THE FINANCIAL SERVICES
PRACTITIONER PANEL

Annual Report
2010/2011

Chairman’s Foreword

Iain Cornish
Practitioner Panel Chairman

A major part of the Panel’s work this year has been contributing to the debate on the Government’s plans for the FSA to be replaced by new and separate conduct and prudential regulators, as well as the addition of a Financial Policy Committee to monitor financial stability. Dealing with regulatory reform has been, and will continue to be, at the top of our list of priorities, as it is vital for firms that financial services regulation is as effective as possible. Our latest survey of regulated firms, published this year, shows that the overwhelming majority of firms across all sectors agree that strong regulation is for the benefit of the financial services industry as a whole.

We, as a Panel, have a unique position in providing an overall perspective of regulated firms and their interaction with the policies of the current regulator. We have used our experience to contribute constructively to the debate on the future of financial services regulation, arguing for proportionality and focus, with an avoidance of regulatory overload – both on the FSA and on regulated firms. We believe that one of the most notable omissions in the proposals is the lack of a formal practitioner voice in the Prudential Regulatory Authority (PRA) and Financial Policy Committee (FPC). Whilst we accept the PRA and FPC do not have to be accountable to the industry, we do believe that early debate with industry on the practicalities of regulation would lead to far more effective regulation.

We commend the FSA on the practical and constructive way in which it has tackled the need to address regulatory change whilst at the same time retaining a focus on the need to carry out its current regulatory responsibilities. This has been made all the more difficult with the inevitable loss of senior staff from the FSA during this period of change.

Throughout our work on regulatory reform and the ongoing work of the FSA, we have emphasised the need to measure costs versus benefits. This is not only in the strict sense of Cost Benefit Analysis (CBA), but also in needing a broader consideration of whether measures are being put in place in the most cost effective way possible.

Of course, the outline of more and more regulation is now driven by the European Union and international agreements. We have been impressed by the FSA’s positive engagement in Europe over the last year. Nevertheless, wherever we have sensed any tendency from the FSA to ‘front-run’ Europe, and try to introduce early or more detailed obligations in the UK compared to other parts of the EU, we have strongly challenged the plans.

We have continued to provide views and guidance to the FSA on its policy development during this year. We have taken particular interest in major issues such as the RDR, MMR and Solvency II, as set out in this report, and will continue to do so over the coming year.

Our Panel's work has been assisted by the constructive and positive attitudes of FSA staff and other regulatory bodies such as the FSCS, Financial Ombudsman Service and Bank of England, as well as trade associations, HM Treasury and other organisations that we have worked with. We are very grateful for their commitment and assistance.

I would also like to thank all the members of the Panel for their contribution over this past year. I would particularly like to thank Richard Berliand, Simon Bolam, Xavier Rolet and Roger Liddell who stood down from the Panel during this year. We have also welcomed Simon Hogan, Doug Webb, Paul Swann, Garry Jones, Colin Grassie and Guy Matthews, who have all started to make positive contributions to our debates.

Iain Cornish
Panel Chairman

1. INTRODUCTION

The Financial Services Practitioner Panel is part of the statutory checks and balances of the Financial Services Authority (FSA). Its remit is to advise the FSA on its policies and practices from the point of view of practitioners who are regulated by the FSA. We believe that our work plays an important role in helping the FSA to carry out more effective regulation. This must be done in partnership with the regulator, with the FSA providing timely insight into its thinking or policy development, and the Panel engaging in constructive challenge.

The members of the Panel are selected as senior representatives of all the major sections of the regulated community – normally chief executive level. During this year, we have significantly boosted representation from wholesale firms. We currently have representatives from accountancy and professional services; asset management; building societies; derivatives trading exchange, stock exchange and clearing houses; insurance; investment and retail banking; investment management services, financial planning and wealth management. Smaller firms have a separate Panel, and the Chairman of the Smaller Businesses Practitioner Panel sits ex officio on the Practitioner Panel to represent those interests in Practitioner Panel debates. The full list of membership over the year is at Appendix 1.

This year, the Panel developed its own strategic priorities to enable the Panel to pursue its own areas of interest, as well as following the agenda of the FSA. The aim has been to develop a more effective and efficient way of operating and to become more aligned to the FSA's EU and international agenda.

The Panel aims to provide early and effective practitioner input into the FSA's policy development from an appropriately assertive position. The key priorities agreed for 2010-11 were set as:

1. **Restructuring of UK regulation**
2. **EU and global regulatory initiatives – ensuring regulation is appropriate and proportionate for the UK market**
3. **Effective delivery of major UK policy initiatives – such as the RDR and MMR**
4. **Effective market infrastructure**
5. **High quality, effective regulation**

The structure of this annual report is based on these agreed priorities for the Panel.

