THE FINANCIAL SERVICES PRACTITIONER PANEL

# Annual Report

2011/2012

# Chairman's Foreword

**Russell Collins**
**Practitioner Panel Chairman**

This year, we have been working with a backdrop of momentous changes being planned in the regulatory environment both in the UK and Europe.

In the UK, we have been actively involved in our advisory role in reviewing the plans, which are now well advanced, for the splitting of the remit of the FSA into the Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA) from 2013. We have regarded it as essential to provide an input on behalf of all regulated firms into the discussions on both the changes of emphasis in UK regulation and the outlook for the new regulators. The current debates will set the framework for regulation in the UK for the next 5 to 10 years at least. It is in all firms' interests to have an effective system of regulation that works for customers, regulators, government and regulated firms alike. We have stressed in our comments on the proposed legislation and in our dealings with the FSA that practitioners are not seeking accountability from regulators, but rather effective engagement and consultation with regulators. We are pleased that the Government has proposed that there will be a Practitioner Panel, a Smaller Businesses Practitioner Panel, a new Markets Panel and a Consumer Panel for the FCA. However, we are disappointed that the Government has not proposed a Practitioner Panel for the PRA.

At the same time, significant changes have been made in Europe which mean that more and more decisions are being taken at international and EU level. With the EU's intention to implement more harmonised rules across Europe, much EU regulation now gives the FSA little discretion about how final rules will apply to UK firms. This will continue with the FCA and the PRA. Therefore, with the FSA shifting its attention towards contributing to the negotiations in the EU fora, so we have looked this year to see how we can also increase our focus on important legislation emanating from Brussels. We want to ensure that in Europe also, the views of practitioners are heard, that regulatory changes impacting UK firms remain appropriate and the costs, benefits and proportionality of new provisions are properly considered. We seek to identify and communicate to the FSA any areas where there are emerging conflicts between European developments and domestic initiatives.

As practitioners, our aim in all our discussions is to help to foster a regulatory environment which enables well run and compliant firms to thrive, customers to be well placed to select the service they require, and the UK to continue to be a centre of excellence for financial services. We have therefore been supportive of a number of the efforts by regulators to strengthen the regime, including in particular the plans for recovery and resolution plans.

We also believe it is in everyone's best interest to have a marketplace where firms in both retail and wholesale sectors are able to meet and even anticipate customer needs through providing appropriate products. The regulators and government need to be able to set the overall parameters to foster that environment but firms must be encouraged and allowed to meet customer requirements. One of our concerns as the regulatory regime has become more intrusive and as we observe the debate over new regulatory powers is that there is an increasing

danger of the regulators becoming too risk averse. This could mean that consumers as well as firms will ultimately lose out and the UK's international competitiveness in financial services will be put at risk. As the FCA picks up the mantle of consumer protection in a much more pro-active way, it will be vitally important that risk is identified appropriately so the market does not become stifled and that retail and wholesale regulatory approaches remain distinct. In this regard we are encouraging the FCA to publish a clear explanation of its risk tolerance; we are also becoming more concerned about the overall regulatory burden and costs on firms and will continue to call for robust cost-benefit analyses and to monitor this closely. This is in the interests of consumers since ultimately regulatory costs which cannot be offset by other efficiencies are passed on to them. We observe that the costs of the FSA have increased throughout its existence, partly due to changes in scope of regulation, but have increased more rapidly since the financial crisis. This is an understandable reaction to the need for strong regulation; however, any further increases in costs as a consequence of moving to 'twin peaks' need to be subject to very careful scrutiny.

There are a number of proposals in the new legislation for UK regulation which will require careful handling by the new regulators. In particular, the powers to publish the details of warning notices has the potential to inflict significant reputational damage on firms without the underlying facts being proven. This needs to be used with considerable care.

We have worked not only with the Smaller Businesses Practitioner Panel this year, but also with the Consumer Panel where our areas of concern have overlapped. This has been particularly on certain aspects of the new regulatory system – the coordination arrangements for the FCA and PRA, as well as the systems for engagement with the PRA going forward. We believe that even under the proposed 'twin peaks' structure there remain several areas of regulation where the FCA and the PRA can usefully coordinate and combine their approaches to achieve their individual objectives.

One of the most important developments in the proposed UK legislation is the establishment of the Financial Policy Committee of the Bank of England and its macroprudential tools. The Panel has been extremely supportive of the plans to clarify and strengthen the responsibilities for financial stability learning the lessons of the recent crisis. Our overriding concern over the past year has been around the practical impact of the proposed macroprudential tools given they are all relatively untested, the transmission mechanisms are not fully understood and there might be adverse and unintended consequences. We suggested that the number of tools should be reduced, and as much as possible should be done to engage with industry to "road test" the proposals before they are used.

