is, so you can make decisions about breaking it up or resolve it in a way that works without panicking depositors. In the end, the question is how you keep the deposit side of this moving along very smoothly while you unravel the asset side of things and work out what the bank is worth in terms of the loans and investments that it has made.

Q58 Baroness Wheatcroft: But the concept of living wills has been much talked about.

Lord Burns: Yes, and we have spent a lot of time on it.

Q59 Baroness Wheatcroft: It is not there yet, is it?

Lord Burns: No, but it is progress. It has forced all of us to look much more closely at aspects of the bank and to be able to set out what the position is. It is a bit like the way Sarbanes-Oxley caused firms to look much more closely at a lot of its risks and various processes to ensure they were clearly set out. This is a process that requires people to be much clearer so the regulator knows in advance what the position is and if there is a problem you can move quickly. With retail banking in particular, speed is of the essence. You do not want queues or people thinking that there may be a wider problem because that is what causes the stress to move from one bank to another, which creates the classic systemic problem. Let's not claim too much for it or hope too much from it. But I think it is an improvement and a very important part of the system where you are able to take a bank that is in trouble and deal with it in a way that protects the depositors you want to protect so life goes on as normal from one day to the next and the people who lose money are those who should lose it.

Q60 Baroness Wheatcroft: But, as we have seen, the danger for banks that venture beyond the narrow banking business is the interconnectedness.

Lord Burns: Yes.

Q61 Baroness Wheatcroft: At the moment there really is not a regime that would deal with a Lehman-type or cross-border crisis, is there?

Lord Burns: That is a side of banking in which I have much less personal experience and involvement. I cannot add a great deal to that. As to the side that I do know about, which is largely the whole Santander model, from what I have seen and our discussions with various regulators, combined with the whole subsidiary nature of it, the position is a rather stronger one.

Q62 Mr Mudie: You usefully touched on the difficulty of accountability in terms of the FCA. In the original Bill there was inserted the single mandate for the Monetary Policy Committee. You have a monetary policy committee with a specific target; you have a financial policy committee with a vague remit. Can anyone define "financial stability"? Because of the projected additional powers, is there a case for bringing in through that a dual mandate, one for the FCA, on growth or unemployment just to balance it? I am looking today at quantitative easing which would be very helpful in the growth part of the economy. What is held against it is that it might affect our monetary policy target or inflation. Because there is one specific target, will there not be a temptation for the bank to have that as the one it must meet above all and growth and unemployment can go by the board?

Lord Burns: I think you are completely correct. One of the characteristics of the MPC arrangement is that it has at its heart a symmetric idea that it is possible for policy in a sense to become too tight as well as too loose, and you may face the possibility of having to adjust it in either direction. It is very important that we have a similar view about the objective of financial stability. By insisting on a very low risk environment you can reduce the risk. It may not be the case that it contributes to long-term financial stability because it has its feedback effects on the economy and its wider performance. I have been looking at these documents and trying to think about how it is you build into it something that is more like the symmetric responsibility that the MPC has.

In mid-August, there was a paper entitled *Risk Off* by Andrew Haldane of the Bank of England which talked about this subject and the need to have a symmetric approach, which is fine, although—I am in danger of running my own book here—if there was ever a time you would be looking for some easing of macro-prudential requirements you would say it was now given what is happening to the economy. Yet in the financial stability report or elsewhere I do not see any thought that maybe one should be looking at what is happening and saying, "Is this one of those occasions when you would be putting less pressure on the banks?" Of course, it does not fit with the general climate. We all want to have a go at banks at the moment and we are permanently worried about them. But if ever there was a time you would have said a financial stability objective should be looking at what the financial system can do to support growth and the economy I would be tempted to think it was now. Building in the issue of ensuring that financial stability just does not simply mean low risk, or no risk at all cost or in all circumstances, is going to be one of the real challenges, along with how they will be held accountable in terms of a symmetric objective.

Q63 David Mowat: I think the draft Bill has a growth requirement for the FPC. It seems to me that, if one requirement is to try to maintain stability, which you cannot measure, and there is also a growth requirement, there is a risk of the whole thing being fudged to the point when it is almost impossible. Anything they do cannot be reported on and it just becomes meaningless.

Lord Burns: I have a clearer view about the task, if I may call it that, of the FPC than about its objective. I have full sympathy with the idea that its task is to monitor and identify all of the risks that are around as they emerge and to ask the question: are the banks in a sufficiently robust position to be able to deal with those risks? In a sense you match the amount of risk and resilience with ability to withstand the risk. You come to a judgment as to whether you need to control the amount of risk or support the resilience. I am less clear about how you define that in a broad objective and, above all, have accountability for that process. It needs more thought and certainly scrutiny. I think it is an issue that requires scrutiny as the Bill goes forward and is something which we all need to reflect on quite a lot.

Chairman: Thank you very much indeed, Terry. You have given us plenty of experience wearing your many hats. With your array of millinery we could probably have kept you here all afternoon, but, as the lunch bell rings, thank you very much indeed for coming and also members of the Committee.

Unite the Union – written evidence

This response is submitted by Unite the Union. Unite is the UK's largest trade union with 1.5 million members across the private and public sectors. The union's members work in a range of industries including financial services, manufacturing, print, media, construction, transport, local government, education, health and not for profit sectors.

Unite is the largest trade union in the finance sector representing some 130,000 workers in all grades and all occupations, not only in the major English and Scottish banks, but also in investment banks, the Bank of England, insurance companies, building societies, finance houses and business services companies.

Executive Summary

- Unite proposes that the process of due diligence in private equity buyout situations must include a full economic impact assessment which takes account of the costs to local communities and wider society of any such buyout;

- The introduction of a financial transaction tax on financial trading including foreign currency speculation, hedge funds and derivative trading;

- Ensure that mutuals are safeguarded among the big players in financial services and that a proportion of the market should be maintained which supports diversity and the different business models in traditional banking and in the mutuals sector;

- The future sale of Northern Rock and the Lloyds TSB branches being divested in line with competition rules should increase competition and diversity in financial services;

- Switching banks should be made easier and less stressful;

- Review remuneration systems and performance management practices to ensure the banking sector applies a process of managing targets and bonus based reward which is transparent, consistent and treats customers and workers fairly;

- The voice of key stakeholders should be heard at a strategic level to ensure that the interests of all those directly affected by the decisions of the banks are given due regard.

Introduction

Question 10. Does the draft Bill adequately deal with the risks posed by the shadow banking system?

1. Unite remains concerned that the Bill fails to pay sufficient regard to the risks posed by the shadow banking sector on the rest of the economy and has raised concerns

about excessive leverage and the risk that this poses previously. [243] In particular private equity has had a significant impact in other areas of the UK economy where buyouts took place with the profitable part of the business hived off and sold and the less profitable parts discarded along with the workforce.

2. A Report by PSIRU at the University of Greenwich in 2008 highlighted research by Harvard Business School which found that:

   "firms taken over by PE have much higher rates of closure, opening, acquisition and disposal of workplaces, in the 2 years following a PE takeover, than comparable firms: we observe more greenfield entry, more acquisitions, divestitures and establishment shut-downs". [244]

3. The study goes on to show that the actual change in employment in the establishments subject to PE takeovers was about 7% worse after 3 years, and 10.3% worse after 5 years, than it would have been without the takeovers. Further, in the 2 years following a PE takeover, 24% of employees will have experienced their workplace being closed, sold, or reduced – double the uncertainty compared with a firm which has not been the subject of a PE takeover. [245] The impact of this was also greatest in the finance sector when compared with other sectors of the economy.

4. According to the US Federal Reserve the size of the shadow banking sector stands at $16,000 billion while the traditional banking sector is around $13,000 billion. [246] Unite is acutely aware of how the crisis has affected the traditional banking sector but less aware of the effects on the shadow banking sector. This highlights the lack of transparency in shadow banking and its effects on the wider economy. However given the interdependency between the two and the enormous global costs of the financial crisis, the world's economies could not afford another such crisis in the future.

5. There should therefore be full public disclosure of private equity/highly leveraged buyout debt including covenants with total transparency in relation to private equity debt. Unite also proposes that the process of due diligence in such buyout situations must include a full economic impact assessment which takes account of the costs to local communities and wider society of any such buyout. The current economic climate is squeezing profit margins in some businesses many of which may also be unable to access affordable credit and with rising debt levels may find that they are susceptible to take over. The fear of this may cause some companies to find other ways to cut costs which could have an impact on terms and conditions, pay, pensions and ultimately jobs.

6. Another element of the shadow banking sector that should be looked at more closely is the trading in 'socially useless' financial transactions. A significant number of these trades are purely speculative with the primary aim of gambling on the price of a commodity rising or falling. Billions of such trades take place every day across the world. Unite and others, including the European Commission, the TUC and the

[243] Unite response to the Treasury Committee evidence session on the banking crisis January 2009
[244] http://www.psiru.org/reports/2008-02-PE-WEF.doc
[245] Ibid. p3
[246] http://www.ny.frb.org/research/staff_reports/sr458.pdf

Archbishop of Canterbury, Dr Rowan Williams, have all called for the introduction of a financial transaction tax on such financial trading including foreign currency speculation, hedge funds and derivative trading. It is estimated that a FTT on each trade could bring more than £250 billion into the global economy, providing much needed revenue to plug the hole in the public sector purse in the UK, fight global poverty and fund climate change initiatives. [247] Even if the number of trades were to be restricted the potential income from a FTT would still generate tens of billions of pounds. Unite would propose that the Committee gives full consideration to this issue.

Question 15. Are the FCA's primary objectives appropriate? Is significant emphasis given to the promotion of competition?

7. Unite welcomes the proposals laid out in the white paper to support the mutuals sector by ensuring the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) consider the impact of any proposed rules on mutual societies. However this does not go far enough. Unite would wish to ensure that mutuals are safeguarded among the big players in financial services and that a proportion of the market should be maintained which supports diversity and the different business models in both the traditional banking sector and the mutuals sector.

8. Unite would wish to ensure that the future sale of bank branches in Northern Rock and the Lloyds TSB branches being divested in line with competition rules results in increased competition and diversity in financial services. The sale of 318 bank branches of RBS to the Santander Group, which already controls a significant stake in UK retail banking, went against the Government's own recommendations in the Coalition Agreement to foster diversity and increase mutuals. This is despite the Government controlling 84% of RBS. Unite is unconvinced that consumers are likely to benefit significantly from increasing numbers of providers or by those new entrants delivering similar products and services alone. Increasing the players in the market must also come with increasing the business models available to consumers which extends the range of products and services in order that real choices can be made.

9. As well as this the process of switching banks should be made easier and less stressful. Portable account numbers is one proposal put forward [248] and would seem reasonably easy to implement and relatively cost effective given advances in technology. However switching banks should not obstruct applications for credit or borrowing, where the time spent with one bank is given a higher credit score than for someone who has chosen to move accounts more often.

Question 19. Will the new regulatory arrangements reduce the risk and cost of dealing with mis-selling of financial products?

10. Unite has called for a review of the remuneration systems and performance management practices operating throughout the finance sector which rewards sales

[247] Robin Hood Tax: FAQs http://robinhoodtax.org/sites/default/files/FAQs_for%20RHT.pdf
[248] Financial Services Consumer Panel response to the ICB 2011 (page 3)

over service and has urged the Independent Commission on Banking to look again at the link between the two. The Bill also fails to address this link. Many of the reward packages within the finance sector link pay and performance, with the majority linked to sales targets. Managers are under pressure to reach group, branch or regional targets and individuals are under pressure to increase personal and peer group targets. For some people the stress can be intense and act to lower morale and performance rather than produce a positive and productive outcome. This may lead to inappropriate or dysfunctional selling taking place. Unite would wish the Joint Committee to consider this issue more fully to ensure the banking sector applies a process of managing targets and bonus based reward which is transparent, consistent and treats customers and workers fairly.

Question 22. Does the draft Bill contain any proposals or omissions, not covered by the questions above, which cause concern?

11. In 2009 Unite commissioned the Financial Inclusion Centre to look at the UK financial services sector and to prepare a report detailing the areas that required overhaul. [249] The report highlighted the need for radical reform including the need for the creation of utility banks with public interest objectives.

12. The Report also identified that a serious democratic deficit existed in the UK's financial system with an over representation of shareholder interests over public, employee or wider social interests on many of the boards and committees of financial institutions in the UK. The Bill fails to address this. Retaining the composition of the regulatory and corporate structures which were there before the crisis is unlikely to deliver independent oversight or provide checks and balances to the process. Given the pivotal role banking plays in the economy it is important that the voice of key stakeholders is heard at a strategic level to ensure that the interests of all those directly affected by the decisions of the banks are given due regard.

September 2011

[249] http://www.unitetheunion.org/pdf/job%201897%20finance%20report%20web4.pdf

Sir John Vickers, Chair, Independent Commission on Banking – oral evidence (QQ 288-350)

THURSDAY 13 OCTOBER 2011

Evidence heard in Public Questions 288 - 350

Members present:

Mr Peter Lilley (Chairman)
Mr Nicholas Brown
Baroness Drake
Lord Maples
Lord McFall of Alcluith
David Mowat
Mr David Ruffley
Lord Skidelsky
Baroness Wheatcroft

Examination of Witness

Witness: **Sir John Vickers,** Chair, Independent Commission on Banking, gave evidence.

Q64 Chairman: Sir John, welcome. Thank you very much for agreeing to appear before the Committee today, all the more so in that it is your second stint this week. We are conscious that Parliament is making very considerable demands on your time. Though your first appearance obviously has helped inform this Committee, we are focused more specifically on the legislative consequences of the Government's reforms and such of your proposals as they may decide to incorporate in this and other legislation. Perhaps I may ask you at the beginning whether you have thought at all about the likely legislative consequences of what you are suggesting, and how much could usefully be incorporated in this Bill by tabling additional amendments and how much is beyond the scope of the Bill, if any is.