2. PRACTITIONER PANEL BIENNIAL SURVEY

Every two years since its inception, the Practitioner Panel has undertaken a survey of the views of regulated firms about the FSA. It is an important measure of the views across the regulatory environment: it feeds into the Panel's work and provides a useful cross check for the advice which we give to the FSA. The latest survey was undertaken during the Summer of 2010, and the results published early in 2011. The 6th Practitioner Panel Survey was completed with a response rate of 42% of all firms and 58% of major firms.

Overall, the overwhelming majority of firms across all sectors agreed that strong regulation is for the benefit of the financial services industry as a whole. This is clearly a good place from which to start, but it was tempered by the fact that a majority of firms, particularly in the retail arena and amongst small firms, believed that the costs of compliance are excessive.

The general levels of satisfaction with the FSA amongst regulated firms fell slightly compared to the previous survey, although in terms of their individual dealings with the FSA the majority of firms did not think their relationship had changed. Given the scale of the crisis we have been through, and the impact which it has had on firms, it was never likely that this survey would register the highest marks for the FSA, or indeed any part of the regulatory infrastructure.

The survey results supported the view of the Panel that the case for significant strengthening of the regulatory framework is inarguable. Specific areas for strengthening were brought out clearly in this survey as follows:

- Policy and supervisory approach should take clear account of the different characteristics of different sectors and the different risks within and between sectors, with no presumption of automatic read across from one sector to another;
- The development of major policy initiatives should take full account of the likely costs and impacts of implementation. This would mean the chances of unintended consequences are minimised, and policy is proportionate to the risk. The Panel believes clear success measures in place prior to implementation would also help here;
- There are clear benefits of greater continuity within supervisory teams which have the requisite skills, experience and firm specific knowledge;
- Greater focus is required on value for money – with the regulator needing to provide clear explanation and justification for increases in expenditure;

- In a time of regulatory change the need to prioritise in a disciplined way and not to lose sight of key imperatives, including in particular engagement with the EU and internationally, is particularly acute;
- The vast majority of firms support strong and effective regulation and this provides a clear opportunity for the FSA to work in partnership with firms without compromise to regulatory objectives.

We have been keen to promote these messages as equally relevant to the FSA currently and to the new regulatory structures going forward. We presented the survey results to the FSA Board in January 2011, and also sent the results to HM Treasury and the Bank of England. We wanted to emphasise that all firms have a vested interest in the regulatory structure being as effective as possible.

The full results of the survey have been published on our website (www.fs-pp.org.uk) and some of the detailed results of the survey are referred to in the relevant sections of this annual report.

3. RESTRUCTURING OF UK REGULATION

The Practitioner Panel is able to offer a unique perspective and overview from the regulated community that is not possible from individual sector trade associations, which provide their own valuable inputs. Therefore the Panel decided that it should take a much more public role on this subject than previously taken on any other issue.

The Panel has submitted formal responses to the HM Treasury consultations published in July 2010 and February 2011. It has also submitted written and oral evidence to the Treasury Select Committee on regulatory reform, and written evidence on the related subject of the accountability of the Bank of England. We have had a constructive and positive dialogue with all parties to the changes over the course of the year. It has been reassuring to see that the Treasury Select Committee and HM Treasury have listened to the concerns of industry and considered our views carefully in developing their reports and consultations. We have also been encouraged by the open and constructive engagement that we have enjoyed with senior members of the Bank of England, as well as, of course, with the FSA.

3.1 Government consultation in July 2010

In looking at the Government's plans published in July 2010, the Panel suggested that the following were needed:

- Clear objectives for the new regulators, which are effectively coordinated;
- Enhancement of the Bank of England's accountability mechanisms as the Bank takes on an additional fundamental role in maintaining the UK's financial stability;

- Strengthening of the role and positioning of the independent panels, or some alternative and effective mechanism for engagement with firms over the potential impact of changes to regulatory policies;
- Changes to the concept of the proposed Consumer Protection and Markets Authority as being a 'consumer champion'. We argued that this was not an appropriate role for an impartial regulator;
- Positioning of the conduct regulator as equally important and not as 'second tier' to the prudential regulator. We urged early appointment of the chief executive designate and a clear emphasis on the importance of both sides of the new regulatory system;
- Clarity of decision making processes and escalation mechanisms to ensure the work of the regulators is fully coordinated;
- More attention given to the positioning of markets regulation in the new structure. Need to consider the downsides of fragmentation, particularly in the proposal to move the UKLA away from the financial services regulator;
- More consideration of the UK's international and European position, so that the UK regulatory structure would be better aligned with European committees.