I was pleased to take over the Chairmanship of the Practitioner Panel in June 2011 from Iain Cornish, and I would like to thank him in particular for his contribution, as well as to other members who have stood down during the year – Mark Hodges, Helen Weir, Andrew Ross and Colin Grassie. We have been pleased to welcome a number of new Panel members who are already making significant contributions to our debates – Graham Beale, Joe Garner, Paul Geddes, Mark Harding and John Pollock. I would also like to thank our secretariat, provided by the FSA, for their professional and effective contribution to our work during the year. I will be standing down from the Panel at the end of May 2012, and am pleased to be handing over the Chairmanship to Joe Garner.

**Russell Collins**
**Chairman**

# 1. INTRODUCTION

The Financial Services Practitioner Panel was set up under the Financial Services and Markets Act 2000 to represent the interests of regulated firms in the work of the Financial Services Authority (FSA).

The membership of the Panel aims to represent a wide cross section of the larger firms which are regulated. The Chairman of the SBPP sits on the Practitioner Panel to ensure that the interests of smaller firms are also considered.

This year, the focus of the Panel has been both on the work of the FSA and also the context in which it is operating: looking at European and UK governmental initiatives as they impact on the FSA. The Panel set itself the following priorities for this year:

1. **Restructuring of UK regulation**
2. **EU and international regulatory initiatives**
3. **UK competitiveness**
4. **FSA core programme**

The Panel has taken the decision not to commission the next biennial survey of the views of regulated firms about the regulator, which was due in 2012. It seemed that, even with the FSA's implementation of internal twin peaks, any results from such a survey would not be relevant to the new regulatory structure being put in place from 2013. This will be something which we suggest should be considered by the FCA's Practitioner Panel in 2013.

The following sections of the annual report are structured to review the Panel's work in each of its core priority areas.

## 2. RESTRUCTURING OF UK REGULATION

The Panel has continued to engage actively in the process of creating a new regulatory structure in the UK for financial services. Our aim has been to work with the organisations making the decisions on the future shape of regulation, and to feed in constructive and practical viewpoint to ensure that the new system is as effective as possible without creating too large a burden on firms.

We have therefore submitted formal responses to a number of consultations over this year to make clear the Panel's views. This has included responses to HM Treasury, the Joint Committee for pre-legislative scrutiny (both written and oral) as well as to the FSA and Bank of England on the proposed approaches for the FCA and PRA.

The key issues that we have highlighted in each of these responses are summed up in the following sections.

### 2.1 Engagement with industry

***Practitioner panel for the PRA***

Our main concern about engagement with industry in the new system has been the lack of plans for any statutory practitioner panel for the PRA. We have not been convinced by the counter arguments: the idea that such a panel would indicate 'regulatory capture' cannot be substantiated when similar panels are being proposed for the FCA, and clearer transparency mechanisms can be put in place for a regular panel than for ad hoc consultations. The argument that prudential issues are more straightforward and less open to interpretation by firms than conduct issues by the FCA is also difficult to sustain: for example, discussions on the proportionality of implementation of prudential requirements on smaller PRA-regulated firms, and the interpretation of macroprudential requirements would benefit from engagement with the industry.

The Panel has continued to present the argument for more joined up and transparent engagement with industry through some kind of statutory panel for the PRA, or statutory linkage to the FCA panels. This has included discussions with HM Treasury, and formal evidence to the consultations, and evidence to the Treasury Select Committee; Joint Committee on the Financial Services Bill and the Commons Committee on the Financial Services Bill.

The key arguments for a practitioner panel at the PRA remain as follows:

- To help the PRA to avoid any unreasonably detrimental impact or unintended consequences on firms, without going as far as making the PRA accountable to the industry (which appears to be the concern around "regulatory capture");
- With similar panels at both the FCA and PRA, the Panels would be able to investigate the coordination of regulatory requirements between the two regulators – as it is often the cumulative impact of regulation that proves to be significant and in a "twin peak" structure this is extremely important;
- Cross-sectoral membership of such a statutory panel provides useful cross-fertilisation and perspective while focusing on effective regulation;
- Panel members can sign ongoing confidentiality requirements, allowing early debate on the pros and cons of new policy developments;

- Panels achieve the Government's transparency requirements for debate with industry in a much more structured way than through ad hoc groupings, with the ability to record discussions through publication of annual reports and other means;
- A regular forum enables members to look ahead to the impact of regulatory developments and pro-actively highlight potentially adverse impact or prudential risks, including the early identification of matters of concern arising from international developments;
- For the PRA to set up various different consultation mechanisms will be time consuming and potentially inefficient. It may also miss an opportunity to have industry input precisely when it could be most beneficial.

At the end of February 2012, the Bank of England published on its website, the planned approach to consultation for the PRA. We plan to engage with the Bank on the basis of this, and stand ready to help further as plans for the PRA consultation are finalised.

***Position of the panels at the FCA***

We have also highlighted some concern that the position of the Panels in the FCA may be weakened, compared to the current position with the FSA. The Bill as presented to the Commons in January 2012, has the same requirement as in FSMA in that the FCA "must consider representations" that are made by the Panels. However, the FCA now only has the requirement to publish in such manner as it thinks fit, responses to the representations. This replaces the previous requirement to respond in writing with reasons for rejecting suggestions from the Panels – so seeming to reduce the ability of the Practitioner Panels and the Consumer Panel to make their voices heard.