Sir John Vickers: The particular area where we did consider the legislative implications was our recommendation concerning the Financial Conduct Authority and the competition duty. Quite clearly, that would fit within the scheme of this draft legislation. Beyond that, the short answer is we did not consider the legislative form that our recommendations, if adopted by government and Parliament, should take. That was for two reasons: first, we did not think it was our place to do that; and, secondly, I and other commissioners—I think I can speak for them—simply did not believe we had the expertise to say anything very sensible about that. We did express the hope that government policy would achieve clarity within the next few months. Of course, we hope the recommendations are adopted. If that is the case we think it would be valuable, not least for the marketplace, for legislation to be enacted within this Parliament. Clearly, there are different ways in which that could happen, and I have no view on which route would be best.

Q65 Mr Ruffley: Sir John, various consumer groups have suggested formulations of the FCA's strategic objective. One is maintaining a fair and transparent market for financial services; another is promoting fair, efficient and sustainable markets that work well for consumers and users of financial services. What is your view on the formulation and those two options in particular?

Sir John Vickers: I should say first that, as a commission, we focused on the question of the competition duty rather than the overarching strategic objective, so what I say in response to your question is more a personal view. As I indicated in an earlier appearance before the Treasury Select Committee on which you sit, I am somewhat puzzled by the primacy of 'confidence' within the strategic objective. Confidence is a matter of beliefs about a market, and it can be misplaced, including confidence in financial markets. It would seem preferable to have some wording about how the markets are actually working rather than the beliefs of consumers and others about it. I do not have a formulation up my sleeve, though when I was at the OFT we used the general banner—this was not statutory language—about markets working well for consumers. The second of the formulations that you read out is very much along those lines. Without having any precise drafting to offer, it would seem preferable to cast it in terms of how the markets are working rather than confidence about them. That is a personal view.

Q66 Mr Ruffley: That is very helpful. In what situations is the competition objective in conflict with financial stability?

Sir John Vickers: On the whole, those two objectives are consistent with each other. It is possible, however, to envisage circumstances where that might not be the case.

Q67 Mr Ruffley: Could you flesh out some scenarios where there might be a conflict?

Sir John Vickers: In our issues paper a year ago, which was recapped in our final report, we referred to some of the academic debate on how there might or might not be tensions or, on the other hand, complementarities between the two objectives. There are risks in trumping competition with financial stability concerns, and what happened three years ago with Lloyds and HBOS is a lesson about those risks. In that case stability considerations

were used to bypass the normal competition machinery and the result was arguably detrimental to both objectives.

In response to your supplementary question, there are some circumstances where there appears to be a conflict between the two but where on a proper diagnosis there is not. An example of that would be the view of some that in the run-up to the crisis there was excessive competition in lending, far too easy lending and loan-to-value ratios going through the roof. That was also feeding through into asset price inflation. Some would say that that was too much competition and bad for stability. I regard that as a misdiagnosis. The fault was the poor regulation, not the excessive competition. If I may use a parallel, in an imaginary industrial market where firms pollute and there is no pollution control someone might say, "Look, there's too much competition and, with all this pollution, the solution is a cartel or something." That would seem to me to be a great mistake, and the answer needs to be pollution control, not to deny consumers the benefit of competition. I would say the same in the context of financial stability.

Q68 Mr Ruffley: That is very helpful. What type of prudential safeguards do you think are necessary to ensure that competition is achieved?

Sir John Vickers: I could refer back to the example just given. What matters regarding competition is not simply a fight in the marketplace. One wants competition to serve customers well and which does not have bad side effects, which clearly happens with things like pollution and can happen with financial risk. I would see prudential regulation as providing part of the framework in which competition channelled to those ends, and without those side effects, can operate. Rather than describe it as a safeguard, I would see it as setting the ground rules for the arena in which healthy and positive competition can then take place.

Q69 Mr Ruffley: What is your assessment of the design of those prudential safeguards?

Sir John Vickers: The design in terms of things like capital ratios, and so on?

Q70 Mr Ruffley: Yes. Do you think there is anything to which we should pay particular attention in the way they are going to be set out in legislation?

Sir John Vickers: There are some questions about levels in general, and we talk a lot about that in the report. There are also questions—perhaps this is where your question is aimed—in that prudential requirements could have effects for good or ill on competition between banks or other institutions of different sizes. If a "too big to fail" problem goes untreated, large, complex and interconnected institutions gain competitive advantages over others for reasons that are not to do with any underlying efficiency advantage. On the other hand, the way regulation applies to small institutions could have the unintended effect of thwarting their expansion or deterring the entry of newcomers into the marketplace. That is certainly a point on which we touch in our report.

Q71 Lord Skidelsky: I would like to take up a point about the complexity of financial products. A major criticism has been that many of the financial products are too complex to understand, not just by the consumer but by those who have been responsible for devising them. As you know, complexity is also a big growth area in academic economics. How can one guard against that? Would you support an amendment to the FCA's objectives to ensure that firms help consumers to make responsible and well-informed decisions? But is "help them to" enough? Is there a case for saying that some products are too complex to be allowed?

Sir John Vickers: These are very deep questions. A moment ago I was referring to the complexity of institutions and now we have moved on in your question to the issue of product complexity. One comment about the ring-fence design that we propose in our report is that some of the particularly complex financial products, of a kind that it appears a number of institutions themselves did not properly comprehend, would be very much outside the fence and would not be allowed to be provided within the ring-fenced entity. A degree of distance would be placed between high street banking operations and that kind of complexity, but that is more in wholesale markets, whereas your question at the end is clearly about consumer financial services.

This is a very difficult area. Ultimately, the consumer has to bear responsibility for his or her decisions in the marketplace, and it is a question about the provision of information to the consumer and whether there is clarity. We all know that more information does not necessarily mean better understanding. A balance has to be struck in that regard. The draft legislation in one of its clauses makes that point about consumer responsibility. There are points made about consumer education and the like. Whether it should be a duty on providers to help consumers, part of one's instinct is to say yes. On the other hand, thinking in practical terms that could be a very difficult thing to do, because for a number of financial services—think of pensions as a classic example—so much depends upon the circumstances of the individual. There will always be a limit on what even the best-intentioned provider can reasonably be expected to know. I do not know one way or the other whether I would favour an amendment of the kind you indicate, but those would be some of the considerations I would have in mind.

Q72 Baroness Drake: To stay with the point about protection of the consumer, whatever the aspirational effect of competition there will always be asymmetric knowledge and understanding. You will simply not be able to get rid of that. The FCA will have these product intrusion powers that almost take them into the area of saying to the providers that they have a duty of care. It is almost saying, "We have looked at your products, how you are selling them and to whom." In a sense, giving the FCA those powers is beginning to walk them down the direction of duty of care. Do you think that is the case and that inevitably there will be a greater drift towards that once those powers are exercised?

Sir John Vickers: I would not claim expertise on this. That might be welcome to a certain point. I was trying to indicate that a balance needs to be struck. If one went too far in that direction one might end up with counterproductive effects for the consumers who one is trying to assist in the first place. It also needs to be borne in mind that consumers are a very heterogeneous group. When some years ago I was at the Office of Fair Trading and appeared before Lord McFall's Committee I am sure he and I both remember that there were a number of issues under general consumer law, including the Consumer Credit Act, but not the regulatory powers that the FCA would have, about such things as misleading

advertisements and unfair terms in consumer contracts. Policy and also case law on that has developed since the late 1990s when those regulations came into force in the UK. Those are also very germane to this set of issues, but this legislation takes a further step both in consumer protection and potentially on the competition side which expands the regulatory tool kit that can be used in these various markets. I think that is a good thing.

Q73 Baroness Drake: The Bill has a very broad definition of consumer from the individual mother to a hedge fund. Would it help if the Bill was amended to enable the FCA to discriminate more between different consumer groups? Do you consider that is a weakness of the Bill as it is currently drafted in terms of that very broad definition?

Sir John Vickers: It is certainly the case that the range of consumers and customers is extraordinarily wide and that is because the range of markets at issue is wide. I believe there is a clause in the Bill that is on the point and makes reference to different types of consumers and the FCA's duties to have regard to that. It is also the case that the general case law in areas like unfair contract terms has been developed in a way that is sensitive to the circumstances of different kinds of consumer. As to whether more is needed in the draft legislation than is already there, the only honest answer I can give is that I do not know. It certainly needs to be addressed. Maybe the current draft addresses it enough; maybe not.

Q74 Baroness Drake: A broader question not directly addressed in the ICB report is whether the PRA should have regard to competition, in effect to examine the effects of regulation on competition. Certainly, the consumer groups have expressed concern about this because of the PRA's power of veto in respect of the FCA. Do you think that the Bill should be amended so that the PRA has to have within its objectives a regard to competition?

Sir John Vickers: As indicated in response to an earlier question, what the PRA does can most certainly have effects on competition, for example in the area of entry barriers. We recommend that the PRA and OFT work together on that particular issue. It includes some quite technical questions about how banks of different sizes can as a practical matter calculate their risk weights for the purposes of meeting capital requirements, and so on. I would hope that the PRA would have regard to competition. The further question is whether that should be enshrined in legislation. I looked at that passage in the draft legislation. To my very amateur eye, I could not see any easy slot into which to place such a "have regard" duty. I do not know whether the scheme of that part of the draft Bill lends itself to doing that. I do not know whether that might be a problematic issue, and my expertise does not give me anything more helpful to say. I reiterate that it is very important that the PRA does have regard to competition. Whether it should be in the statutory scheme is much harder for me to say, and if there is a list of "have regards", then there would be a question of which others should go on that list.

Q75 Baroness Wheatcroft: Part of the crisis we are in was exacerbated by the sale of bonds and derivatives related to sub-prime housing. Without going into Adair Turner's concept of "socially useless" in relation to financial products, do you think that at the moment there is anything in the legislation that would go not just to consumer

protection but the greater market risk and make some of those products potentially unsaleable? If there is not anything there at the moment, do you think there should be?

Sir John Vickers: That happened in a context where regulation around the world was poor, but, as we all know, it blew up most in that area in the United States. I believe that much higher capital requirements and changes to make sure that providers of debt to banks—bondholders—unlike in the crisis where many came out whole but are in line to take losses, would instil all sorts of incentives and disciplines around risk and lending which would go a long way to addressing that kind of issue. We had low capital requirements, so-called 'risk weights' that were no such thing, and what turned out to be a very brittle debt structure, so the taxpayers were marched very near to the front of the queue of taking losses in a way that should never have happened. In a properly functioning market system things would not happen that way. I believe that would be one of the important disciplines in this whole area.

In its supervisory role the PRA would surely have regard to what was going on in the marketplace in the UK on all these fronts. The PRA's remit clearly does not extend to the United States. That takes us back to the question of how vulnerable or not the UK financial system is to imported shocks from elsewhere. Again, I point to our ring-fencing recommendations, one of the aims of which is to give a strong degree of insulation against such imported financial shocks.

Q76 Mr Brown: How far will economic activity be outside the scope of the regulatory regime that we have under consideration? In other words, those who do not want to be regulated will just try to move to a shadow market outside the reach of the regulator. How far should the regulator, particularly the FPC, at least be able to understand what is happening in these overseas markets and make recommendations accordingly? My point is that it is quite important they are able to act in time rather than describe what happened after the event.

Sir John Vickers: In the work of the commission we faced a variant of that question which was about activity potentially moving from UK banks either to non-banks and/or to non-UK institutions altogether. Your question is a wider one because it is in the context of the draft legislation. Surely, the FPC must have very close regard to global as well as domestic developments to do its job properly, especially because of the very open nature of financial markets in the UK. We have banks whose balance sheets collectively are four or five times a year's GDP. It is not Icelandic but it is otherwise at that end of the spectrum. That would be an essential thing for it to do.

As to the levers it has to pull to deal with those global issues, there are limitations because of the scope of the jurisdiction, but through European fora in the context of the EU and Brussels, especially through the international Basel processes where the UK does play a leading role, that is another route by which UK regulators can seek to address problems on those fronts.

Q77 Mr Brown: Therefore, it is essential to understand what is happening if a problem is emerging at a very early stage and be able to take action with trading partners. Obviously, the United States and our partners in the European Union are the most significant in this. Is there anything you can say to us about the way in which the legislation is

currently framed as regards amending it or strengthening it to make sure that point is made more explicit

Sir John Vickers: I apologise that I am not familiar enough with the relevant passages of the draft Bill. I would hope it went without saying that the FPC's horizon would be global in terms of what it is looking at. Clearly, the scope of the legislation in terms of regulatory powers, the authorised persons covered by the legislation and so on can only be within the jurisdiction of the UK Parliament. Therefore, in terms of formal powers to address those issues there is inevitably that jurisdictional limitation. But a great deal happens, and the UK institutions are central to this in terms of the international debate. It may be that enough is done. I simply do not know whether legislatively there is more that would enhance and bolster those efforts.

Q78 Mr Brown: In defending the ring fence structure in the House of Commons the Chancellor of the Exchequer, in answer to Michael Meacher, said he thought there were strengths in the investment arm of a bank being able at a time of difficulty in its retail arm to transfer money to support that retail arm. Can you explain how that is compatible with a ring fence?

Sir John Vickers: Let me try. This leads to the question of why we did not recommend a full split. One of the arguments for a full split, some would say, is that it deals emphatically with the risk that problems in the non-retail bit would contaminate the retail arm of the bank despite the greater capital cushions and all the rest of it that go with the retail part of the ring-fence design. The argument in the other direction is the one you have alluded to, which is that, depending on the economic and financial shock at issue, there may be some occasions when the retail side is in trouble and globally things are fine. In that circumstance, with a ring fence as distinct from full split, there would be scope for rest of bank to bring in capital to support the troubled retail operations and see them through it. We took evidence on this. We believed that not only would that possibility exist, but there would be very strong reputational incentives for a wider banking group not to let its retail arm in the UK go in those circumstances. Therefore, there are arguments on both sides as far as that is concerned.

It is not just fanciful to suppose that there might be a UK retail problem and not a global one. As we have seen in some other economies, there may be a domestic property market crash, commercial or residential, given the focus of retail lending, whether it is mortgage lending or business lending secured on commercial property, or companies very much involved in commercial property. You can have domestic shocks. Even with fantastically good macro-prudential regulation, you cannot banish that risk. It seems important to retain the possibility of rest of bank supporting the retail operation.