3.2 Government consultation in February 2011

When the Government published its second consultation document on regulatory reform in February 2011, the Panel was pleased to see that a number of their issues had been addressed. The consultation had a much greater appreciation of practical requirements of a fair regulator from industry's point of view. The new name of the Financial Conduct Authority was an improvement on balance compared to the previous name of the Consumer Protection and Markets Authority (CPMA). The CPMA name was linked with the role of 'consumer champion' and, whilst having a helpful reference to markets, promoted an inappropriate role for what should be an impartial regulator. This move, together with the recognition of the need for consumer responsibility in the objectives, helped to restore balance into the perception and objectives of the conduct regulator. We were also pleased to see a much greater emphasis on the need for coordination – both in the new UK regulatory system, and in order to ensure effective linkages with international and EU requirements.

Our formal response was submitted to HM Treasury at the beginning of April, just after the end of this financial year. It emphasised the following:

- Structured mechanisms for engagement with firms throughout the regulatory system are needed. We suggested that a Practitioner Panel or similar mechanism would be needed at the PRA as well as the FCA, with a joint advisory Panel to bring all the Panel members together and advise on coordination between the regulators;

- Effective coordination between regulators would need further emphasis to ensure day to day coordination in the regulation of firms. We recommended that the statutory duty to coordinate should also be enshrined in the regulatory principles, and processes should be shared and streamlined as much as possible;
- Judgement led regulation must be consistent, with some mechanism of informal and confidential appeal or escalation process for firms within the PRA, as an interim step rather than full judicial review;
- The FCA must highlight different aspects to its remit, so that it ensures a different approach to wholesale and markets regulation compared to retail regulation. It must also emphasise that it will undertake prudential regulation for the majority of firms, albeit those who do not pose systemic risks to stability;
- There are potential problems of liabilities in product intervention powers for FCA, both for when it bans a product which is subsequently agreed as safe, and for consumer losses if a product is not banned which is subsequently found to have caused problems;
- The role and remit of the FPC will be hugely significant. It will be able to use macro-prudential instruments which are relatively untested, and yet have not only economic, but often social consequences – as in the recent debate around levers to be used for the FSA's Mortgage Market Review. Speeches and other opinions expressed by members of the FPC could have wide ranging impact on firms, with limited opportunities for accountability and consultation. The choice of members of the FPC, and the resources given to them to undertake their job, is therefore fundamental to the success of this model;

- The impact of external factors must be considered, as the UK changes are taking place on shifting sands of international and EU regulatory systems.

3.3 FSA preparations for regulatory change

In addition to considering the future structure of financial regulation, the Panel has been monitoring the work of the FSA in preparing for the transition.

We have encouraged and supported the FSA in its intention to avoid change for change's sake in the restructuring. We believe that much has been done by the FSA since the financial crisis to improve regulation. Firms would like to see as much stability in the regulatory requirements as possible at a time of other changes in the wider environment and a background of uncertain economic conditions. We have urged the FSA to do all in its power to ensure that firms are not required to reinvent these processes, but that they will be carried across to the new regime.

We will actively seek to engage in the development of a new philosophy for the FCA. We do not want significant FSA policies such as Treating Customers Fairly (TCF) to be thrown away, only to be replaced with something similar, but with a different name. Embedding TCF has been a massive undertaking for firms and it will take some time for such cultural shifts to show through. We do not want such a process to be stopped if firms then have to adapt all their systems to take on board an alternative means of measuring the culture in firms.

We registered some concern that the FSA's initial plans for the FCA involve it taking a more thematic approach than the FSA. This will mean that most firms (apart from high impact firms) would experience thinner relationship management in the new structure, although firms should notice more sectoral expertise from their supervisors. We felt that this would be unfortunate, particularly given that this year's survey indicated that regulated firms appreciated the current relationship management structure.

We have also been keen to emphasise the need for cost control in the new plans. All are aware that two regulators replacing one will tend towards greater costs and some diseconomies of scale. We have encouraged the FSA to offset any additional costs where possible in the new structure, as well as controlling transition costs. The scope and significance of the restructuring exercise means that good project management and cooperation between the FSA and the Bank of England are of paramount importance and this appears to have been recognised. We have been impressed with the close working between the FSA and the Bank of England so far in the transition period. We have however, suggested that there should be a commitment to undertake a review some time after the transition to ensure that the new framework is working appropriately.

We have commended the FSA on the efficiency of the project set up for the transition. We have also been pleased to see the planning team integrated with that of the Bank of England to assist with a smooth transfer. The Panel has supported the FSA's focus on regulatory and operational risks arising from the transition and its plan to move to new management structures from April 2011. This will help to minimise the likely disruption to current supervisory relationships with firms and help to develop effective twin peaks best practice in respect of both formal and informal processes.

3.4 FSA regulation in the face of change

The Panel has also supported the FSA in its important role of maintaining 'business as usual' in the interim period when the FSA still has regulatory responsibilities under the current remit of financial regulation in the UK.

We were reassured that the 2011/12 Business Plan proposed minimal discretionary new initiatives. It will be important for the FSA not to lose sight of any potential significant market issues during the transition, and it must also allow sufficient resources of people and budget to be made available to focus on the transition process.