We believe that under the new legislation, the FCA could choose to ignore certain suggestions from the Panels without any explanation. We suggested that the Bill should be amended to include the requirement that if the Authority disagrees with a view expressed, or proposal made, in the representation, it must give the Panel a statement in writing of its reasons for disagreeing. This would be in addition to the new concept that the FCA must from time to time publish in such manner as it thinks fit responses to the representations.

***Scope of the Markets Panel***

We have pointed out that the new Markets Panel for the FCA will be far better placed to undertake its role if it has a responsibility to engage on markets regulation aspects in the Bank, as well as the FCA. In the new system, much of the trading infrastructure that the FCA regulates will rely on clearing and settlement infrastructure which the Bank oversees.

We have therefore suggested that there should be some responsibility for the Markets Panel to monitor cooperation in this area. This could be achieved through an amendment to the Bill that says that the Bank must consult with the FCA Markets Panel on the regulation of clearing and settlement infrastructure when the FCA agrees that proposed changes will have an impact on the regulation of trading infrastructure. The FCA's Markets Panel should also be able to request information from the Bank via the FCA to enable the Markets Panel to provide appropriate advice to the FCA.

## 2.2 Overall approach and coordination

Over the course of the year, we have made a number of contributions to the debate on the future of regulation where we have highlighted some key issues to be considered in the overall approach. We are pleased that there is an emphasis on proportionate regulation in the legislation, and have sought to ensure that such a proportionate approach is carried through into all aspects of implementation.

***Coordination***

Whilst the creation of two distinct regulators is the key ambition of the current regulatory reform, we have continued to emphasise that, for dual regulated firms there must be effective coordination of action and requests at all levels – from the detailed point of not overlapping on regulatory visits, up to clear coordination of regulatory approaches. Ensuring effective coordination between the regulatory authorities in future is crucial. We have not been convinced that the draft Memorandum of Understanding for the FCA and PRA is strong enough in fostering a culture of coordination between the regulators. We believe that as well as creating additional burdens for firms, an uncoordinated approach presents risks

for regulators in wasting resources in overlap, as well as missing difficult issues through underlap. Our view is that the discussion ought to start from a principle of joint cooperation between the two regulatory bodies wherever possible, and adopt an approach which has a clear rationale for areas where there should not be cooperation, rather than the current view which seems to run the risk of doing the opposite.

***Clear and integrated regulation***

Firms need to understand clearly what is expected of them, and for there to be clear and consistent guidance from the regulators on what is required. We have pressed for the new UK system to be fully joined up not only in the UK, but also working in an integrated manner with EU and other international initiatives.

We have been pleased by moves in this direction so far, and the Joint Committee's recommendation that there should be a joint committee to look at international coordination.

***Competitiveness***

Whilst it is important for the regulators to take strong and effective action, it is also important for them to have an awareness of the impact that their actions may have on the competitiveness of the industry. We have said 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 effect on competitiveness. 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.

Further details on the Panel's work on competitiveness is included in Section 3.

***Cost effectiveness***

The Panel fully supports there being a strong and effective regulator in the UK, and we completely accept that this should be paid for by the industry. We are as keen as everyone else for regulators to act firmly and effectively when things start to go wrong: it is the industry as a whole that suffers if confidence is undermined, and the industry pays more directly through contributions to the FSCS levy. The recent increase in the levy to provide compensation for the customers of Key Data, has had a significant impact on the bottom line of contributing firms. The FCA will have an increased remit to intervene early, and it must use it to ensure that it acts on issues of detriment before they reach the size of recent problems with PPI and mortgage endowments.

Nevertheless, it is important to have clear disciplines of budgetary control and effective challenge on spending in the new system. Ensuring value for money is in the interest not only of the regulated community, but also the public as a whole, as increased costs are often passed onto consumers. There is a danger of duplication of efforts in the two organisations and this must be controlled. The NAO should take an early and proactive part in monitoring the costs of the PRA and FCA.

The latest HM Treasury consultation on financial services reform stated in the impact assessment that 'Overall... this impact assessment assumes that the FCA's and PRA's combined ongoing running costs should not be materially different....from the current FSA budget... .'[1] The FSA has similarly stated that 'The FSA recognises that given the economic circumstances the industry faces, it is not realistic that the cost of regulation continues to rise at this rate in the long term, and therefore the new authorities will be very focused on controlling costs.'[2]

Already, we are concerned that such assurances of aiming for a cost neutral impact after transition costs are looking unlikely. The Panel strongly supports high quality regulation, but would like to emphasise the importance of ensuring value for money in spending and avoiding throwing away existing valuable initiatives going forward. It is also highly aware of the financial pressures firms are under, and the need to control costs.