The other set of reasons we went for ring fence rather than full split was that there are, at least arguably, various kinds of synergy between the different banking operations, some would say a diversification benefit, which a full split would lose. The cost-benefit analysis overall led us to the recommendation here.

Q79 Baroness Wheatcroft: Sir John, when the report came out the initial reaction from the banks was that the cost of lending would go up. As far as one could see that was unjustified. Did you think there was any justification for that reaction?

Sir John Vickers: We did some estimates and looked at those made by others of the costs to the banks and, as a separate question, the economy of recommendations of this kind. In so far as these and other measures would get the taxpayer off the hook, to put it in those terms, inevitably bank funding costs would rise because the risk that the taxpayer ultimately bears would lie instead where it should, which is with investors. That would be reflected in funding costs. Our best estimate is that the cost to the banks expressed in terms of their collective balance sheet, which is more than £6 trillion, would be of the order of one tenth of 1%. We believe that most of that cost would be felt outside rather than within the fence so that any effect on lending costs would be very small in the wider scheme of things. To say there would be no effect at all is to go too far. There may be some effect but it is likely to be small. I would not regard it as a completely unjustified response that some have made, but I would want to put it in its quantitative context. I certainly would not agree with the estimates made by organisations such as the Institute of International Finance, which have huge effects on lending costs. I do not believe they are credible estimates.

Q80 Baroness Wheatcroft: The other objection from outside the banking industry is that the banks will find a way through the ring fence. They have become increasingly sanguine about the proposals because one suspects they have been looking at how porous the ring fence could be. There is a bit of flexibility in your report as to what goes inside and what does not.

Sir John Vickers: Yes.

Q81 Baroness Wheatcroft: To what extent do you think that they, clever people that they are, might find ways through?

Sir John Vickers: I would like to distinguish between the flexibility of the fence and the question of its strength. We recommended a ring fence that was flexible but, as we would see it, strong. It would be flexible because, while there are some activities like current accounts that we recommend must be in ring-fenced banks, there are other activities, such as trading, derivatives, markets and lending to financial firms—some of the very complicated lending within the financial system—outside it. But for corporate deposits and, on the other side of the balance sheet, lending to non-financial corporates, the logic of the design did not point strongly one way or the other, so why not leave that up to banks and their customers? That might also have a diversity benefit in that different banks might migrate to different points within that architecture if government and Parliament were to adopt it.

The question of the strength or porosity of the fence is quite a separate one. There we think a number of safeguards are needed cumulatively. We said quite a bit about the scope of permitted dealings between the ring-fenced part and rest of bank, essentially proposing a third-party basis. We have recommendations on separate and distinct capital and loss-absorbing debt requirements. An area that we said very little, if anything, about in our interim report, which in part was because of responses to consultation and in part because of our own work we realised was much more important, was the whole set of governance arrangements. Who is on the board of the ring-fenced bank; what are the directors' duties in the ring-fenced bank; what are their public reporting requirements, and so on? Clearly, there will be an important role, if a scheme like this goes forward, for the PRA in policing the boundary. That would also be necessary with a full split. It would be nice to think that with a

full split all these problems are magicked away, if I am allowed to use that expression. That is not the case, because there would still be a need to monitor, even with a full split, whether the retail bank was creeping into activities it should not, and so on. Essentially, you have the same task whether it is full split or within banking groups.

There are lessons to learn from other jurisdictions. In the US there are regulations on what banks can and cannot do within wider financial conglomerates, and in the UK we have had under the building societies' legislation limits on the kind of hedging activity that can happen within those institutions. Hedging is an area which, if ill-policed and ill-monitored internally, could stray into activities that do not sit with the logic of ring-fencing, but that seems to work perfectly well in the building society arena. We think that could be a very good guide to what the treasury functions of a ring-fenced entity might do.

Q82 Baroness Wheatcroft: You have explained why you think full separation is not the answer and that the ring fence will bring some benefits, although they seem far from overwhelming. Nevertheless, do you think that shareholders might decide that if there is a ring fence they would prefer a full split and demand that from their banks?

Sir John Vickers: It is entirely possible, and it was a point we considered. In our view that would be fine and up to them. One of the questions on which we received - and ourselves could generate - frustratingly little evidence was how great were the benefits of synergy between retail and wholesale investment banking. Distinguishing between the true synergy benefits and the scope of the implicit taxpayer guarantee is a very hard thing to do. If the true synergy benefits are minimal it could well be that some institutions would follow the path that you have described, but that would be up to the institutions in the marketplace. If a series of policy measures can get the taxpayer very remote from all these institutions there would be much cleaner market incentives than the distorted arrangements which have existed recently.

Q83 Baroness Wheatcroft: You were not overwhelmed by corporate customers saying they really had to have everything under one roof?

Sir John Vickers: Not overwhelmed. That benefit, as far as it exists, is to a considerable extent maintainable under a ring-fenced system, because if a medium-sized corporate wanted maybe some foreign exchange hedging or whatever that could be arranged in a one-stop shop way consistent with a ring-fenced architecture. Therefore, it is permissive of those synergy benefits, but if they are worthless in fact then full separation is a possibility for some banks. It is not that I have some in mind, but that would be the logic and it seems perfectly reasonable.

Q84 Lord Maples: What one finds in practice—my experience of this is limited but not non-existent—is that if you are a corporate and you want different services from a major banking institution you deal with one branch if you want a forward foreign exchange contract, other people if you want M&A advice and others if you want to float a bond issue. To bring that together they give you a relationship manager, who is usually an advertising executive type in a smart suit who takes you out to lunch and points you in the right direction. If that is the synergy benefit, I wonder how valuable it is. The report talks about

agency benefits. Is it that difficult for a medium-to-big corporate that uses these services not to buy them on an ad hoc basis from this or that institution without a loss to the economy?

Sir John Vickers: I doubt that it is huge, but we felt that in crafting in these recommendations that they would allow certain kinds of relationships as you describe without undercutting the logic of the financial stability benefits that we are seeking to achieve.

Q85 Lord Maples: Was the decision as between total split and ring-fencing a difficult one for the commission to make? Was it a finely balanced decision when you thought of this and that, or in the end were you unanimously and overwhelmingly in favour of the ring fence?

Sir John Vickers: As chair of the past commission, we were wonderfully united in our thought process throughout. A year ago I was not counting any chickens at all on that front. I would not describe it as finely balanced as between full split and ring-fence design; we firmly came down in favour of the latter. Rather than it being a binary decision, in our interim report in April we had spoken in general terms about ring-fencing without fleshing it out, so through the summer a lot of our work was on that. At one extreme, ring-fencing by a matter of degree could end up almost as full split. We thought the right way to go was to have a strong fence, ideally with zero porosity, and yet allow co-ownership of different kinds of activity under the same ultimate corporate umbrella. There is some merit in having the benefit of flexibility about where the line is drawn, and it is not so clear how that would fit with a full split. A final point was that there are some EU law issues that would make a full split more difficult to implement, but that was not the decisive consideration. We had come to the collective view before addressing that legal difficulty that a ring-fence design like this was preferable.

Q86 Lord Maples: You said that whether you had a total split or a ring fence the policing of either the total split balance sheet or the ring fence itself would be complex issues. What clearly emerged from the last crisis was that the people doing the policing did not really understand what the offenders were up to. When the Chancellor gave evidence to us earlier in the week the phrase he used, which also appears in his book, was that we needed much more intrusive regulation. It seems to me that policing this ring fence will require very proactive or intrusive regulation—I would like to know what word you would use—to make sure that these clever investment bankers are not finding ways of shifting risks to the retail banks' balance sheets.

Sir John Vickers: I agree. It would need a number of things: close supervision, as you describe, and internal governance arrangements. None of these things is perfect, but I think the internal governance arrangements and the duties on the directors, with an appropriate degree of independence in respect of those directors, are another brick in the wall, if I may put it in those terms. There will be the indirect effect of higher capital requirements and greater loss-absorbing debt if recommendations like this are followed, because in the crisis it was not just that the policemen were unaware; sometimes the institutions themselves and their investors were unaware. A lot of their investors did not have much incentive to be aware because they reckoned, correctly, on coming out whole in the case of a number of the debt holders in any event. Senior medium to long-term unsecured debt providers in particular, or maybe contingent capital providers, will have much stronger incentives to

monitor a number of these risks. It is a separate point from the ring fence and monitoring that line, but I think it is germane to it. They will have stronger incentives. You will have directors with much sharper incentives in the ring-fenced entity and also much closer regulatory attention.

Q87 Lord Maples: If we may switch for a moment to the question of how the independent board of directors will behave, you talk in your report about culture. If we go back to the long distant past of the early 1980s, retail bankers were dull people who were not all that smart, did not expect to be paid a lot of money, did not take a lot of risks and their shares were owned by widows and orphans; and investment bankers were clever people making money off their wits, and this trouble happened when they got together. We now have our ring-fenced retail bank over here with its independent directors. Their performance did not shine in the last crisis. Nevertheless, I agree that the structure here would be different. But presumably the chief executive of the bank will be appointed by the banking group, dominated certainly in the current balance sheet context by investment bankers. Are you not creating a situation where there is almost an adversarial relationship between the executives appointed by the investment bank, or the group which will be dominated by investment bankers, and some independent directors whose performance in the past in all sorts of corporate scandals, not just banking, does not fill one with confidence that they would be able either to understand the issues or stop a powerful chief executive doing what he wanted to do?

Sir John Vickers: He would have a different job to do in this scenario from that in the unstructured scenario that led up to the crisis. As to adversarial relationship or friction, that might indeed arise from time to time, and that I would not see as unhealthy. That would just be the way of things. There might well be times when the wider group was very frustrated at the inability to transfer capital out of UK retail to other ends. They might well be frustrated at the inability to put UK retail deposits into global wholesale investment banking, but that is just how it would be under ring-fenced architecture. I believe that the directors' duties and independence, the higher capital requirements and the supervisory attention to all these things would create a very different set of incentives and information conditions from those that existed pre-crisis. The activities of the ring-fenced bank would be much simpler than the spaghetti which operated in a number of institutions pre-crisis.

Q88 Lord Maples: To make those non-executive or independent directors effective seems to me to be a rather different job from the typical non-exec of a public company who perhaps devotes a couple of days a month to it. This seems to me to be a job that probably ought to be very well paid, more importantly better resourced in terms of the staff and the information gathering that is available to you and the amount of time that one is expected to devote to it. Do you see it like that, or do you see it as a more typical non-exec function?

Sir John Vickers: No. I would be sympathetic to what you have said. In the work of the commission an issue that arose in many contexts was how detailed and prescriptive we should seek to be. That was always going to be a question of balance, whether it is on how independent directors would operate or the nature of loss-absorbing debt. We tried here to strike a balance. It was also dictated by how much time we had at our disposal, but those

would surely be very important issues to develop and for the regulatory institutions, the PRA in particular, in the future world.

Q89 Lord Skidelsky: Perhaps I may repeat some of the questions asked by Baroness Wheatcroft and Lord Maples by citing a financial correspondent, whose name I can certainly provide. This is a very sceptical view, so please do not feel you have to repeat answers that you have already given: "Chinese walls break under pressure. There will always be huge shareholder pressure for universal banks to boost profits at the expense of a sound commercial banking core. Senior executives will still have a legal obligation not only to maximise profits but to know what's going on across the entire group. The Vickers proposals also depend too much on sophisticated regulation which assumes regulators will always be one step ahead of bankers." I think the argument of that particular correspondent is for complete separation.

Sir John Vickers: I would refer back to some of the things I have said already and add one or two further points. I certainly used to think of Chinese walls mostly in the context of information flows between parts of a bank or financial institution. Do the dealers know what the investment bankers are up to? In the context of information flows there are well-known issues about forms of separation. I suggest that what we are talking about here is rather different in kind. While not wishing to play down the policing of the boundary and risks around that, I would say that the package of measures—the ring-fence design, the legal context, the independence of the directors, the duties on the directors, the regulatory context and the disclosure requirements—together create a strong boundary and there would be a distinct ethos and culture on either side of that fence. Some of the points made by that commentator would arise just as much under full separation. Full separation does not do away with these difficulties.

Q90 Lord Skidelsky: I have one other question that is a little different and it is about the time scale of implementation. In evidence to the Treasury Select Committee you suggested that an earlier implementation date such as 2014 would result in short-term negative impacts on the industry. In the ICB report you say that implementation should be completed at the latest by 2019 and that early resolution of policy uncertainty would be best. In your view should the Government commit themselves to a more ambitious time scale? I can see a potential issue about recovery versus reform. In terms of reform, you want to get these larger capital requirements in as soon as possible, but as to recovery you want the banks to lend as much as possible. How do you view that sequencing problem? I would call it recovery and reform.

Sir John Vickers: I agree that that is the heart of the dilemma. We saw our task as being to make recommendations for the medium and longer term. There were two main reasons we went for the end date of 1 January 2019. One is that the Basel III agreement has that as the date. Our recommendations go significantly beyond what Basel III requires. Our recommendations would require banks to do more than baseline Basel III would require. We certainly did not think that that factor argued for an even later date than 2019, but it did create some difficulty in going for an earlier date. The second reason was exactly the one you state, which is that the current fragile state of the macro-economic recovery in the UK

and globally would make hazardous a rapid acceleration of the timetable, trying to get it all in place within, say, three years. We were comfortable with stating the beginning of 2019 as the end date for the financial stability measures in here. The competition measures are on a different timetable according to our recommendations. Personally, I would be happier if the Basel date were a little earlier, but it would have seemed arbitrary for us to say 1 July 2017 or some such, given that the international agreement has already put up that end date.

Q91 Lord Skidelsky: Are you not worried about the emasculation of the proposals the longer the wait in the improbable event that we recover fully in the next four or five years and people say, "Well, what's the problem? Here we are; there's no longer any pressure"?

Sir John Vickers: At one of our early meetings we spent no more than one minute on whether we should state a slightly more hawkish view than our true view so that after emasculation things would end up where we truly wanted them. We thought that was dishonest for one thing, so we have stated our view exactly as we saw it. It is for government and Parliament to resist emasculation or watering down if they see fit in the policy making and legislative process. It will then be for the regulatory authorities, if Parliament does enact measures of this kind, for the further future. It is a risk. One sees evidence of lobbying activity in a variety of jurisdictions on these fronts, and it is very important both within the UK and in the wider international community that there is strong resistance to watering down such things internationally as the Basel III requirements. Indeed, we think there is a strong case for strengthening, not weakening, those international requirements on matters such as capital requirements.