The Panel has also had significant concerns over the loss of key staff at a time when the already heavy regulatory agenda is further burdened by the transition process. Although the Panel considered the staff turnover rate within the Supervision Business Unit of 8% to be reasonable, we have continued to highlight the dangers of too many gaps in senior management caused by the high number of senior staff leaving the FSA.

We have also highlighted the risk of potential loss of senior executive leadership and influence in Europe during this period, as it is vital for the FSA to engage effectively in European negotiations. However, the Panel acknowledges that the FSA has done some excellent work within the EU agenda. The FSA has taken a welcome proactive approach to nominating representation on the new European bodies.

4. EU AND GLOBAL REGULATORY INITIATIVES

The Panel's role in this regard has been to ensure that implementation of EU and global regulatory initiatives is appropriate and proportionate for the UK market. We share the FSA's belief that the most appropriate strategy is constructive engagement with other member states in Europe. We believe that, wherever possible, industry and the regulator should speak with a co-ordinated voice in respect of strategic issues in order to maximise the influence of the UK. We plan to work more closely with the FSA in engaging with the new European structures in future.

4.1 FSA engagement in Europe

We are pleased that the FSA has used its increased focus and resources on international issues to take a more active part in European developments. This has been crucial as the new European supervisory architecture has been put into place over this year.

As part of our interest in anything that might impact negatively on the FSA's ability to influence events, we have asked the FSA to consider how it might help to coordinate the comments from different UK based firms. We fear that the UK's position would be weakened if firms lobbying in respect of European issues gave differing viewpoints and that, to be most effective on behalf of the UK, coordination would be important.

4.2 Solvency II

We have continued to be supportive of the FSA's engagement within the Solvency II development work and its journey towards delivery within the UK. We are mindful of the progress of development and debate within Europe and will now be looking to focus more on the implementation within the UK.

We have noted that the FSA is executing this initiative against a backdrop of proposed regulatory change and transition work and success is important for the UK industry; we are therefore supportive of its work in this area, although the Panel remains watchful over the resource implications for firms and the FSA.

We have noted the proposed regulatory framework for insurance companies within the new regime and will be keen to see that the FSA is able to continue to secure the resource and focus to ensure that Solvency II is implemented effectively.

4.3 Prudential Policy

In April 2010, the Panel was advised of the developments in this area with the main focus of efforts by the Basel Committee on Banking Supervision (BCBS), the proposed reforms to the Basel II prudential framework for internationally active banks and the developments of CRD IV by the European Commission. Following on from this, various specific policy developments have been discussed with the Panel including areas such as: Capital Requirements for Banks, Review of Trading Book and Solvency II.

On the whole, the Panel is supportive of the enhanced measures that have been put in place to ensure security of the banking sector of the market and will continue to be engaged in the specific developments of related prudential work as these progress over the next year or so. These areas are vital for financial stability, and they are also complex. However, we have emphasised the need for proportionality in the way these requirements are applied in the UK and the implications of these measures for other sectors within the industry.

4.4 Alternative Investment Fund Managers Directive (AIFMD)

The Panel considers that the FSA had done a good job overall in respect of AIFMD and feels it is important the FSA works together with HM Treasury to ensure maximum technical and market-facing input to European negotiations. The Panel also noted the acknowledgement that the complexity and timescales within which the FSA and its successor organisations would be required to implement AIFMD, combined with the ongoing regulatory reform programme and the increasing volume of European regulation, presented a number of operational challenges.

4.5 Remuneration Code

In the early part of the year, the Panel discussed the Remuneration Code as it was developed by the FSA. We raised a number of scenarios where we felt that the resultant actions might cause the Code not to meet the regulator and Government's requirements. For example, if guaranteed bonuses could only be awarded to new hires, firms would be unable to protect themselves against competitors poaching their staff; if firms could buy out deferred bonuses for new joiners, this would negate the benefit of bonuses being linked to the risk at the firm where the bonus was earned. In addition, there is the potential to end up with risk-insensitive remuneration structures where higher salaries, or other forms of remuneration, are paid instead of bonuses, thus negating the intended benefits of the Code.

Although this has been driven by the EU, we also warned against wider application of rules that were drawn up for banks, as being insensitive to different remuneration structures in different sectors of the industry. We also reminded the FSA that the UK's code was developed further than in other markets with an impact on competitiveness.

4.6 European Market Infrastructure Regulations (EMIR).

The Panel has also expressed some concern that potential systemic risk could arise from proposals relating to OTC derivatives being brought into the European Market Infrastructure Regulations (EMIR).

4.7 Liquidity Calibration Proposals

The Panel remains alert to the potential for gold plating of liquidity calibration proposals in the UK and also to firms being disadvantaged in the interim. We offered to engage with the FSA at an early stage in determining the scope and terms of reference of any cost benefit analysis of the implementation of these proposals.