The graph below was compiled by the Panel to illustrate the increase in the direct cost of regulation for firms since 1998. However, the figures need to be read carefully because there have been several increases to the scope of the FSA's work in this period, as noted below. In the period 1998 to 2007 the FSA's costs grew by 6.3% per annum but this growth rate in costs has increased to 12.4% per annum between 2007 and 2013 (using budgeted figures for the current financial year).

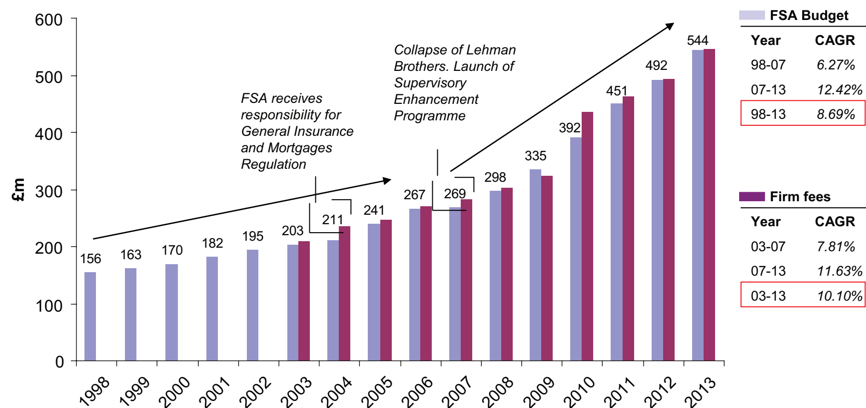
The figures for fees charged to firms are slightly different but also reveal an increasing trend line. It is important to note that this analysis of costs excludes the impact of the current regulatory reform, the additional costs to firms from compensation payments under the FSCS, the costs of the Money Advice Service and Financial Ombudsman Service and also indirect costs (such as firms own compliance costs). Indirect costs by themselves could potentially be very significant – one study estimates that for every pound of direct costs, the financial services industry's indirect costs are approximately four pounds.[3] But even without including these significant costs in our calculation, the graph below demonstrates a considerable increase in FSA budget and firm fees over time.

We have registered concern with the FSA that all the signs are that this trend of increasing costs is likely to continue in the future, as the regulatory authorities adopt a more pro-active

1 *A New Approach to Financial Regulation: Securing Stability, Protecting Consumers* (January 2012), page 107
2 Source: http://www.fsa.gov.uk/library/communication/pr/2012/031.shtml
3 Source: *The direct and compliance costs of financial regulation*, Schaefer et al., Journal of Banking & Finance (1997)

and interventionist approach to regulation. Hector Sants has stated that 'A more interventionist and proactive regulator offers the prospects of greater success but comes with the certainty of extra cost'.[4] At the moment, the magnitude of this cost remains unclear.

## FSA growth in budget and firms fees, 1998-2013




*Note – Figures prior to 2001 reflect the actual budgets of the FSA and predecessor bodies as appropriate. The years reflect the FSA's financial years, with 1998 being the 1997/1998 financial year. Fees reflect actual fees, with the exception of 2013 which represents the Annual Funding Requirement. Figures do not include the regulatory reform programme, but are not adjusted for all scope changes for the FSA. Differences between the budget and firm fees are primarily due to scope changes. The majority of firms are likely to have received a deduction on their fees invoice as a result of financial penalties collected the previous year.
Sources: The Financial Services Authority – Annual Reports and the 2012/13 Business Plan. Please note all figures are rounded to the nearest full number.

The Panel has further asked the FSA to be clear about the risk appetite for the FCA going forward, as it will help to give an indication of resources required and priorities – this was one of the lessons for regulators from the recent financial crisis. In addition, we will be seeking clarity on the combined costs of the FCA and the PRA. For instance, the Bank of England has stated that the PRA will carry out at least an annual review of the banks under its supervision.[5] Hector Sants has indicated that should the decision be made for the FCA to similarly move to annual inspection of non-relationship managed firms in the future, this is likely to lead to an increase in the cost of regulation of £200m per year.[6] We look forward to discussing the FSA's long term budget plans in more detail as we approach transition.

## 2.3 Financial Conduct Authority (FCA)

### *Overall approach*

We registered concern that the launch of the FCA's Approach in June 2011 was unnecessarily negative and adversarial towards the industry. The Panel has always been clear that

4 Source: Speech by Hector Sants, Chief Executive, FSA at the Financial Conduct Authority Conference (29 June 2011)
5 Source: *The Bank of England, Prudential Regulation Authority: Our Approach to Banking Supervision*
6 Source: Speech by Hector Sants, Chief Executive, FSA at the Financial Conduct Authority Conference (29 June 2011)

industry participants strongly support fair treatment of customers. We have urged the new conduct regulator to build on existing initiatives, such as Treating Customers Fairly, rather than simply layering on new requirements. We have emphasised that the regulator needs to take a proportionate, balanced and constructive approach whilst carrying out robust challenge. We believe that it will not help the FCA to pursue its objective of protecting and enhancing confidence in the UK financial system if it spends too much of its time criticising the industry it regulates. It is also important to note the FCA's future role in regulating wholesale markets. The FCA must ensure that equal weight is given publicly to its work in this area. We look forward to engaging in a constructive debate with the FSA as it further develops the FCA's approach.