Q92 Lord McFall of Alcluith: I recognise your phrase "wonderfully united" in the context of your commission's unanimous report. I used to hear that quite regularly, but there is a lot underneath on that issue. On the psychology of the market and companies and the herd mentality, did you consider reputational risk here? Is there a case for saying that with full separation there is less likelihood of reputational damage because if there is an entity then the strong part will step in to rescue the weak part?

Sir John Vickers: We did, and in a sense that is the problem of contagion. If international part of bank X is in trouble, would that jeopardise the UK retail entity? It would be foolish to say that that risk is zero. It exists. The other side of it is the point you covered earlier about circumstances where retail is in trouble and rest of bank can bring resources to see it through those problems. There are ways to seek to mitigate that risk, and we would argue that a number of the proposed measures do that. It is not just the bigger self-standing equity capital cushion, at least 10% in the case of the large ring-fenced banks on our recommendations; it is the further loss-absorbing debt, which might take the form of contingent capital, beyond that getting us to at least 17% of risk-weighted assets; and, beyond that, if a bank is judged by a regulator not to be resolvable, a further 3% capital or loss-absorbing requirement, possibly pure equity. There is also the point about the insured depositor preference. One of the contagion risks is that queues form, as with Northern Rock; people wanting to pull out their money. If you have much greater loss absorbency and ordinary depositors and the insurance scheme backing them are nowhere near the front of the queue—indeed, they are at the back of the queue of taking losses—that is a lot of mitigation of the risk you describe, but I agree it does not disappear altogether. I agree.

Q93 Lord McFall of Alcluith: Looking at the crisis in the past few years, two issues came to the fore: the lack of corporate governance on boards and the attitude to risk. For example, in HBOS it was excessive risk; in the case of RBS it was lack of corporate governance. Quite a bit of the evidence taken by the Treasury Committee indicated that it was very hard to measure risk. Professor Charles Goodhart, who was here on Tuesday, said it was almost impossible to measure risk. Professor John Kay, who was also here, said he had been teaching it for 25 years at Oxford but threw his lecture notes into the bin just before he came before the Committee. How do we ensure that we make risk more transparent to companies and the regulator themselves so they know they are measuring it?

Sir John Vickers: I am very sympathetic to the thrust of that question and would say a few things in response. To repeat an earlier point, the supposed risk weights did no such thing. As leverage was rising from the '-20s through the '-30s and '-40s the average risk weight, in almost a perfect mirror image, was declining[250]. We see it again in a very different context with eurozone sovereign debt. It is perfectly plain for everyone to see that the risk weights do not properly reflect the risk. Part of the Basel III process is to improve the risk weights. Any improvement is to be welcomed, though it is certainly not an improvement to a state of perfection.

One of our recommendations I have not mentioned this morning is about aggregate leverage; that is, the ratio of balance sheet to equity capital unweighted for risk. In the Basel III proposals a leverage ratio of 3%—in other words, a factor of 33—is part of the agreement. We think it is very important to have a leverage backstop of that kind precisely because of the difficulties of risk-weighting, and that for the large ring-fenced banks, which on our recommendations have a higher than Basel III capital requirement, the leverage backstop ratio should be moved pro rata. I find it a bit curious that in the Basel proposals I have seen the globally systemically important banks do not have a tightening of that leverage ratio in line with the proposed higher capital requirements on them. Normally, if risk weights are doing their job I doubt that leverage backstop would be a binding constraint on institutions. If I was a regulator and it started to be a binding constraint, I would worry whether the risk weights were doing their job. I think it can be informative about the very point you make.

A final response would be that the problems you cite are even worse when the providers of finance to banks are not themselves bearing the downside risks.
When you get them into a place where they are bearing the downside risks they have much greater incentives to monitor these things themselves.

Q94 Lord McFall of Alcluith: At the last general election a report came out from the Future of Banking Commission on which I, David Davis, Vince Cable and Clare Spottiswoode served. We focused on the issue of culture, being behaviour, ethics and the resolution of conflicts of interest. Is that an issue that should be on the agenda, because there was not much reference to it in your report? Should it be a permanent feature of the agenda going forward?

Sir John Vickers: It is certainly a very important set of issues. It seems to me quite difficult to regulate directly. However, a number of indirect influences can be brought to bear. We

[250] This refers to leverage ratio figures, not decades.

would say that the ring-fenced architecture, the governance arrangements that go with it, the directors' duties and the point just mentioned about providers of finance and risk should all be helpful in this regard. Another point which has not yet been mentioned explicitly—but why not?—is the whole question of remuneration and the very understandable public anger around it. I believe it has been particularly acute in a context where the taxpayer and public finances have been bearing risk. While getting the risk away from the public finances would not solve all remuneration problems, it would be a pretty important step towards addressing them, along with other measures and regulations which directly bear on that.

Q95 David Mowat: Your report sets out quite a lot of onerous requirements for these ring fences to work. What is in it for a composite bank to have a ring-fenced subsidiary if that ring fence is working properly?

Sir John Vickers: I hope that the recommendations are proportionate, and they are certainly intended to be. If a scheme of this kind were adopted then UK banks and non-EEA banks doing retail banking in the UK would have to operate in a ring-fenced setting. If they are not doing activities of the kind disallowed from being in a ring-fenced bank that would not touch on their corporate structure. I think one of the advantages of the flexible fence is that, compared with drawing a sharp, immovable line, there will be a number of institutions which will not have a line through them because they can situate themselves on one side or another. In line with Baroness Wheatcroft's earlier question, they might say to themselves, "Given all this, we'll separate ourselves and float off the retail or wholesale investment banking bit." That would be a matter for them, and that would be fine. I do not think it should be a public policy concern if they made that choice.

Q96 David Mowat: I think that is true. My concern is that perhaps one of the reasons the banks are more sanguine about the ring fence than we expected is that they think they can get round it in a way that takes away the efficacy of the reform. It is almost a Catch-22 situation. If the ring fence works the banks will not want to do it, i.e. they will split because there is no purpose in a composite bank having a properly ring-fenced retail organisation in terms of cost of capital and all sorts of things.

Sir John Vickers: Of course, they would disagree with the statement that there is no purpose in composite banking. We have talked about the one-stop shopping point, which may or may not be material in the scheme of things. Some have argued publicly, and very much to us in hearings, that there are capital and liquidity synergy benefits in universal banking. As I indicated, we were a bit frustrated at not having more quantitative evidence on how great those benefits would be. If they are small it is more likely that banks would make the choice to separate themselves if the fence operates as intended. There is perhaps a note of scepticism in your question about how well the fence would operate. We believe that what is proposed here would be a strong fence and that would deal with half of your question.

Q97 David Mowat: But if there is a liquidity benefit in a composite bank having a ring-fenced retail outlet, it almost implies that it is not ring-fenced in the way your report talks about it as being almost like a third-party entity with arm's length transactions and all that go with it?

Sir John Vickers: Not quite, because there would be freedoms. In a way, I find it easier to think about the capital side. Subject to the various parts of the banking group maintaining required capital ratios, there would be freedom for capital to move around the group and at least in principle there could be a risk diversification benefit in that. It is not the case that risks hit in a perfectly correlated way. It is an entirely coherent argument that there are capital synergies of that kind and corresponding liquidity synergies. The hard question on which we did not reach a satisfactory conclusion is quite how large those benefits are, which was the point I mentioned earlier.

Q98 David Mowat: The implication of ring-fencing as a structure is that we would accept that the non-ring-fenced parts should go bust. Can you really imagine a scenario in which several investment banks were able to go bust without it causing retail issues, even in a ring-fenced environment?

Sir John Vickers: It would depend on the nature of the crisis. There may be some situations where the investment bank going down would pose no threat to the retail side. There are other crises one can imagine where because of the surrounding circumstances there would be some jeopardy to the retail side. Ring-fencing would gain a huge amount relative to where we were previously in terms of much higher capital and other loss-absorbing capacity on both sides of the fence. With a modular structure banks would be much easier to resolve than the rather hopeless situation beforehand where, on the same banking book, you had high street activities and some quite exotic global things. There would be many greater options available to the authorities to cope with a crisis of that kind. Indeed, the retail banking entities would be able to go under in a way that nevertheless preserved the continuity of the vital everyday service provision that those banks provided. In the US, albeit with much smaller banks than we are talking about here typically, the FDIC routinely winds up banks yet ensures that the service provision, which is what the customer cares about, is able to carry on.

Q99 Chairman: I would like to clarify a slight element of ambiguity, or maybe even misunderstanding on my part, about your report. One of the primary aims is to protect the British taxpayer from having to bail out more than necessary and to limit that implicit obligation to UK retail banking.

Sir John Vickers: Yes.

Q100 Chairman: That is achieved both by ring-fencing to reduce the risk of contamination of the retail bank by more risky activities and, within the ring fence, requiring a higher equity capital ratio. Is the equity capital ratio requirement of 10% just limited to UK banks, is it UK banks and their European Economic Area activities or is it the retail activities of any group worldwide?

Sir John Vickers: Before I answer that question, perhaps I may seek to clarify a remark you made earlier. Our aim is not to limit the government guarantee to the retail part but to go further than that and put the taxpayer as remote as possible from losses also in the retail entities, so it is to limit the scope in various ways. We hope that the circumstances in which the taxpayer would be called upon to rescue activities within the fence would be much rarer

and smaller in scope than we have seen in the past. As to the scope of the 10%-plus equity capital requirement, that would be for the ring-fenced entity.

Q101 Chairman: Is that the ring-fenced UK activities?

Sir John Vickers: Yes. A simple setting would be that a UK subsidiary but the scope of those activities would be partly a choice of the bank and the customers. You would have to have current accounts and overdrafts for individuals and SMEs; they would have to be within the ring-fenced entity, and there would be various kinds of other deposit and lending to non-financial corporates which could go beyond the UK, partly for reasons of EU law. The scope of that is cast in terms of EEA, not UK, so it would be whatever the ring-fenced entity is doing. The scope of its activities would have applied to it the 10%-plus capital requirement.

Q102 Chairman: But there would be no obligation on an international bank headquartered in the UK to have the 10%-plus equity capital requirement for a retail subsidiary in New York, China or Africa?

Sir John Vickers: No. Maybe all its activities are not of a kind within the UK retail ring fence, and then it would be either the regulatory requirements in the other jurisdictions or the international requirements. We see an advantage in the ring-fence design as well as the insulation and resolvability advantages. It enables one to have higher capital requirements domestically than apply internationally, and in our view for reasons of competitiveness in the international banking business that architecture has merit.

Q103 Chairman: The second element of my clarification is that the wider capital requirements apply to the whole group, so the 17% to 20% of loss-absorbing capacity?

Sir John Vickers: The primary loss-absorbing capacity.

Q104 Chairman: That applies to the activities of the whole group, if the group is headquartered in the UK?

Sir John Vickers: Yes. When I said just now and in our interim and final reports that international capital standards could apply to the international activities of the banks, i.e. those outside the ring fence, that was always subject to the explicit proviso that the bank should be sufficiently resolvable that the UK taxpayer is not on the hook for the external activities. We regard the primary loss-absorbing capacity, which could take the form of equity, contingent capital and debt with at least a year to run that is subject to a statutory bail-in power, as an essential part of credible resolvability. Therefore, those requirements would indeed apply. One can readily think of UK high street banks doing international activities that would not have the 10%-plus equity capital requirement for their activities outside the fence but would need credible resolvability, including primary loss-absorbing capacity of that kind, for the major banks.

Q105 Chairman: Have you considered whether that creates an incentive for large banks to move their headquarters outside the UK while retaining all their current activities

in the UK so that they have only the 10% requirement for UK retail, plus presumably 17% to 20% for UK activities generally? They would not be required to have capital adequacy higher than international standards for all their other international activities, but they would just have to have what was required wherever those activities were, or their headquarters were located?

Sir John Vickers: Perhaps there are two aspects to that question. A question we spent a lot of time considering is whether in theory a bank could evade measures of this kind by moving elsewhere in the European Economic Area and run UK retail operations from headquarters elsewhere in the EEA. I say "the EEA" because of the passporting rules. Moving headquarters to New York would not be a way of avoiding these recommendations, if they were adopted.

Q106 Chairman: But, surely, it would be a way of escaping the 17% to 20% on their global activities outside the UK?

Sir John Vickers: Yes. I was coming to that. I was starting with the very closely related question about avoiding the retail requirements. On that our conclusion was that the incentive to make such a move was pretty limited, especially in the context of retail banking where a few basis points here or there are not going to cause activities to whoosh one way or the other. The UK high street is where it is. In addition, a bank would have to confront formidable legal and major reputational and operational costs in making the kind of move I have just described. We do not think that our proposals give rise to the risk of that kind of geographical arbitrage.

As to your question about a bank trying to minimise the extent to which its activities are subject to the requirements that go with ring-fencing—the 10% and so on—in our scheme they would have a degree of flexibility. They would have to conduct the mandated services—current accounts for individuals and small businesses—within the fence, but they would have a choice about operating other activities outside the ring-fenced entity. As to going up to 17% to 20%, we do not believe that the costs of that to the banks are very great. We doubt that the incentive for that kind of arbitrage would be a very strong one. We were very conscious of the international market and regulatory surroundings of any UK proposals, so we factored that very much into our analysis.

Q107 Lord Maples: I want to follow up the previous question asked by Mr Lilley. Your answer was about the resolvability of investment banks. One of the issues here with investment banks is not so much the depositors and their confidence in the whole system, which obviously is relevant to retail banks, but the incredible web of counterparty risks that most investment banks have built up. If you let one go under you risk dragging the rest with it. Do you think the lesson of Lehman Brothers was that that is an overwhelming reason why we should have saved them, or that allowing them to fail has demonstrated that those counterparty risks are not an overwhelming reason for saving a bank?