5. EFFECTIVE DELIVERY OF MAJOR UK POLICY INITIATIVES

5.1 Retail Distribution Review (RDR)

We have supported the development of this programme and believe that the overall aims of the RDR are to be applauded. However, we have grown increasingly worried about the detail and the timing of implementation over this past year.

We sought and were given reassurance from the FSA that the five original objectives of the RDR remained in place – including 'sustainability of the sector' and 'consumer access to products and services'. However, we highlighted that, whilst it is acknowledged that a significant number of advisers will leave the market rather than undertake additional qualifications, we could see that a further wave of leavers is likely to follow when the full additional capital requirements also impact on firms. We urged the FSA to monitor the number of advisers leaving during implementation of the RDR and to consider a flexible approach both in respect of qualifications and capital requirements if the number of advisors leaving the market is large.

We have worked actively to seek clarification from the FSA on the regulatory parameters for simplified advice, as clarity is needed to enable firms to consider the viability of different business models going forward. We suggested for instance that lower qualification requirements would be appropriate for simplified advice 'facilitators'.

We pointed out that the RDR's continuing professional development (CPD) proposals seemed to be more rigorous than other professional requirements, although there was more flexibility in their application than was first thought.

We also urged the FSA to be seen to engage fully to address the remaining concerns of all interested parties. This should help there to be an assessment and resolution of the economic and social risks of the potential loss of access to financial advice for less affluent consumers. Otherwise the potential benefits of the RDR will be in danger of being lost to unintended consequences.

As part of our work in representing the views of regulated firms on significant FSA issues, we also gave evidence to the Treasury Select Committee's Inquiry into the RDR in January 2011. We suggested that the Treasury Committee should particularly ask the following questions:

1. **Will there be significant consumer detriment?** – through the reduction in the number of independent advisers, and the lack of clarity of regulatory guidelines for providing simplified advice.
2. **Will the RDR cause a disproportionate increase in cost and bureaucracy?** – through the increase in professional standards and capital requirements. Firms face significant costs in implementing regulatory changes.
3. **How will success be measured?** – there must be a post implementation review, and the setting up of the FCA must not provide an excuse to reassess and make major changes to the RDR without clear justification and cost benefit analysis.

5.2 Platforms

In October 2010, the Panel proposed that the FSA delay its proposals on the regulation of platforms and engage independent consultants to undertake a comprehensive review of the market and the mechanisms that would maintain competition whilst achieving alignment to the objectives of the RDR. We felt that the FSA did not appear to appreciate the scale of resultant issues that could ensue from adopting the proposals, and that the suggested approach would potentially damage competition and customer choice in what is currently a competitive market segment, ultimately driving up charges to consumers.

We continue to be apprehensive about the impact of FSA intervention on the competitiveness of this complex area. At the same time, the FSA must be alive to the potential of payments to platforms to undermine the principles of the RDR and transfer product bias to a different part of the system. We will continue to urge the FSA to take a strategic approach, which has fully considered the implications of regulatory action.

5.3 Mortgage Market Review (MMR) Responsible Lending

Over the course of the year, the Panel expressed a number of serious reservations in respect of the proposals to promote responsible lending and, in particular, considered that an indirect and indiscriminate restriction on fast track mortgages was unnecessary and would result in a greater impact on the mortgage market and consumers than that anticipated by the FSA. Although a number of the proposals appeared to be sensible in isolation, the Panel highlighted that there was a significant likelihood that together they could stifle the market, thus resulting in consumer detriment.

The Panel encouraged the FSA to consider the wider implications of their proposed actions in the mortgage market. We welcomed the decision to undertake a wider cost benefit analysis at the beginning of 2011 and were pleased to see the breadth of the considerations being incorporated into it. We suggested that a similarly broad cost benefit analysis should be considered for the implications of the RDR.

5.4 Conduct strategy and product intervention

We supported the FSA's development of its Conduct Strategy during this year. We believe that earlier intervention, with as much foresight as possible, is a positive step which will help to increase consumer confidence.

As part of this, the FSA published a framework for product intervention in November 2010, and we welcomed the opportunity for pre-publication discussion. We pointed out that linkages within the EU would need to be considered to ensure that there is regulatory consistency to enable UK companies to operate on a level playing field.

We warned against any intention to apply different rules to firms based on their size, albeit temporarily. We pointed out that there needed to be a clear process for firms to be able to challenge any restrictions placed on their activities by the regulator. The availability of a robust system of challenge, together with consistent behaviours between supervisors who were capable of making the appropriate judgements would also be crucial elements if the proposals were to operate effectively.

It was recognised that the FSA's work on product intervention is likely to form the basis on which the FCA's more interventionist approach will be based. Therefore it is all the more important that there should be clear objectives and outcomes set at the beginning. There should also be a commitment to a post implementation review to determine whether the objectives were being met in a cost-effective way.