***Consumer responsibility and firm duties***

The legislation includes a single definition of consumer for the FCA which is of concern to industry, as it is important to have clear recognition that retail consumers need higher levels of protection than wholesale 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 dynamism and efficiency in wholesale markets. With the proposed broad definition of the consumer, it will be all the more important to have a clear recognition of consumer responsibility and the different levels of consumer knowledge.

We have emphasised that consumer responsibility must be a key element in the principles of regulation by the FCA. Firms should be able to rely on consumers taking an honest and responsible approach to dealing with financial services firms. At the same time, we have been concerned about the suggestion that other firm duties be added to the existing protections provided through the regulation of financial services firms in the UK.

***Enforcement action and publication of warning notices***

We have said that there must be some safeguards around any additional powers for the FCA to publish the details of warning notices to provide earlier notification for consumers of the regulator taking disciplinary action against a firm.

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 not being up to standard – this could have significant negative implications for both firms and consumers. For instance, in cases where consumers hold a given product and then see a warning notice has been issued, they may feel compelled to sell at a fire-sale price. Should the product subsequently be proven as 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).

For the firm who is subjected to publication of warning notices, there is the potential for significant reputational damage, for an activity which remains as yet unproven.

In addition, we have suggested in the past that, as well as penalties for firms that behave badly, there should be some kind of regulatory dividend for firms that work well. So firms which provide all that the FCA requires in a timely, accessible and efficient manner should maybe have some benefit, in terms of a reduction of their fees.

***FCA risk framework***

We have suggested that the FCA needs to define and publicly set out its risk appetite and/or tolerance. The FCA Approach document said that it will need to have a lower risk tolerance than the FSA going forward, but this needs to be considered carefully and explained in detail, given the effect it would have on required resources and therefore costs. In order to assess its own effectiveness over the longer term, the regulator will need to more closely define what type of risk it would be willing to allow, and the type of risk that it would find unacceptable. This will be essential in order to understand cost control in the new regulatory system.

The FCA will need to clearly set out its own expectations of what is meant by 'intensive and intrusive' supervision and how it will approach this, similar to a set of principles on which the authority will operate and crucially outlining what is expected of firms. Such an approach could also provide an internal measure in regard to the effectiveness of the relationship and supervisory activity with the firm.

## 2.4 Prudential Regulation Authority (PRA)

***Judgement led regulation***

Our key concern in the development of the PRA has been the need for clarity on the principles that will lie behind judgement led regulation. We were pleased to see Government support for rigorous, evidence-based, judgement led decision making in the White Paper. We remain concerned to ensure that firms will be given clear and reasonable guidelines, so firms can be clear about their responsibilities in responding to the requirements.

As part of the new system, we have suggested that there should be a workable "internal" appeal mechanism for regulatory decisions.

***Cost and benefits***

We were unhappy with the idea that, although cost and benefits analysis will continue for the PRA, they will not always be included in published documents. We believe that the PRA's plan to analyse the costs and benefits of proposed regulation as part of the policy development process but not always include quantitative estimates of costs and benefits in published documents is a potentially unattractive route for the PRA to follow. The decision on whether to publish is based on whether the estimates can be meaningful or be reasonably estimated, but it seems to allow the PRA to introduce new policies with insufficient rigrous justification based on costs and benefits, which naturally causes some concern for practitioners.

***Remuneration structures***

We would be interested to hear more about how the PRA will consider how boards operate and the effect that incentive and remuneration structures may have on regulatory outcomes. This is particularly because we consider that remuneration is a primary driver of behaviour and as such, would also expect it to be a conduct issue for the FCA.

***International negotiations***

Much of the PRA's work will be dictated by international and specifically EU negotiations and requirements. Therefore, it is important for the UK to introduce the new PRA perspective in the negotiations on the directives and rules coming through – as set out in section 3 on EU and international regulatory initiatives.

## 2.5 Bank of England

We provided evidence to the Treasury Committee investigation into the accountability of the Bank of England, as well as in our responses to the Government's consultation, setting out our concern about the lack of structured practitioner level engagement in the decision-making processes at the Bank. We believe it is vital to have some system for engagement – probably linked to the new FCA Panels – for the PRA, which will be a subsidiary of the Bank. We also believe it should be considered for the FPC, and a link to the FCA Markets Panel for the systemic infrastructure which will be supervised by the Bank.

We have also raised the question of whether it is practical for the Governor of the Bank of England to have responsibility for so many different aspects of the new regulatory system, in addition to the duties which he has already.