Sir John Vickers: There are many lessons from Lehman Brothers. I should mention other regulatory initiatives going on internationally which go some way to addressing those issues. In our report we said very little about the moves towards central counterparties and central clearing of some of these derivative contracts. Instead of this great multifaceted web, if things are channelled through central points though without care that can locate risks in a particularly dangerous place, it simplifies the monitoring of a number of these things.

Another point is that in our ring-fence design we seek to provide a degree of insulation from that kind of complexity and the risk that goes with it through to the more simple, ordinary, traditional retail banking activities. Another point is to do with the wholesale markets and the term of funding there. When doubts start to arise about counterparties and all the rest we saw how rapidly that could seize up. Another topic on which we did not say a lot is liquidity regulation, partly because so much is being done on other regulatory fronts. That also goes to the point about dealing with those risks.

Q108 Lord Maples: Are you reasonably sanguine about the possibility in future of letting an investment bank go into resolution, whether that means administration or liquidation?

Sir John Vickers: At this point I would not be sanguine, no, because despite the measures just mentioned the question of international resolution has not reached an adequate resting point. In the Basel process with the Financial Stability Board and so on the question of international resolvability of these geographically complex institutions is an extremely important one on the agenda. It is not the only very important item of work in progress internationally, but one could not be at all sanguine at least until that point is satisfactorily dealt with.

Q109 Mr Brown: The European Union's regulatory architecture, rather obviously, provides minimum requirements. From what we have been told at previous hearings, I have started to form the impression that those in charge of these things intend them to be a maximum as well, yet you are describing a United Kingdom regulatory regime that in some respects, for example capital requirements, goes further than the European Union's minimum requirements. I would just like to get your understanding of how far it is possible for the United Kingdom regime to do that, how far we can require the consent or acquiescence of our partners in the European Union, and whether you think that might be an obstacle to doing what you are recommending to us?

Sir John Vickers: We did look at that, particularly after the publication in July of the European Commission's draft directive CRD IV, which is the latest in the series of capital requirements directives. That is in a form which in principle applies maximum as well as minimum harmonisation, so it is a kind of uniformity across the Community. In the report our unanimous view is that that is not a wise approach. The problems are of a race to the bottom, not a race to the top, and in line with what the Basel process and IMF have said in their comments on the financial regime in the UK, a much more sensible international approach is to have minimum standards above which jurisdictions can go. If they do go above they are doing a favour to other countries, not the opposite. That is our position of principle.

There is, however, the practical question: if the Commission's proposal were enacted in exactly its current form—there is a long way to go because of parliamentary and ministerial deliberations within the European processes—to what extent would that constrain capital or liquidity requirements? That is another one where this question arises. On that, the indications are mixed. There is some scope in the proposal as drafted for different member states to do different things if their circumstances are judged to warrant that. It is true that in the UK we have banks whose balance sheets collectively are a very

significant multiple of GDP. Some of those balance sheets individually are an order of magnitude similar to GDP. Therefore, entirely consistent with European Commission logic, there may well be scope for flexibility in that regard, but it is mixed. Just looking at the face of the draft proposal, it is not immediately clear what the answer is.

There was a letter from the director-general of that part of the Commission which deals with these issues published in the *Financial Times*. That indicated there would be very significant scope for variation of the kind I have just mentioned, but these things remain to be seen. We certainly do not draw back from our point of principle that we regard maximum harmonisation as just wrong from an economic and policy point of view.

The other point I might mention which is of some relevance is the Basel proposals on the so-called globally systemically important banks. For the largest in that category, which includes some of the largest UK banks, there would be an equity requirement of 9.5%, which is obviously very close to 10%. Therefore, the degree of difference in relation to those banks is not so great. There are, however, some banks which are nationally systemically important but are not globally at the high end of systemic importance. My view on that is that the whole logic of the Basel approach to globally systemically important banks needs to be applied nationally as well. It is entirely consistent with that logic, almost driven by it, to have higher than baseline requirements at national level, too.

Q110 Mr Brown: Where do you believe authority ultimately lies when this question has to be resolved?

Sir John Vickers: That would take me well beyond things I know about in the area of European law and policy. I assume it is an EU treaty obligation to comply with European law, so if a regulation goes through the European processes, which applies to the UK, then the UK like any other Member State must operate within it. There may well be scope—who knows?—for at least some of these measures.

Q111 Mr Brown: But do you think that includes not going beyond it? There is no question of not complying with it.

Sir John Vickers: Just as an abstract point which is well away from our context, if European law says that a Member State may not do a certain thing I imagine that it may not do that thing. As to the economic logic of this, I go back to my example of pollution. If a European regulation said that Members States must keep their pollution down to this level and also up to that level people would rightly laugh.

Q112 Baroness Drake: I think the reference in the *Financial Times* was to M Barnier's comment that there is flexibility. We have had the advantage of talking to Mr Enria, chairman of the European Banking Authority. His evidence was that if you want to move from the minimum capital requirements, as in the rule book, there will be a process and an evidential burden that will have to be met to vary from those. One of the concerns he expressed was that national banks would try to improve their financial stability and liquidity at the cost of other countries within the single market. If that is the view he

articulates, how do you feel it sits with being able to argue the case for the UK implementing the standards that you put in your report?

Sir John Vickers: I would not share the phrase "at the cost of". It seems to me that it would be to the benefit of others to have stronger and more resilient UK banks. Then they are less likely to be a source of shocks that might ripple elsewhere in Europe, and a transmitter and amplifier of shocks internationally.

Q113 Baroness Drake: I was not trying to invite you to comment on the merits of your standards but merely ask how, if the UK Government faced that kind of argument in the European context, one manages that view and achieves the standards that you are recommending? There seems to be a tension there with the EU authorities wanting quite a firm evidential burden placed on governments before they move away from those standards.

Chairman: Before they moved above, or even towards the maximum?

Baroness Drake: Yes.

Sir John Vickers: I do not know how great that burden would be. In the reference I made I did not have in mind M Barnier's remarks as quoted in the *FT* but rather a letter subsequently by Jonathan Faull of the directorate-general of which M Barnier is the commissioner. I simply do not know, even under the draft proposal which may of course be amended, how easy or difficult it would be to vary in those ways. If I were the UK in these international fora the point I would make is that it is to the benefit of European partners to have safer UK banks. Far from being in any way antithetical to the interests of other Member States, it is a thoroughly good thing for them, all the more so given the important role that the UK plays in the international financial system. I can see that if someone has a philosophical desire for uniformity for the sake of it that argument might not cut much ice, but that would seem a very odd position to adopt in the first place, and common sense and economics are in unison on this issue against maximum harmonisation.

Q114 Lord Skidelsky: I ask a slightly more theoretical question. I want to probe your economic philosophy a little bit. Am I right in thinking that your proposal is designed to make less frequent those bursts of excessive credit creation, which in a Hayekian view lie at the origins of crises or collapses, and make banks less likely to over-expand credit? In that context one goes back to a more repressed financial system as it worked in the 1950s and 1960s in the era before big bang and post Glass-Steagall. Is the design of the whole set of these proposals to retain the advantages of stability that once existed within a framework of free capital movements? Is that the way you look at it? Many people do regard the trigger of the crisis as excessive bank lending, and this is perhaps designed to make it more difficult for that to happen.

Sir John Vickers: I certainly agree that ICB proposals, along with other measures—we have not talked about macro-prudential regulation, which would be another part of it—are designed, among other things, to curb excessive lending. I and, I believe, my colleagues have not thought about it in the philosophical or Hayekian terms that you described earlier in the question. If I may put in simple terms how I have thought about some of these questions, clearly we had grossly excessive leverage before the crisis. Moreover, it turned out that a lot of the debt which should have borne loss did not. It would bear loss only in insolvency which

was too horrible a place for governments to let these institutions get to. We had a thin layer of equity capital and a very brittle debt structure. Ordinary market forces—I do not intend to sound Austrian at all—do not operate properly in that environment, particularly when everyone has worked out that that is the environment in which we now live. It would be a very hazardous way to run a market economic system to continue to tolerate such thin layers of equity capital and brittle debt structure. To move over a period of years to a system where there is a much greater equity cushion, where some debt can do its loss-absorbing job and where the providers of funding, who are best able to monitor the risks that banks are taking, have financial incentives aligned with that, that is the place to try to get to. The other side of that coin is the taxpayer getting very remote from all these activities. That is not exactly philosophical, but in very broad terms that is how I would describe it.

Q115 Lord Maples: Just to reassure you, "Austrian" is not a term of abuse to some of us.

Sir John Vickers: I meant it neutrally.

Q116 Baroness Wheatcroft: You have been very eloquent in explaining the merits of the system that you propose. I understand that the Basel timetable has influenced your thinking, even though you feel it is a little long winded. Without racing ahead of Basel on capital requirements, do you think there would be any merit in making the structural changes sooner?

Sir John Vickers: Quite possibly. We did speak about the Basel date at the latest. I should add that part of the ring-fence design is precisely to do with capital and loss-absorbing debt requirements, so it is not an altogether separable issue. But it would be entirely consistent with our recommendations for government and/or Parliament and/or the regulator to say that the subsidiarisation part has to be in place by, say, 2017 and the full population of the capital bucket could take a little longer. That would be perfectly coherent and consistent with what you have said.

Q117 Baroness Wheatcroft: Did you consider how quickly it might be possible to do it?

Sir John Vickers: We did not spend a great deal of time thinking about that, in part because we were hesitant to say more about the legislative timetable than to express the hope that it happened within the current Parliament, which takes us up to the spring of 2015. We did not think it was our place to do that. I should not go further than to say that a 2017 date for the structural component would be consistent with what we said, but we did not draw wall charts with such timing on it.

Q118 Baroness Wheatcroft: Related to the timing, your commission has now been disbanded?

Sir John Vickers: Decommissioned.

Q119 Baroness Wheatcroft: You have been good enough to come and give the House some of your time. You were before the Treasury Committee earlier this week. Do you see yourself having any continuing role to ensure that something is done as a result of your work?

Sir John Vickers: Not to ensure something is done; that would not be our role. I am sure that all of the commissioners will remain very interested in this topic. One has frequent opportunities to write in a well-read organ about these matters. Of course, he was muzzled on these questions for 15 months. I refer to Martin Wolf. I will certainly continue to take an interest but would not intend to hover frowning if less than all of this was done. I am very glad that we as a group have concluded our business on this.

Q120 Baroness Wheatcroft: Can you say something about the role of auditors and bank accounts in taking us into the situation we found ourselves in? Nobody, regulators or auditors, comes out of the situation looking particularly good, but do you think something should be done to change the role that auditors play to some extent in supervising banks?

Sir John Vickers: It is not a topic that I have thought about in any detail. The role of auditors in the context of ring-fencing would be another imperfect but additional safeguard to the other points discussed in response to Lord Maples's question. Linked to that are the public disclosure requirements with which we believe ring-fenced banks should have to comply.

Q121 Baroness Wheatcroft: You talked about risk earlier. There is quite a widespread view that the auditors were lax in flagging up the risks that banks were taking. Would that be your view?

Sir John Vickers: That strikes me as a very plausible view. I have not seen direct evidence that would allow me to be definitive on that.

Q122 Lord Maples: On the point about auditors, is the issue not so much that they did not flag up the risks but that they did not insist on write-downs in values of impaired debt and impaired assets?

Sir John Vickers: There are other initiatives in parallel with, but beyond the scope of, what we were doing about accounting standards in this area, too.

Q123 Lord McFall of Alcluith: Should auditors go back to the old principle that they should attest that the accounts represent a true, fair and comprehensive statement of the affairs of the company?

Sir John Vickers: Is that not the standard?

Lord McFall of Alcluith: No.

Sir John Vickers: Again, I have no expertise or standing on that question, but yes.

Q124 Lord McFall of Alcluith: If the FSA had followed this regulation, then auditors would be at the centre of a company's business model. The FSA did not look at the company's business model before but now look at it. Given that element of independence, the Treasury Committee previously said there should be a link between auditors and the FSA so there is a true and fair assessment of the company, because they know the company inside and out.

Sir John Vickers: My instinctive response would be very sympathetic to that, but I do not know enough. I apologise.

Q125 Lord McFall of Alcluith: If I may follow up the 2019 time scale, there are two issues here: first, political impetus and the 24-hour news cycle. Today's news is stale in a few months' time. Secondly, there is a war of attrition by the banks and lobbyists on politicians. Do you have one piece of advice for us as parliamentarians on how we lock in your reports? Do you have one real message for us as you leave hoping that these recommendations will be implemented?

Sir John Vickers: We certainly hope that they will be implemented. I repeat that we have not pitched our recommendations more hawkishly than we think right, and we very much hope that the legislative process and the ensuing regulatory process would absolutely hold its nerve against whatever pressures may arise.

Your point about impetus is an important one. It would be highly desirable if in the first instance government could give early clarity about its position in a way that was absolutely clear to the marketplace. The market can then start doing its job ahead of the regulatory timetable. With Moody's downgrades last week and the reasons given for them, we see that there can be benign developments in the marketplace once the market is convinced that things are going to happen. That can accelerate the market timetable relative to the official timetable in a healthy way.

Q126 Chairman: On the timetable, you envisage quite a substantial increase in the capital of the banks over the next seven years. Do you expect that to come from rights issues, retained earnings, suspending dividends for a significant period, increasing the margin on lending, or shrinking their balance sheets?

Sir John Vickers: We believe that can be done given the time scales without a form of deleveraging that would be detrimental to the real economy, to use that phrase. It is very instructive that over the last 25 years by far the greatest growth in bank lending has been within the financial sector rather than to households and non-finance businesses. Even though those two other segments have grown, the rapid growth and enormous rise in leverage pre-crisis was in lending within the financial system.

As to where the capital and debt are to come from, given where the banks are now with their equity ratios the move to 10% over a period of seven and a bit years is not a very steep path. Through some fresh raising of capital but also the scope within retained earnings and—possibly beyond equity capital—there may be things about deferred remuneration,—that transition path would seem very much achievable. As to non-equity, other possible components of primary loss-absorbing capacity could be debt subject to bail-in powers, contingent capital and other forms of capital. There are different ways in which banks could

achieve those requirements. Most of the main banks already have unsecured debt of the appropriate maturity. What is less clear at the moment is how truly loss-absorbing that debt would be if push came to shove, and with a statutory bail-in power that would be a major enhancement of the credibility of that loss-bearing debt. This could happen in various ways. It might depend on market appetite for contingent capital, bail-in debt and all the rest, and it is hard to foresee exactly which path would be taken. Maybe different institutions would take different paths.