5.5 FSA priorities and the application of cost benefit analysis

The Panel continues to be presented with policy proposals which it believes have not received a full enough assessment of the costs versus the benefits of such an approach. There were a number of areas where we suggested there should be more consideration of the relative costs and benefits both within the regulator and for regulated firms to implement as follows:

- We were concerned that the FSA had spent time preparing a regulatory guide on **financial crime** at the beginning of 2011. While we acknowledge that consolidation is laudable, we warned that the guide would create an additional checklist which supervisors would require firms to address even though many of the areas would be irrelevant for most firms;
- We urged the FSA to undertake a full, comprehensive cost benefit analysis of the combined impact of the **Mortgage Market Review** proposals. We highlighted the potential of such actions to stifle the market through a combination of regulatory pressures. We welcomed the FSA's announcement that it would undertake such a review at the beginning of 2011;
- We questioned whether it was appropriate for the FSA to initiate specific new work on the **regulator's role in the culture of firms** during 2010. We recognise the central role of a firm's leadership and culture in its adherence to regulatory principles. However, we believe that assessment of culture should already be a core part of the close and continuous supervisory approach, and should not become established as a separate and distinct workstream resulting in a separate set of initiatives. We suggested that the initiative on culture in firms should be de-prioritised at a time of such significant change to the regulatory framework;
- **PPI complaints** handling guidance was subject to inadequate cost benefit analysis;
- The Panel had been generally reassured by the FSA's intended approach on **consumer redress schemes**, based on assurances of how it might have been applied in past cases. We have registered that the application of effective cost benefit analysis will be crucial and we will monitor this going forward;
- We have welcomed the intention to include a cost benefit analysis with the proposed Consultation Paper in respect of **recovery and resolution plans** expected after the end of this financial year. We suggested that the FSA must formally recognise that the proposals would be likely to involve a considerable amount of additional work for firms. This should be fully taken into account in the CBA.

6. EFFECTIVE MARKET INFRASTRUCTURE

Much of the Panel's detailed work as set out in this report – in terms of engaging in debate on regulatory reform, major FSA policy initiatives and effective regulation – will contribute to our interest in the regulator facilitating the development of an effective market infrastructure.

This year, we have added to the expertise of the Panel in the wholesale and markets area. This has immediately borne fruit in enabling the Panel to contribute in more detail to debates on regulation affecting these areas.

6.1 The work of the FSA Markets Division

The work of the FSA's Markets team, especially on a European level, is critical to the strength of the UK financial services market. We registered a high level of concern about the risk that the Markets Division was under resource pressure in dealing with changes in Europe, and that was compounded by the regulatory re-structuring process in the UK. We urged the FSA to ensure that appropriate resource was allocated to the Markets Division, even if that resulted in the postponement of some of the FSA's wider, lower risk initiatives.

We received some reassurance from the FSA that efforts were being made to ensure that appropriate levels of resource and budget are allocated to the Division, and this is an area that we will continue to monitor over the coming year.

6.2 Markets priorities

We are planning more detailed engagement with the key market priorities at this time of European regulatory change. This will be an increasing area of priority for the Panel in the next year.

7. HIGH QUALITY, EFFECTIVE REGULATION

7.1 Intensive Supervision

The Panel remains supportive of the ambitions of the Supervisory Enhancement Programme (SEP) and the increased focus on qualitative measures. However, it is crucial that supervision remains proportionate and appropriate. It is only in this way that the FSA will be able to apply its risk based philosophy and identify when significant things are going wrong.

We have challenged the FSA to ensure that real improvements are delivered and to measure performance. We questioned whether the FSA was monitoring whether the new supervisory approach was delivering value for money. We acknowledged that the programme of intensive supervision had brought the FSA closer to firms, and that information on unexpected issues uncovered during regular ARROW assessments were now reviewed by the FSA Board.

Although we have been reassured to a certain extent by the FSA, we nevertheless retain significant caution about the FSA's recruitment and retention of the high calibre staff needed to carry out more intensive supervision. As the FSA looks more and more at business model analysis and is being required to challenge judgements made by a firm's management, the Panel has emphasised that top quality staff will be needed to do this. Recruitment of these staff will become harder as the market improves. We have also seen that over the course of 2010/11, the FSA has lost a significant proportion of its senior management. We recognised that the FSA is facing additional pressure on its recruitment and retention during the transition process to the new regulatory structure, and has been working hard to address this within the confines of the parliamentary and legislative processes.

7.2 Risk Tolerance

We were fully supportive of the FSA Board setting an overall level of risk tolerance for the organisation in 2010. This allows the organisation at the highest level to agree that the FSA's focus would be on the failings of the most significant magnitude – in both prudential and conduct areas. The FSA retained its commitment not to be a zero failure regime, but needed to set an appropriate level of consumer protection and consider the consequences of failure and its impact on consumers.