# 3. EU AND INTERNATIONAL REGULATORY INITIATIVES

As the majority of financial services regulation is now being determined through European and international bodies, the Panel decided this year to increase its work in this area. The aim of this work has been to consider how the voice of UK practitioners can be heard and considered in the discussions that decide the direction of regulatory policies before they reach the UK. The Panel has focused on EU policies, as decisions here will impact most directly on the UK, albeit against the background of global regulatory standard setting.

## 3.1 Increasing Panel engagement on EU policy development

The Panel has increased the number of briefings on EU developments over this year. It has had overall updates from the FSA's international team as well as particular policy specific discussions. There are now plans in place to increase the attention to this area and to build regular engagement and information exchange between the Panel and key trade associations specific to European work.

## 3.2 MiFID II

The Markets in Financial Instruments Directive (MiFID II) aims to create more robust and efficient market structures across Europe and to update provisions to take account of technological innovations, increase transparency in non-equity markets, reinforce supervisory powers for commodity derivatives markets and enhance investor protection.

The Panel has been taking an ongoing interest in MiFID II and it will continue to look on it as a priority. We encouraged the FSA to continue to represent UK interests as effectively as possible in negotiations in Europe particularly as there are aspects of the proposals which could impact significantly on financial services businesses, for example in the derivatives markets. The UK markets are significantly different to the rest of Europe in both wholesale and retail, and so this must be accommodated as much as possible within the European legislation.

We also raised concerns about ensuring that the FSA does not implement RDR proposals on commission sales of investments which will run counter to MiFID II. We have been partially reassured that the FSA believe that the RDR proposals will not be inconsistent with MiFID. However this is dependent on a lengthy process of negotiation in Europe over the next few years. We have pointed out to the FSA Board that firms are currently spending significant amounts of money to prepare for the RDR. Therefore firms would be very disillusioned if significant changes had to be made to comply with new European requirements within a few years.

## 3.3 CRD IV

The Capital Requirements Regulation (CRR), and the Capital Requirements Directive, which together make up CRD IV are crucial for the future shape of UK regulation of capital

requirements in the UK. As well as reflecting the Basel III capital proposals, the legislation also links to the COREP requirements and new proposals on sanctions for non-compliance with prudential rules, corporate governance and remuneration (there are also proposed changes to the current framework).

We have supported the FSA's concerns about the binding nature of the Regulation, which means that the standards set out are the maximum levels of capital, liquidity etc that firms will be expected to hold under the Pillar 1 standards. We are uneasy about the plan that for certain issues, the EBA or the EU Commission will be able to review and oversee decisions taken by national authorities which could affect how supervision is carried out.

We have been increasingly concerned about the cumulative impact of the different capital requirements, which place more and more pressure on banks' capital. We have asked the FSA to draw together information on the cumulative impact and look forward to discussing this further.

## 3.4 Solvency II

The Panel continues to take an interest in and have briefings from the FSA on Solvency II, the new, strengthened EU-wide requirements on capital adequacy and risk management for insurers. The Directive, agreed in late 2009, continues to be a focus for European policy makers, as the text faces amendments by the Omnibus II Directive and as EIOPA and the European Commission develop further Solvency II technical provisions and guidance.

The Panel has expressed a particular concern about ensuring that the calibrations of capital requirements in technical delegated acts are appropriate and proportionate. The Panel also took a particular interest in the FSA's CP11/22: Transposition of Solvency II – Part 1, which was published in November 2011. Please see section 5.3 of this report for more information on the Panel's engagement with the FSA on Solvency II transposition.

## 3.5 Recovery and Resolution Plans and other crisis management initiatives

The Panel has had an ongoing interest in the development of Recovery and Resolution Plans (RRPs), as we have been keen to ensure that a pragmatic view is taken on the resources needed to prepare for any future financial crises. We welcomed the recognition in the FSA's consultation in 2011 of the work that is being done on RRPs on an international level, especially in the EU Commission and the FSB.

# 4. UK COMPETITIVENESS

## 4.1 FCA and competitiveness

We have continued to request a commitment to foster UK competitiveness (as different from competition) in the new regulatory structure. It seems entirely appropriate that both the FPC and the FCA should be asked to consider the competitiveness of the UK industry.

We have pointed out that UK firms compete in a global environment. Therefore, we must guard against a lack of regard of regulatory actions on the relative competitive impact of our industry compared to those of competitors situated abroad. Otherwise this could have significant long term implications for the presence of London as a financial centre, and the UK as a whole being a centre of excellence for financial services.

We believe that ongoing financial stability needs the support of an industry which is competitive in the global marketplace. Therefore, 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.

## 4.2 Macroprudential tools and competitiveness

The Panel responded to the Bank of England consultation on macroprudential tools for the FPC in December 2011. We recognised the significant challenge that the Bank faces as it develops its approach to macroprudential policies. In addition to the technical challenges around how these tools will work in practice, they could also have significant economic and social effects which in certain scenarios could result in pressures being brought to bear on the Bank at precisely the time that the measures are needed. We therefore commended the plan to stimulate a discussion on these tools in advance so that, as far as possible, consensus can be reached on the tools in advance of their implementation.