Chairman: Sir John, thank you very much indeed. We are extremely grateful to you for your very lucid, coherent and clear evidence. I also congratulate you on your report. Whether one agrees with its recommendations, I think everybody would agree it is a beautifully written and coherent report, and I hope that ours will be at least somewhere on that scale when we finally report at the end of our deliberations. You deserve your decommissioning in a most positive way.

Mr Michael J Wade, Chairman, Besso Insurance Group – written evidence

To the Joint Committee on the draft Financial Services Bill; the comments below will most likely apply to questions 4 and 14 to 17 in your call for evidence and I would be pleased to elaborate further if requested.

The comments made are in a personal capacity drawn upon my experience serving on the Council of Lloyd's and on the Lloyd's Taskforce of 1991 and also on behalf of Besso Insurance Group Ltd which is an SME owning a Lloyd's insurance broking firm with 180 employees generating $0.5bn of premiums annually of overseas business into the London Market.

Please accept these views as being specialist by nature; they specifically relate to the prospective regulation by the FCA in respect of an insurance or reinsurance 'wholesale' broker operating in the London Market as a 'generic sector focused' category and where the customer is not 'retail' and where the placement originates from outside the UK.

Consequently, I refrain in commenting on other similar businesses and the essential main thrust of the new regulatory objectives / framework in areas such as systemic risk and consumer protection.

The intention is to be both respectful and supportive of the new regulatory principles set out in the blueprint for reform dated June 2011 and the general objective of maintaining the UK's ability to regulate to the highest international standards.

May I offer the following comments:

It would seem more appropriate to **house the regulation of wholesale Lloyd's brokers under the PRA rather than under the FCA**; in common with the regulation of Lloyd's itself by the PRA. There is likely to be a much greater understanding of the business transacted and the nature of regulation necessary. However, I will address my comments towards the FCA as proposed.

I would suggest that **there needs to be a greater 'regulation of the Regulator'** to ensure that fairness is achieved in dealing with the regulated. For each generic business area regulated it would be beneficial if there were an **independent appeals panel** with the power to direct the regulator if it's actions prove to be disproportionate or incorrect – and with the obligation by the **FCA to compensate** the regulated if complaints are upheld.

It has been correctly stated that **rules should be appropriate within the FCA for each 'generic sector' regulated and not a 'one rule fits all' approach** (In particular, I refer to 'Section 166' notices where there is no accountability for such requests nor compensation of costs of the regulated; accounting within the international insurance business which requires a bespoke rule-book and inappropriate use of TC4 rules are examples in this sector.) And so it is really important for the FCA to **develop expert internal teams with generic specialist remits** as seems to be envisaged although with

no detail at this stage. In turn, they would interact with the independent appeals panel, as above.

In turn, such a structure with strong checks and balances will give confidence to the regulated and enable the culture of partnership to the achieve excellence of standards that HMG seeks.

It would seem reasonable to propose that **the FCA should not be able to take Enforcement actions without fully explaining it's position, providing due notice of it's intentions and providing an appropriate mechanism for the regulated entity (such as the panel) to challenge any proposed action under *normal* circumstances.** It should be *'exceptional'* not to follow this procedure (for example, in cases of suspected fraud etc). Further, it would be fairer if the FCA were not permitted to make public any investigation or action during any normal process.

I think it **misguided to fine an entity *purely* on the grounds that, in the view of the regulator, inadequate systems and controls were not in place -** unless prior written notice about what should be in place had been previously given. It would be better, and **should be, based upon *actual* failures or wrong doing**. If a culture of co-operation is to be cultivated then the relationship between the regulator and the regulated needs to be a two way street with the same objectives of high standards. The regulated should not fear open discussion or recommendation in order to improve systems and controls.

The FCA will **need to define much more clearly what it means by 'encouraging competition'**. Ironically, it is the weight of regulation that is actually reducing competition by favouring larger companies – as the smaller competing firms become uneconomic. My earlier comments above protect the smaller companies and therefore underpin the number of entities operating – and competition. My view is that it is an **inappropriate objective for the FCA to ensure there is competition in the supply or pricing of an insurance or reinsurance contract within the 'London Market'** which is highly competitive and complex **-** where there is also a subscription market placement.

The number and amounts of **fines levied against regulated firms should surely be seen as a failure not as a success** – and the regulator should not retain any fines or have staff remunerated against such measure ? Otherwise this presents a conflict of interest and an inappropriate relationship to the cultural objective of co-operative regulation. It has been suggested, and not denied, that the FSA sets internal targets for fine generation and also for number of S166 notices issued – if true, hardly the basis of an appropriate culture for a regulator ?

It would be of great advantage **if it were possible to approach the regulator and seek a binding agreement** on handling particular aspects being regulated in respect of this generic area of business. For example, in dealing with individuals or firms overseas which are often in the Middle East, Africa, Asia, South America. The Anti-Bribery Act places a serious burden of uncertainty upon firms wishing to trade with overseas firms or individuals in these territories if coupled with the current regulatory approach adopted by the FSA. My view is that the regulated should be working with the regulator to examine how to deal with these complex tasks in a constructive culture – can we introduce some process into this principle if it were adopted ?

As has been stated within the documents, it is essential that staff employed by the regulator are experienced personnel and that longevity of employment is achieved for good regulators; failure to retain staff becomes hugely wasteful for the regulated too.

In conclusion, the establishment of a generic specialist business assessment board to regulate the regulator would address many of the issues and concerns raised here; it would 'partner' an equivalent generic specialist unit within the FCA. The objectives would be to achieve the highest standards of regulation whilst also recognising the practical realities of generating overseas business into London, the nature of wholesale activity in this respect and, above all, proportionality to the issues it addresses. In this way, it will be possible to be excited and embracing in the function of regulated wholesale insurance and reinsurance brokers and their value in helping the UK in its quest to deliver an export led recovery for the Economy.

September 2011

Which? – written evidence

Overview

- Which? will judge any proposal for reform on one basis: will it deliver a better outcome for consumers? Structural change should not be seen as an alternative to undertaking in-depth reforms to the culture and way in which the regulators operate.
- We would like to see additional measures around resourcing for the Treasury Committee and transparency on Board processes to improve the accountability of the regulators. However we support the need for the regulator to be independent from Parliament.
- We strongly believe the PRA should have the same obligations, set out in legislation, as the FCA to maintain and consult practitioner, small businesses and consumer panels. Consideration should be also given to how the FPC interacts with the panels.
- Measures should be put in place to ensure that a diverse range of expertise and experience is included on the board of the regulators.
- Changes are needed to strengthen the language used in the PRA's insurance objective so it matches that of the FCA's consumer protection objective. The PRA should also discharge its functions in a way which promotes competition.
- We are extremely concerned that the draft Bill does not go far enough to ensure a new regulatory culture and a more proactive approach to regulation. We would like to see changes made to the objective and powers of the FCA that would ensure the Government and Parliament's intentions are hard-wired into the way the FCA operates.
- We believe amendments are needed to the 'efficiency and choice' objective to give a clear definition of 'choice'. This 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.
- We are comfortable that the need to promote competition is given sufficient weight as a result of the inclusion of '*efficiency and choice'* as an operational objective, when suitably defined, and the duty for the FCA to discharge its general functions in a way which promotes competition. However, it is important that the FCA is able to receive 'super-complaints' and is required to report back on the action it has taken.
- We are concerned that there is a significant imbalance between the responsibilities of consumers and firms as set out Section 3B of the Bill. We would oppose any proposals for the regulator to designate specific actions that consumers should be responsible for undertaking.
- We welcome the measures in the draft Bill which seek to address mis-selling including the new product intervention and financial promotion powers, s404 powers, information sharing between the FOS and the FCA and the consumer redress proposals.
- The FCA should conduct more mystery shopping, tackle remuneration structures for staff which encourage mis-selling and take greater enforcement action against the senior management.
- We reluctantly accept the need for the PRA to be able to veto an FCA action in the interests of financial stability, but are clear that the use of the veto should be seen as regulatory failure and should trigger an independent inquiry.

- The Government's decision to place certain aspects of the regulation of with-profits policies with the PRA means that improvements need to be made to the PRA's objectives and consultation mechanisms so with-profits policyholders do not receive second class protection.
- The Government and the FSA need to set out a clear strategy for engagement and influence with the ESAs, including how to best engage with the ESAs in their consumer protection remit.
- Clarification is needed over whether to promote competition the Government intends for the FCA to have the ability to make interventions on pricing issues, particularly with regard to ancillary / default charges.

Introduction

Which? sees the impact of poor financial regulation across numerous areas of our work. Our mystery shopping frequently reveals unacceptable standards in financial services, our money research team comes across numerous badly designed products, and our money helpline hears from a plethora of people who've suffered financially and emotionally as a result of these poor products and services. Because of this we have worked closely with the Financial Services Authority (FSA) on numerous issues since its creation. This has given us insight into the way in which the regulator works, and clearly showed us that their approach to regulation did not deliver for consumers.

While the failures of the FSA in the prudential sphere in the run-up to the financial crisis have been much documented, it should not be forgotten that there were also serious flaws in conduct of business regulation over the past ten years. There have been numerous areas in which the FSA's regulatory approach has failed to ensure consumer protection: the endemic mis-selling of payment protection insurance, long delays in properly resolving complaints about endowment mortgages, mis-selling of precipice bonds and structured products, the proliferation of poor quality financial advice and the introduction of poor affordability assessments for mortgages all occurred under its watch. Indeed, in our review of the regulator in February 2007 Which? concluded "the FSA still has to do considerably more to ensure consumers are properly protected and to ensure the industry genuinely treats its customers fairly"[251].

Our research supports this view and shows that consumers believe that the FSA does an important job in principle and practice, but does so imperfectly. Criticism focuses on the fact that consumers believe that the FSA isn't powerful or sophisticated enough to control providers, or is too close to those it regulates[252].

Consumer views on the FSA

"I think the FSA wait for people's responses. I don't think they investigate something before it comes on the market, only after it has gone wrong"

"I think the problem with the FSA is that they are trying to regulate an industry which has the means to hire much cleverer people than it can, so they are always ten steps behind what the industry is doing, especially investment banks."

"The people in the FSA are the same people who used to be bankers. They're from the same school"

"They're too close to the industry. The industry can get away with anything"

As a result we have welcomed the changes the FSA have made to their approach since the crisis, including an increasing pro-activeness and a greater willingness to tackle the root causes of consumer detriment. We also support the commitment the Government has made to putting the consumer at the heart of the regulatory system and ensuring the FCA has the tools and powers it needs to secure protection for consumers. Our key focus during the passage of the legislation will be to ensure these changes are hard-wired into the new system so consumers receive the protection they deserve.

We have only responded to those questions where we have expertise and for the most part the views set out in this response focus on the proposals relating to the FCA. In addition to our views we have also included the advice we received from John Odgers, a barrister specialising in financial services issues who we commissioned to provide analysis of the draft Bill.

1. Is the separation of prudential and conduct regulation into a "twin peaks" system the right approach?

Which? will judge any proposal for reform on one basis: will it deliver a better outcome for consumers? We would endorse the opinion set out in the Sassoon Review that "creating an effective regulatory structure is a necessary but not sufficient condition for a successful regulatory regime[253]". Furthermore we would agree with the broad thrust of the view expressed by Professor Jeffrey Carmichael on the limitations of structural change:
92. *"New structures do not guarantee better regulation. More appropriate structures may help, but, fundamentally, better regulation comes from stronger laws, better-trained staff and better enforcement."[254]*

Thus while we are not opposed per se to any change in regulatory structure, we do not believe this should be seen as a magic cure for regulatory failings. Structural change should not be seen as an alternative to undertaking in-depth reforms to the culture and way in which the regulators operate. We strongly believe that regardless of any changes to the regulatory structure, major non-structural changes are needed to ensure successful conduct of business regulation. These include ensuring the regulator has:

- A more diverse and accountable board;
- Increased regulatory transparency;
- A tougher approach to enforcement;
- Powers allowing product regulation; and
- Suitable mechanisms for effective redress.

[253] The Tripartite Review Preliminary Report, March 2009, para 39.
[254] Ibid.

We would also argue that there is an additional factor necessary to ensure better regulation, and that relates to the philosophy and mindset of the regulator. As Lord Turner of Ecchinswell, Chairman of the FSA, noted in his evidence to the Treasury Select Committee in 2009:
"We had a philosophy of how we did regulation which focused on organisation structures, processes, systems and whether the reporting lines were correct. It fairly overtly said that it was not the function of the regulator to cast questions over the overall business strategy of the institution… I think it is also the case that that existed within a political philosophy where all the pressure on the FSA was not to say: "Are you looking more closely at these business models?" but to say: "Why are you being so heavy and intrusive? Can you not make your regulation a bit more light touch?"[255]

2. What lessons can be learnt from the approach of other countries to regulation of the financial sector?

There are a number of lessons which can be learnt from the operation of the twin-peaks model in the Netherlands. The Dutch system gives responsibility for prudential regulation to the Dutch Central Bank (De Nederlandsche Bank) and responsibility for conduct regulation to the Authority for Financial Markets (AFM). In particular, we believe lessons can be learnt about the failure of DSB bank (Dirk Scheringa Beheer Bank). DSB bank had a business model which involved the sale of single premium insurance policies alongside mortgages. The bank received very high commissions for selling these insurance policies and there were reports that the bank had been informing customers that they would only get the loan if they also bought the insurance. The premium for this insurance policy was added to the loan. This meant that when the initial low interest rate expired, consumers struggled to make their payments and were unable to move or sell their house due to the fact that the cost of the insurance policy had been added to the loan. When the substantial mis-selling by DSB came to light the bank collapsed. Subsequently, concerns were expressed about the dominant position of DSB's chief executive – Dirk Scheringa.

The report into the collapse of the Bank by the independent Scheltma Commission concluded that the Dutch central bank did not sufficiently recognise the defects in the structure of DSB's business model and failed to intervene proactively. By contrast, once it had been granted the additional powers the AFM had acted to warn about the potential for detriment from DSB's approach.