7.3 Rules, principles and guidance

We welcomed the FSA's review, and supported the plan to continue to apply a tailored approach to the balance between principles, rules and guidance in any particular area, and to reinforce a consistent FSA-wide position on what guidance is with a planned communication strategy to increase understanding and accessibility of information.

However, we expressed strong reservations at the potential for retrospective regulation if the regulator chooses to judge issues from a different perspective than the standards in place at the time of the original transaction. It is particularly important in the move to the new regulatory structure, that the background and rationale for particular decisions are effectively recorded.

7.4 Treating Customers Fairly (TCF)

The Panel recognises the positive intentions behind TCF, and firms have spent considerable time and resource over recent years ensuring their culture and processes are compliant with TCF requirements. Given the investment to date by both the FSA and the industry, the Panel would be keen to avoid a reinvention or loss of this initiative in the new regime.

7.5 Prudential regulation

We have taken an increased interest in prudential issues this year, reflecting the importance of regulatory changes taking place. We welcomed the publication of a separate Prudential Risk Outlook to focus on prudential issues separately to conduct issues.

We also recognised the huge range of prudential initiatives that the FSA has been involved in. We were reassured that the FSA seemed confident that it could 'punch above its weight' and so have a positive influence for the UK on the outcome of negotiations on global and EU initiatives. The Panel has undertaken to follow the progress of the Prudential Strategic Policy and to support the FSA's efforts both in Europe and with the G20.

Going forward, the Panel will also take a detailed interest in certain policies where the Panel can assist. So, for instance, we have looked at improving the FSA's processes for measuring derivative risk.

7.6 Enforcement

We have been encouraged by the rigorous application of enforcement over this year. As highlighted in our survey, the vast majority of firms believe in effective regulation and want to see the rules upheld.

On the other hand, we also believe there needs to be a method of internal appeal. We support the current RDC system, and would like to see a similar set up in the new regulatory structure. We have highlighted the lack of detail about enforcement in the new regulatory structure at this stage, and look forward to debating these issues further.

7.7 FSA Business Plan 2011/12

We were pleased to hear that the FSA was not planning any additional discretionary initiatives in the next year. However, the Panel remains keen to highlight the challenge for the FSA in being able to deliver successfully on all its ongoing initiatives. Projects such as the MMR, Retail Distribution Review (RDR) and Solvency II all require the allocation of significant resource and will, of course, be even more difficult when combined with implementation of the new regulatory structure and increasing staff turnover.

Having supported the need for a more intensive supervisory regime, the Panel has raised doubts about this being scaled back at a time of continued heightened risk. We appreciate that it has been necessary to undertake risk reprioritisation to accommodate regulatory reform. However, with less 'horizon scanning' by supervisors, there is a risk of new issues going undetected. On the other hand, we have suggested that, if this period of rigorous prioritisation of supervisory work is successful, then the FSA should consider whether they should maintain such a reduction and achieve some longer term cost savings.

We have said that we would support strongly greater consideration of the alternatives of, for example, delaying implementation of the MMR (where we do not perceive risks in the current market to be outside the FSA's risk appetite) and narrowing the range of RDR implementation. Although these have only taken a relatively small number of policy staff to develop, the implementation of these changes will create additional burdens on the time and resources of supervisors.

We argued that the FSA needs to exercise maximum budgetary constraint in developing its business plan. Sometimes it is unclear to the Panel that the strictures of commercial companies are truly applied in developing the FSA's budget when the FSA has the elasticity of increasing industry levies to cover any increase in budget requirements.

7.8 Fees & Levies for 2011/12

The Panel registered concern at the level of increases in the fees planned for 2011/12, particularly when these are added to the significant year on year increases seen previously. We have asked for further information and a medium term trajectory, setting out how the fees will be spent and also further information on expected efficiency savings.

We were supportive of the concept that allocations of funding requirements across fee blocks were based on the level of regulatory activity levels in the previous year. However we were still unhappy about the scale of some of the increases that in some cases exceed 100% for the second year running.

7.9 Money Advice Service – formerly Consumer Financial Education Body (CFEB)

Although the Panel has long been an advocate of improving financial literacy and accepts that CFEB's ambitions are laudable, we have become increasingly concerned about the funding requirements for this body. This is particularly since the Government withdrew funding and has directed the FSA to collect money from the industry to fund the whole CFEB project. We regard it as vital that the CFEB business plan should include much more detailed objectives and criteria against which progress and value for money can be measured at an operational and strategic level, and that this should be set out in the context of a 3 year plan. We are also anxious that money previously spent on the development of brands (such as Moneymadeclear, for example) should not be wasted.