Our overriding concern has been around the practical impact of the proposed macroprudential tools given they are all relatively untested, the transmission mechanisms are not fully understood and there might be adverse and unintended consequences. We suggested that the number of tools should be reduced, and as much as possible should be done to engage with industry to 'road test' the proposals before they are used.

We also pointed out that the proposed macroprudential tools will interact directly and indirectly with the UK's (changing) microprudential and conduct regulations, so reinforcing the need for coordination between regulators to avoid duplication and potentially conflicting initiatives which would impact on competitiveness.

In addition, the Panel expressed a preference for further development of internationally coordinated macroprudential tools rather than too many country specific tools. We suggested a strengthening of the need for the FPC to take account of the proportionality a commitment to consultation on any new powers that are introduced at a later date (although in certain circumstances this might need to be after the event).

## 4.3 Impact of current regulatory actions on UK competitiveness

Over the year, we have drawn attention to various areas of regulatory policy which have the potential to undermine the UK's competitive position if not properly supported. We have pointed out that there is a line where intensive and intrusive becomes unfair or disproportionate.

We have asked the FSA to consider the potential impact of FSCS levies, product intervention and other regulatory issues in undermining competitiveness of UK financial services. We have also sought to highlight how rising capital levels may strengthen financial stability, but the significant cumulative effect of the proposals may not always be right for the economy.

We have also tried to draw attention to the problems likely to stem from the convergence of new regulatory requirements in 2012/13 affecting competitiveness (RDR, MMR, Solvency II, regulatory reform, CRD 4 and Basel 3). In addition, the plans for the implementation of the recommendations of the Independent Commission on Banking could stimulate yet more change.

## 4.4 Impact of regulatory costs on competitiveness

Whilst the Panels have been supportive of the need to improve the effectiveness of regulation since the 2007/2008 events, the Panels remain concerned about the level of recent and proposed FSA fee increases, especially in light of the cumulative impact of the continual increases we have seen over the past few years. At a time of great economic difficulty for many firms, it is unclear whether sufficient consideration has been taken of the impact on industry of yet another significant increase in fees even before the impact of the proposed “twin peaks” reforms are put in place.

The Panels do have concerns that there may be additional costs to industry going forward and these might even exceed the large increases estimated in HM Treasury's regulatory reform papers. In considering these future costs, the regulators should also consider the cumulative impact not only of the costs of the regulators, but also the funding costs of the FSCS and Money Advice Service. Taking into account all the proposed costs, we continue to seek further assurance that there has been sufficient impact and cost benefit analysis of the impact of the totality of the future fees on industry.

# 5. INTERACTING WITH THE FSA ON ITS CORE PROGRAMME

## 5.1 Conduct

***Retail Distribution Review (RDR)***

The Panel has continued to follow the developments on the RDR with interest over the year. We were particularly interested in the call from the Treasury Select Committee for a 12 month postponement to implementation of the RDR. In our discussions we found that various sectors of the industry (and in some cases firms within sectors) had very different views as to whether or not a delay would be a good thing. Views were dependant on the progress made by that firm in implementing the RDR already, and the amount of direct impact on their businesses from the RDR.

The Panel believed that there was probably enough concern to merit a delay, although there were also arguments in favour of pressing ahead. A delay would have enabled the FSA to clarify in advance, the remaining aspects of RDR not yet finally agreed, and enable implementation within a practicably achievable timeframe. Secondly, it would have allowed time for further consideration of the emerging concerns that MiFID will not be fully aligned with the RDR.

A sub-group of Panel members received an update on the progress of the simplified advice guidance work from the Policy Team in late August and the full Panel then held a wider discussion on the RDR, and on the Treasury Select Committee report, at its September meeting.

***Simplified Advice***

The Panel has spent some time over this year encouraging the FSA to provide some guidance on the provision of simplified advice. We believe the Retail Distribution Review is likely to reduce the level of advice available to some consumers. So simplified advice will be critical to the success of the RDR in terms of ensuring that the broadest range of consumers can access some kind of financial advice on how to save and invest.

As a Panel, we are keen to see a regime that facilitates the giving of simple advice on simple products to people who otherwise would be unable to afford information. We felt that the FSA’s guidance consultation as published in September 2011 was over-complicating the matter, although we appreciate that this is a complex subject which must fit in with the overall rules for financial advice. The FSA published the finalised guidance at the end of March 2012. There were no substantial changes, although we were pleased to see some useful clarifications and additional context as suggested by the Panel in terms of suitability criteria and guidance for firms on choosing the right products for a simplified advice service.

***Platforms***

The Panel registered concern in May 2011 about the FSA’s proposals for platforms and the intention to continue to allow product providers to make payments to platforms. We

suggested that the FSA should undertake further work in this area, as it appeared to be contrary to the principles of the RDR. We pointed out that the varying interests within the financial services industry meant that it would be unlikely to reach a consensus. Therefore, it was all the more important that the FSA took time to look at the overall balance of opinions expressed before taking decisions. We were therefore pleased when the FSA announced in August that although it had decided in principle to ban both cash rebates from product providers to investors and product provider payments to platforms, it needed to take more time to research the implications for consumers before proposing new rules.