We believe this experience illustrates that prudential authorities need to consider the potential for consumer detriment from a firm's business model when supervising the firm. Both regulators should ensure that management of potential risk from consumer detriment should be a key part of the culture of the firm. The potential risks from lapses in conduct regulation must be addressed and both regulators should ensure that the firm makes early provisions for potential costs[256] and that these are disclosed to shareholders. It also highlights the need for the conduct regulator to be able to prohibit specific products which pose risks of consumer detriment. In areas where the regulators disagree, it is important

[255] Lord Tuner of Ecchinswell's evidence to the Treasury Select Committee, 25 February 2009. Q2145 from Banking Crisis Oral Evidence, Volume 1 (HC 144-1).
[256] It is unclear how prudential regulators will address risks from consumer protection lapses and how banks will be expected to make allowances for potential consumer protection issues as part of the Basel capital adequacy requirement to hold capital against 'operational risks'

that the views of both regulators are communicated clearly. Finally, where a failure has occurred it is important that there is an independent inquiry into the actions of both regulators.

4. Are the accountability and governance arrangements for the Bank of England, FPC, PRA and FCA satisfactory?

Accountability

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.

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. These could either be undertaken by the committee as a whole or by a new sub-committee if it was felt this would be more efficient.

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.

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 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.

Panels

We are very concerned by the Government's decision that the PRA will not be required to establish, maintain and consult panels and will instead be given the flexibility to decide what arrangements it wants to establish. This concern is exacerbated by the fact that the PRA's

general duty to consult contains no mention of the need to consult consumers or consumer groups. We do not believe it should be in the gift of regulators to make these decisions – it is a matter for Parliament to determine the structure within which regulators operate and their consultation mechanisms should be part of this. Furthermore we do not see any reason why, given the Government accepts the benefits that the panels provide the FCA, they are not seen to be similarly necessary for the PRA. We therefore firmly believe the PRA should have the same obligations, set out in legislation, as the FCA. The existing FSA panels have played a valuable role in allowing the FSA to consult with the industry, small businesses and consumers on issues of regulation. Panels that would overarch both regulators would help to ensure that the cumulative impacts of prudential and conduct regulation are assessed at market, regulated firm and consumer levels.

We also believe that consideration should be given to how the FPC interacts with the panels. It is clear that the FPC is not going to be a consumer-focussed body. However its decisions could have a huge impact on consumers – for example the decision to limit credit to cool a housing bubble will have a huge impact on both potential and existing home-owners. We are concerned that the FPC will not have the expertise, desire or remit to examine these impacts. We therefore believe the FPC should ask the Consumer Panel to approve its analysis of the potential impact of its proposals on consumers.

Board structure

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.

It is clear that alternative perspectives are needed and the Boards needs to be more diverse. As a result we believe it is necessary to ensure there is an increase in the number of Board members with experience and knowledge of consumer issues. It is also important that all Board members are independent of the industry and should only be allowed to participate in decisions where they are free from conflicts of interest. Given that the PRA will be responsible for undertaking areas of conduct of business regulation we believe this consumer focus should also be reflected in their Board composition.

8 & 9. Has the right balance been struck between the powers of the FPC and the powers of the Treasury? Can Parliament take an informed decision about the proposals for the FPC without details of the macro-prudential tools at its disposal?

Which? believes it is important to ensure appropriate safeguards are in place given the extensive powers proposed for the FPC. We support the proposal set out in new section 9L that, in general, orders under section 9K must not be made unless a draft is laid before and approved by Parliament. We also support the safeguards set out in new section 9K(4) that orders may require the FPC to maintain a statement of general policy that it proposes to follow in relation to the exercise of its power of direction. However we believe this drafting

should be amended from 'may' to 'must'. This will ensure Parliament has the necessary information on how the FPC will use its powers and will thus be able to make a more informed decision when deciding whether to approve the order.

11. Are the PRA's objectives clear and appropriate?

We believe changes are needed to the PRA's insurance objective which currently reads *"Contributing to the securing of an appropriate degree of protection for those who are or may become policyholders".*

This drafting may be contrasted with that of the FCA's consumer protection objective which requires the FCA to aim to secure protection (see new section 1C(1)). We believe the drafting used in the FCA's objective is more appropriate. This view is shared by John Odgers, a barrister specialising in financial services issues who has given us advice on the draft Bill. He states:

"It seems to me quite unnecessary, and unhelpful, that such different language is employed in the insurance objective. Nobody would suggest that either regulator is solely and uniquely responsible for protecting consumers or policy-holders, hence the efforts of both are necessarily no more than 'contributions' towards those ends. But drafting a statutory objective in terms of merely contributing to the desired outcome seems a virtual license for failing to take a leading role and/or passing the buck if the objective is not met… In my view, therefore, the drafting of proposed new section 2C(2) should be amended by omitting the phrase 'contributing to the'". [257]

As outlined in our response to question 22, we are concerned that the PRA is being given responsibility for areas of conduct regulation in the insurance field. Given the regulator's lack of focus and experience on conduct issues we believe, if it is to have these responsibilities, it is essential that it is given a clear remit to protect policyholders.

We also believe it would be beneficial for the PRA to be given the same overarching duty as the FCA to discharge its functions in a way which promotes competition. This would help ensure that it doesn't focus on preserving existing institutions, but instead on creating a market where individual institutions face a realistic prospect of failure. It would also create an incentive and duty for the regulator to limit and remove the implicit subsidy received by the banking sector which distorts competition and disadvantages new entrants.

14. Given that the PRA and the FCA will inherit FSA staff does the draft Bill do enough to ensure a new regulatory culture and a more proactive approach to regulation? Will these two new bodies have staff with the appropriate skill and expertise?

We are extremely concerned that the draft Bill does not go far enough to ensure a new regulatory culture and a more proactive approach to regulation. We very much support the intentions set out by the Government in its White Papers 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

[257] Written advice from John Odgers, Barrister, 3 Verulam Buildings, 12th August 2011

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. We believe a series of amendments could be made to the objective and powers of the FCA that would help, in a sense, to legislate for the culture of the organisation.

In order to ensure the FCA takes a more proactive approach, we believe it is necessary to amend its proposed strategic objective. This objective will be vital in conditioning the approach the regulator will take and thus it is essential that the legislation gets this right. We do not believe the current drafting of "protecting and enhancing confidence in the UK financial system" sets the right tone for a regulator which is intended to take a proactive approach and place the consumer at the heart of the regulatory system. As John Kay noted in a recent comment piece on the Government's plan, the stated objective is more appropriate as the duty of a trade association not a regulator:
"The mission of the Medicines and Healthcare Regulatory Agency is to "enhance and safeguard the health of the public by ensuring that medicines and medical devices work, and are acceptably safe". If the MHRA is successful in that endeavour, the public is likely to have confidence in the healthcare system. But it is that way round. "Protecting and enhancing confidence in the pharmaceutical industry" is the duty, not of its regulator, but its trade association.[258]"

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. We also have concerns about the unintended consequences that could result from the current proposed primary objective. 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".

In addition to the need to amend the strategic objective, we also believe amendments are needed to the powers of the FCA to ensure it takes the proactive approach intended. We would recommend two adjustments to the powers to apply financial penalties.

Currently any proceeds from financial penalties are applied for the 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.

[258] "A flawed approach to better consumer protection" John Kay, Financial Times, 28/06/2011

While we welcome the steps taken to encourage the FCA to be more transparent, we are concerned that the regulator is severely constrained in its ability to be open. This is a result of the constraints imposed by s348 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 of 'confidential information' and identify areas where the FCA can be more transparent.

15. Are the FCA's primary objectives appropriate? Is significant emphasis given to the promotion of competition?

As noted in our response to q14 we believe the strategic objective of the FCA should be amended and the current objective of "*protecting and enhancing confidence in the UK financial system*" should be replaced with one 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"*.

We support the operational objectives set out for the FCA. However we are concerned that the drafting of the 'efficiency and choice' objective is not sufficient to ensure it achieves the intended outcomes as the legislation does not give any clue as to the intended definitions of these terms or include any 'have regards' to direct the FCA. We would thus suggest section 1E 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.

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. The current draft only includes the term 'accurate' information. We would note that information may be 'accurate' without being 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'.

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. As a result we are comfortable that the need to promote competition is given sufficient weight as a result of the inclusion of '*efficiency and choice*' as an operational objective, when suitably defined, and the duty for the FCA to discharge its general functions in a way which promotes competition. We support the view that when promoting competition would undermine consumer protection, the latter should be given primacy.

Which? are clear that competition is only effective if it acts to protect and benefit consumers. As we note above 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.
- Conflicts of interests between firms and their customers are removed or managed appropriately

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.

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.[259] 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.

The FCA board should also invite and resource a suitably qualified, independent person to review its performance at the end of the business year in respect of how it has exercised its relevant powers to promote effective competition and make enhanced referrals to the OFT. This person should report to the board with proposals to improve the FCA's practices for the forthcoming business year. This report should be published.

17. Does the draft Bill strike the right balance between the responsibilities of consumers and firms? Are the FCA's new powers in the area of consumer protection appropriate?

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.

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'."[260]

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[259] In relation to financial services Which? has made super-complaints regarding Northern Ireland banking, Credit card interest calculation calculations and Card surcharges
[260] Written advice from John Odgers, Barrister, 3 Verulam Buildings, 12th August 2011

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*"[261]. As a result we believe it would be wholly inappropriate to extend consumer responsibility beyond the common law principles.

19. Will the new regulatory arrangements reduce the risk and cost of dealing with mis-selling of financial products?

In the past ten years we have seen substantial detriment caused to consumers in a number of areas including mortgage endowments and Payment Protection Insurance. The impact of these problems on consumers has been compounded by the slow response of the industry and regulators. Excessively long timescales, poor complaints handling and inadequate redress have become all too common.

We therefore welcome the measures in the draft Bill which seek to address these issues:

- 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.

- 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.

- FCA and the FOS: We 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.

[261] A new approach to financial regulation: building a stronger system, HMT, February 2011, para 4.26, pg 64.

- 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.

- 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.

- 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 order to further tackle mis-selling, it must also be ensured that:

- The FOS retains its powers: The existence of an effective consumer redress system is vital to ensuring confidence in the financial system and to facilitate the smooth running of the industry. Which? believes that the FOS is effective at providing a method of dispute resolution which is fair to both consumers and firms. The FOS ensures a level playing field between firms and consumers and provides an effective alternative to the court system. It is important that the reforms to regulation do not downgrade the role of the FOS. We would oppose the introduction of any fee for consumers to access FOS or extra appeals processes for firms.

- 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.

- 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.

- The FCA tackles the root cause of detriment from remuneration 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.

- 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.

We accept the Government's view that there can never be a zero-failure regulatory regime. However we believe the above measures will be effective in reducing mis-selling to consumers and ensuring effective redress when such mis-selling occurs.

21. How do the proposals in the draft Bill fit within the new European regulatory regime? What freedoms and constraints will the UK have to operate within that regime?

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.

22. Does the draft Bill contain any proposals or omissions, not covered by the questions above, which cause concern?

PRA veto

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.

While we reluctantly accept the need for the PRA to be able to veto an FCA action in the interests of financial stability, 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, while 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.

With-profits

We are concerned about the Treasury's decision to place certain aspects of the regulation of with-profits policies with the PRA. We have two key issues with respect to the treatment of with-profits in the reform process:

1) PRA undertaking conduct regulation: 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 the proactive approach to consumer protection that is envisaged for the FCA. The PRA also lacks the remit of the FCA to promote competition. In addition unless the Government consents to our suggestion, the PRA does not have in place any consumer representation mechanisms. As a result with-profits policyholders face a situation where they may receive second class protection when compared to holders of other financial services products. We are clear that the regulatory regime for with-profits must focus on the fair treatment of policyholders. Any downgrading of this requirement would be a retrograde step.

2) Terminology in the draft Bill: The draft Bill re-introduces the concept of 'Policyholders Reasonable Expectations' (PRE) which we believe is retrograde step in terms of policyholder protection. As the FSA stated in their with-profits review in 2002 "*'Treating customers fairly', unlike the former 'policyholders reasonable expectations' is an obligation imposed by rule and no longer only a ground for intervention derived, in part from actuarial best practice.*"[262] Unless this drafting is reassessed we are concerned that policyholders will face an unwinding of the positive improvements the FSA has made to regulation in recent years.

In order to address these weaknesses we would suggest five legislative amendments. Firstly, as set out in our response to q11, we believe the PRA insurance objective should be amended. Secondly, we believe the drafting with respect to with-profits should be amended from '*responsibility for contributing to the securing of an appropriate degree of protection for the reasonable expectations of policyholders*' to '*responsibility for securing an appropriate degree of protection for policyholders*'. Thirdly, the PRA must be given a remit to discharge its functions in a way which promotes competition. Fourthly, the PRA must have a specific duty enshrined in statute to consult the FCA with regard to with-profits funds. Finally, if the PRA is to be given responsibility for areas of conduct regulation, we believe it is all the more essential for

262 With-profits review feedback statement, FSA, May 2002, para 5.43

the regulator to have statutory duties towards proper consultation and the maintenance of panels as set out in our response to q4. Unless all of these changes are made and there is a clear commitment for the PRA's regulation of with-profits to focus on the fair treatment of policyholders then moving regulation for with-profits funds to the PRA poses a significant risk of consumer detriment.

Clear and transparent pricing: Avoiding price obfuscation through ancillary / default charges

We believe clarification is needed over whether the Government intends for the FCA to have the ability to make interventions on pricing issues.

We 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.

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.
"The FCA will thus consider exercising its powers to take action where costs or charges are excessive."[263]

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."[264]

We would therefore welcome clarification from the Government on this matter.