We have challenged the FSA to explain the basis on which it had signed off the CFEB budget for 2011-12, as the Panel considered that there did not seem to be enough information for this to stand up to any rigorous scrutiny. We have also asked the FSA to institute further scrutiny of CFEB, and will be watching these developments with interest.

7.10 FSCS Funding

We took part in initial discussions on the FSCS funding review at the beginning of the year, although this has now been delayed pending the regulatory restructuring. We emphasised that the UK must avoid gold plating any European requirements. Also, if the UK follows the European route in respect of pre-funding, at least in the deposits class, there will nevertheless be important considerations in the amount of pre-funding, the period during which the pre-funding would be built up and the starting date. Threshold figures will be significant as the pass-through element will be crucial in determining affordability. A risk-based model for levies is a positive step although there are dangers that firms who could least afford it could be required to input the most capital.

We believe that it is unfair for firms to be required to fund compensation payments when issues have been flagged to the regulator but ignored. In such instances of regulatory failure it believes the Government should fund the compensation scheme.

This year, we have used the regulatory restructuring debate to make the point that the funding requirements for FSCS have the potential to cause systemic risks for certain sectors of the industry which are called on to fund significant levies. In January 2011, investment management firms were unexpectedly required to contribute £236m towards the cost of the FSCS compensating investors who lost money in the collapse of Keydata. This was because the claims went over the limit of contributions allowed from the intermediary sector. The contributions from individual medium and larger investment management firms went into millions of pounds – making a significant impact on those firms' bottom line. The FSA has claimed that it has no responsibility to consider the impact of FSCS levies on the finances of firms, as the decision to raise the levy is for the FSCS. However, we continue to argue that the FSA should take an interest in the impact of levies when they are likely to cause other firms to become financially unstable.

We suggested that the Government's regulatory changes provide an opportunity for this situation to be changed. The Government could introduce a requirement on the regulator to consider the impact on those sectors affected by any contribution requests for the FSCS which go near the limits in future.

We also pointed out that the Keydata-FSCS issue is a good example of how a conduct issue in a single fairly small firm can create potentially significant prudential issues across a wider range of firms crossing the FCA/PRA divide. This is another example of how crucial the coordination between the regulators will be in the new system.

We have also asked for further discussions with the FSA about the impact of the FSCS interim levy and that, in effect, industry was being asked to insure against under-regulation. We also plan to discuss the lessons learned by the FSA from the Keydata issue in the coming year.

7.11 Financial Ombudsman Service

We were pleased to note the aim of the Ombudsman Service to achieve a real 10% reduction in its cost base. We agree with the view held by consumer groups that better regulation is needed for claims management companies currently overseen by the Ministry of Justice. At the moment, there are many claims management companies which encourage consumers to complain when they have no chance of success. This causes an additional and unnecessary burden on the system.

8. FUTURE PLANS

In the coming year, we will continue to focus our attention on the plans for regulatory reform. We will be particularly interested in the development of the new philosophy of the FCA and the plans for product intervention. This is a major change in the development of regulation, in looking at product design, rather than on the way products are sold, and needs careful consideration of the potential implications. We will also take a detailed interest in the changes coming through in prudential regulation, which will set important ground rules for PRA regulation in the future.

We will also continue to follow major FSA regulatory developments, such as those stemming from the Retail Distribution Review. At the same time we will be urging further clarification on areas such as the future of enforcement and the future structure of the Financial Services Compensation Scheme, which still need to be addressed.

Members of the Practitioner Panel

April 2010 – March 2011

Panel Member	Position
Iain Cornish (Chairman)	Chief Executive, Yorkshire Building Society
Richard Berliand (Member to January 2011)	Head of Global Cash Equities & Prime Services, JP Morgan Securities Ltd
Simon Bolam (Member to October 2010)	Principal, EH Ranson and Company
Russell Collins	Head of Deloitte UK Financial Services Practice
Colin Grassie (Member from February 2011)	Chief Executive Officer UK, Deutsche Bank
Mark Hodges	Chief Executive, Aviva UK
Simon Hogan (Member from May 2010)	Managing Director, Institutional Equity Division, Morgan Stanley
Garry Jones (Member from November 2010)	Group Executive Vice President & Head of Global Derivatives NYSE Euronext
Roger Liddell (Member to March 2011)	Chief Executive, LCH.Clearnet Group Limited
Guy Matthews (Member from November 2010)	Chief Executive, Sarasin Investment Funds [Chairman SBPP]
Helena Morrissey	Chief Executive Officer, Newton Investment Management
Andrew Ross	Chief Executive, Cazenove Capital Management Limited
Malcolm Streatfield	Chief Executive, Lighthouse Group plc
Paul Swann (Member from November 2010)	President & Chief Operating Officer, ICE Clear Europe Ltd
Douglas Webb (Member from November 2010)	Chief Financial Officer, London Stock Exchange Group
Helen Weir	Group Executive Director Retail, Lloyds Banking Group plc

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