September 2011

[263] The Financial Conduct Authority Approach to Regulation, June 2011, Pg 19
[264] Written advice from John Odgers, Barrister, 3 Verulam Buildings, 12th August 2011

Which?; Reserve Bank of Australia; Consumer Focus; Citizens Advice Bureau; moneysavingexpert.com; Mr Paul Lewis; Financial Services Compensation Scheme; Financial Ombudsman Service and Money Advice Service – oral evidence (QQ 99-206)

Transcript to be found under Consumer Focus

Which? Citizens Advice and Consumer Focus – written evidence

Evidence to be found under Citizens Advice

Williams Farrell Woodward – written evidence

The FCA – The Replacement for the Failed FSA

1. Background

i. Financial services regulation began with the 1986 Financial Services Act which received Royal Assent on 7th November 1986. This Act introduced financial regulation based on the report by Professor Gower and a subsequent Government White Paper. The Act introduced statutory regulation through the Securities and Investment Board (SIB) and established various self-regulatory organisations, for example, LAUTRO, FIMBRA.

The 1986 Financial Services Act is often confused with the de-regulation of financial markets in the City of London on 27th October 1986. This de-regulation broke down many of the vested interests and restrictive practices that made London uncompetitive in a growing global market for financial services. The purpose was to liberate the power of competition to drive down price and drive up quality.

In contrast, by the nature of these things the SRO's (self-regulatory organisations) established by the 1986 Financial Services Act grew more bureaucratic and morphed into organisations that sought to set the agenda for the various sectors they regulated. They missed no opportunity for regulatory marketing to parade themselves as 'honest representatives' in alleged 'chaotic' market (Note, the 'market' is quite beyond their comprehension, as it is of all of us as individuals, but as a voluntary collective trending always to spontaneous order it is the most efficient way of resolving all the billions small equations necessary to maximise production to satisfy the infinitely disperse wants of all of us).[265] They executed a neat reverse power grab.

ii. Undoubtedly there were teething troubles with self regulation where various alleged scandals – for example the Maxwell pension thefts, the alleged problems with pension transfer sales and endowment linked mortgages – were used by a feral media to press for more 'regulation', as in bureaucratic control, of financial services. However most of these alleged scandals were well on the way to internal solution until they were spotted as an excellent political opportunity by unscrupulous politicians also seeking power.

iii. The establishment of the PIA under the last Tory administration still had at its heart the freedom and markets and responsibility agenda of the original drafters of the 1986 Act, and in general it was developing nicely, until 1997, and the advent to power of New Labour.

iv. New Labour, under Gordon Brown's (now incontrovertibly evident) flawed financial stewardship then set about introducing an entirely different type of regulation under its Financial Services and Markets Act 2000. This Act not only introduced the now entirely discredited 'tri-partite regulatory system', but also had a much more insidious purpose to proto-nationalise all levels of financial services by way of very prescriptive and highly detailed rules that were intended to set out exactly how every element of financial services needed to be conducted – in the view of a very few,

[265] See Ludwig von Mises 'Human Action'.

largely ignorant, functionaries. And worst of all remove the regulators from any possibility of democratic accountability and the Rule of Law. These bureaucrats were handed arbitrary power and the permission to exercise hindsight judgements and made safe from challenge in the Courts. This is the Fabianistic Gradualism agenda in action.[266]

v. Needless to say such an approach failed spectacularly, as all such proto-communist/socialist central planning always does. This type of proto-nationalisation predictably:
   - Presided over the collapse in the savings culture,
   - Deliberately engendered for its own ends the destruction in trust of financial services by the general public,
   - Positively encouraged the massive expansion of money and credit that again predictably precipitated the failure of a dozen or so banks and the near collapse of the UK financial system.

The end result being the socialising of massive debts onto the taxpayer. These policies are now ending in rampant inflation – as in the destruction of the purchasing power of money. By whatever measure the FSA as part of the entirely discredited New Labour era has utterly failed.

vi. However by skilled propaganda and the use of the corporatist mindset of the monopolistic BBC and other captive media the Failed FSA has worked hard to shift the blame onto the regulated and 'the market' (aka human action) whom it failed. The fact that it is now being consulted on the terms of reference for its replacement, is like asking the fox how best to secure the chicken run.

vii. In all this one overriding quality is evident, and that is deceit. New Labour gained power by the skilful use of deceit. In government it ruled by deceit (aka 'spin') and the institutions it established, like the failed FSA are made in its image as entirely deceitful.

viii. There is an autocratic European dimension to all this.

The rot begins with the EU. Given that our courts system is not emulated elsewhere in the continent, EU directives stipulate things like (2005/29/EC):

"*Member States shall confer upon the courts* ***or administrative authorities powers enabling them****, in cases where they deem such measures to be necessary taking into account* ***all the interests involved*** *and in particular the public interest...*

*...****even without proof*** *of actual loss or damage or of intention or negligence on the part of the trader.*"

and

"*The administrative authorities referred to in paragraph 1 must ...* ***normally*** *give reasons*

[266] Fabian Gradualism:
In the context of socialism or Marxism which is where you have probably heard it, it means a slow revolution that makes massive changes over a period of time and is masked by diversions. Such diversions are usually created as smoke screens and could be economic like a failing economy, a health care crisis like a pandemic, pop culture crisis like Michael Jackson's death, or the use of media to divert attention from real issues by concentrating on such issues as marriage infidelities and the performance of past leaders. Over a period of time, a revolution in a government occurs and the citizens are duped and don't even realize it. That's what fabian gradualism means. Sound familiar From Yahoo http://answers.yahoo.com/question/index?qid=20090628142526AAXCPF0

for their decisions. EU directives are full of things like this that enable the 'administrative authorities' to behave in an entirely arbitrary and unaccountable manner.

ix. Our agenda with this paper is to encourage honesty and a return of freedom and responsibility to Financial Services and its clients and customers by setting the terms of reference for the FCA to be a genuinely light touch regulator which recognises the superiority of free people to decide their own priorities. Ideally the FCA will seek to work itself into redundancy. Markets, all markets trend to spontaneous order. Capricious bureaucratic control always creates chaos.

2. Key Requirements for the FCA

i. Democratic accountability

If there is one thing that characterises all the fake institutions and quangos established by New Labour it is their utter lack of any democratic accountability whatsoever. The failed FSA is one of the worst offenders in this regard, gaily riding roughshod over all the hard won personal liberties established over hundreds of years and acting as a quasi-judicial body as it suits its proto-nationalising agenda.

There are no circumstances when it is acceptable for a small number of capricious petty functionaries to hold sway over the livelihoods and free choices of millions of free citizens by the application of arbitrary judgements enforced by coercion entirely un-moderated by the rule of law.

Parliament is Sovereign. MP's are the people. The consent they rule by is that they are accountable at the ballot box for their successes and failures. Hence institutions established by Parliament must be entirely and absolutely accountable to it. These institutions exist for the benefit of all the people, not the other way about.

ii. Subject to the Rule of Law

The Failed FSA has admitted that it 'makes law'. In a representative democracy only Parliament has the mandate from the people to 'make law'. Once the law is made by Parliament the Judiciary interprets its application. If this interpretation contradicts the intention of Parliament the law can be amended.

If the Failed FSA – or its successor – can make law willy nilly we are putting into the hands of democratically unaccountable bureaucrats the control of free people. There is no method of challenge. Self evidently this is not acceptable.

The presentation made by the Failed FSA seeks to have the FCA not subject to the Law. That is it can act as it wishes without any chance of a legal challenge. (See 1. (ix) above). This is entirely unacceptable. No-one must be above or not subject to Law, especially administrative functionaries working through quangos.

iii. Honesty of Private Business

The FCA will recognise the inherent honesty of private business. Private business is only successful by consent. It can only succeed if it serves well its customers and employees.

The success of its employees and customers is intimately linked to the success of private business. It is a self regulating system where entrepreneurs can only profit if their employees and customers do so as well.

In recent times we have seen the institutions of Parliament and the civil service and attendant quangos become increasing mired in dishonesty. This is the direct result of a lack of accountability, and the absence of any skin in the game. There is zero motivation for any capricious functionary to be anything other than self serving and a seeker after entitlements all funded by coercion on private business.

iv. The Inherent Ignorance of Bureaucrats

It has been proved conclusively that socialist/communist bureaucratic central planning always fails since knowledge and wisdom is entirely dispersed in society and is always changing. No bunch of capricious functionaries is ever able to be in front of the curve of the ever shifting knowledge of the free market. It can only do so by entirely negating liberty and enslaving us all. Even then it will fail since once it has done away with freedom and the price signal it then must have no method of calculating economy and hence the internal tensions and massive inefficiencies so brought about will cause it to self-destruct. Those of us of sufficient age – say about 35 – and aware of history in the making are fortunate to have seen this effect in action with the collapse of the centrally planned socialist soviet empire in 1989. In short the FCA must abandon any form of socialist central planning and calculation (in any event impossible) and seek to work through a clear understanding of the philosophy of freedom and responsibility and superiority of markets in calculating the least disadvantageous outcome for all agents.

v. Humility

By more than any other measure the Failed FSA is arrogant in the extreme. Combine this with its institutional ignorance and you have the perfect recipe for the most toxic combination of characteristics. The FCA must be constitutionally reminded that it is the servant of Parliament, that is the people, and that its ignorance cannot be compensated for by an arrogant assumption of superior morality or worth, which it self-evidently will never possess.

vi. Equity

The Failed FSA, like New Labour, just loves ‘fairness’. This is juvenile in the extreme. Life is not fair. Get over it. However what everyone should expect is that everyone else treats them equitably, whether it is in business dealings or before the Law. Equity means fair *and* just.

The FCA must ditch all the ludicrous ‘fairness’ agendas of the failed FSA and seek to encourage equitableness in all its dealings and the wider financial services market place. This approach engenders responsibility which the unavoidable companion of liberty. And liberty is the fundamental value on which all other values are built.

vii. Agenda for Banking Reform

The key component in the recent troubles (the appalling excesses and general incompetence of the States' centrally planned money managers not excepted) is the current banking settlement. Parliament must pressure the government executive to implement Mr Douglas Carswell MP's proposed[267] reforms prior to the inception of the FCA. Sound money and banking is an absolute prerequisite for a successful financial system. No amount of fringe regulation will be able to succeed without it.

In regards to the adequacy of bank capital reserves the FCA must move away from the various flawed Basel initiatives and seek market solutions. Hopefully these competencies will be passed to a reformed and re-strengthened Bank of England.

viii. Funding

The current deceit that the Failed FSA is 'funded by the industry' will not wash. Everyone knows that economies consist simply of people and things and that governments and companies are just convenient administrative fictions by which we try to better organise our lives. Hence all the Failed FSA's fees (aka trading taxes) paid by the regulated are passed straight through to the end user, the client or customer. The coming of the FCA is a golden opportunity to reform this deceit. FCA fees must be an explicit product levy paid by all individuals on all financial products they buy or use. If the EU can posit a 'Tobin Tax' as administratively do-able then, and with the evidence of IPT, it is equally easy to fund the FCA in the same way. This method will connect the citizen directly with the cost of regulation; he will see the true 'price'. After all, regulation is a form of insurance offering protection benefits in the event of commercial failure. No doubt the FCA would like this made compulsory, but personally I would construct it as an 'opt in' at the point of sale. This would then be a true test as to exactly how much the taxpaying population actually value 'regulation'.

ix. Separation of Powers

It is a fundamental principle for accountable government that powers are separated. At present the Failed FSA is prosecutor, judge, jury and executioner. This conflicting arrangement encourages arbitrary judgements and lunatic 'fines'. For example the Nationwide building society – a mutual society – lost a lap top with customer data on it. The Nationwide itself exposed the problem, dealt with it and no-one's date was compromised. It then reported itself to the Failed FSA which slapped a £2m fine on it. This is Alice in Wonderland stuff. It makes no sense to 'fine' a mutual society for a lapse as the members pay their own fine.

x. Coercion

In the UK we have a settlement whereby the State has the monopoly of violence but at the same time the State is severely restricted in how and when it can apply such coercion, ultimately enforced by methods of violence. The principles enshrined in Magna Carta and Habeous Corpus are paramount. The Failed FSA uses coercion willy nilly to

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[267] Douglas Carswell MP – Banking Reform Proposal
http://www.talkcarswell.com/show.aspx?id=1587
http://www.cobdencentre.org/2010/11/carswell-and-baker-on-bank-reform/
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enforce its agenda. A good example is the upcoming RDR, where unless one complies, the businesses and livelihoods will be snatched away from IFA's at the instance of midnight on 31 December 2012.[268] How can it be right that an unelected bunch of functionaries to have such power ? The FCA must not have such autonomy and arbitrary authority.

xi. FCA as a Competitor to Private Business

For all the reasons of liberty and free markets it is unacceptable that the Failed FSA and if it has its way, its successor the FCA, is permitted to put itself in direct competition with private business but without the financial restraints of private business and without any responsibility. It is not that it out-competes private business, it does not . What it is, is a monopoly state player funded by taxation on private business and individuals. It will have no skin in the game and it will not be at all accountable for its advice.

xii. Conclusion

This is a golden opportunity to reform the Failed FSA model and to return lost liberties to all of us – practitioners and citizens alike. At the moment the flawed and self-serving analysis of past failures made by the Failed FSA are deliberately inhibiting such debate. We must correctly analyse the reason for failure, which include…

- epic unaccountability,
- central planning,
- bureaucratic capriciousness and institutional ignorance,
- the destruction of personal responsibility,
- the unwarranted expansion of money and credit consequent upon the failure of the States money managers,
- weak Parliament,
- the bureaucratic excesses of the EU and many other factors

…before we can design the appropriate regulatory structure. At the current time this is not happening. We must recognise the superiority of freedom and markets to create spontaneous order as opposed to the chaos created by bureaucrats, the evidence for which is all round us.

November 2011

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268 The Retail Distribution Review – 'RDR'
The RDR is the design for the retail advice and product distribution system that the Failed FSA 'believes' (that is has no idea at all whether it will work) will 'reform' such advice and distribution for the better. As part of this project all existing advisers are required to achieve a set level of qualification by 31 December 2012, and if they do not they will not be able to practice as financial advisers from that date. This is entirely authoritarian and is enforced by coercion – the loss of ones livelihood. There is no reliable evidence whatsoever that any of the outcomes of this project predicated by the Failed FSA will happen. It is the arbitrary whim of a capricious bureaucracy that is entirely democratically unaccountable.

Furthermore most people would rather be an unqualified success than a qualified success.

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