***FCA Supervision Plans***

We have been pleased to engage with the FSA team who are developing the FCA supervision approach in the second half of the year. With mis-selling apparently still being seen even after the introduction of the Supervisory Enhancement Programme, it is likely that it will be equally difficult for supervisors within the FCA to identify issues. It will be essential for the FCA to have a coherent supervision plan, and also for the FCA to have significant numbers of staff with experience of working at senior levels in industry even though these people may be difficult to recruit.

We have also been keen to understand more of the FCA's risk appetite going forward, and this has a knock on effect on the costs of regulation – both in terms of the funding of the FCA and in terms of the funding of the FSCS levy for firms which have failed. The industry believes there must be a clear balance in this regard.

***Product Intervention***

The Panel has engaged with the FSA's discussions on product intervention as it prepares for the more interventionist role proposed for the FCA. We have supported the development, although pointed out that one of the challenges of this new role is that there are very few innately toxic products: it is much more likely that products become toxic at the point of sale.

We reviewed FSA work on PPI replacement products, and insurance policies bundled in packaged bank accounts in the light of the changes planned for product intervention. We pointed out that interaction with the overall product intervention proposals would be important and that ground rules would need to be developed in order to provide clarity for firms and to ensure a consistent approach. The Panel was encouraged that the FSA had undertaken consumer research as part of its work on packaged bank accounts. This showed that consumers like these products for convenience and cost reasons, although it is difficult to judge their value. We have said that we would be interested to see how this work feeds through into changes to the Insurance Conduct of Business (ICOBS) rules.

As part of our discussions on product intervention, we also warned that the FCA will need to ensure that supervisors are up to speed with all relevant terminology and technical knowledge in the industry. It is only with the appropriate expertise that effective interventions can be made.

We also urged the FSA to build on initiatives such as Treating Customers Fairly (TCF) when developing these policies for the FCA. Implementation of TCF involved considerable time and expense for firms, and the benefits of such a cultural change may take some time to

become wholly apparent. However, we would be disappointed if the FCA demanded a total change in direction to achieve similar ends to TCF in the new regime.

***Mortgage Market Review (MMR)***

We were pleased that the FSA responded to the concerns expressed last year and undertook a wider cost benefit analysis to look at the combined implications of the MMR on the housing market economy as a whole. The Panel was broadly happy with the FSA's actions in this area, although care will be needed in the transfer period, given the importance of mortgages to UK consumers.

At the end of this year, the industry will be moving on to the practicalities of implementation of the MMR. In the transition to the new environment, difficulties have been highlighted with advice on mortgages, and the question of whether mortgage companies will avoid interest only mortgages and restrict the availability of this product even though the FSA has agreed not to ban the interest only mortgages.

***Review of Complaints Data Publication Rules***

We were pleased that the FSA undertook a post-implementation review of the complaints data publication rules. We suggested that the FSA should look at whether publication of complaints data is more likely to achieve its regulatory objectives in a cost effective manner than alternative tools and if it is consistent with the actions of regulators in other jurisdictions. We believe there is still the potential for unintended consequences from the publications, given the difficulties in contextualising the data and continue to encourage the FSA to keep this under review.

***Claims Management Companies***

In December 2011, we joined with the SBPP and the Financial Services Consumer Panel, to write to the Chairman of the Treasury Select Committee about the lack of regulation of claims management companies. We said that we did not think that the current regulation by the Ministry of Justice was strong enough. We suggested that it would be more consistent for the FCA, particularly given its proposed more intrusive and proactive approach to conduct supervision, to regulate CMCs for financial services complaints. We are keen for better regulation in this area as these companies are having an increasing impact on financial services companies, without providing real benefits for consumers.

## 5.2 Markets

***FSA Markets Division***

Throughout this year, we have encouraged the FSA to work hard to ensure that its Markets Division is provided with enough resources to achieve its potential. We have been impressed by the expertise of the staff, but

concerned that there were not enough people engaged in this work which is vital to the UK's interests.

The Panel recognises the current market issues and the comprehensive EU driven regulatory agendas create challenges for the Division to navigate through at a time of change; we remain concerned about the pressures on available expertise and associated resource implications for this area during such a challenging period.

***Future markets regulation***

We have raised the point that vesting sole responsibility for post trade infrastructure with the Bank of England will make the UK an outlier in some respects as, in other countries operating a twin peaks system, the power has been shared between the central bank and the regulator. This will mean that the UK's engagement with ESMA will be on a different basis to other countries and it will be important to try to ensure that there is a level playing field (for example by ensuring that UK central counterparties are not penalised by being required to have central bank liquidity). To assist in this, we have suggested that the FCA's Markets Panel is given a remit to represent those parts of the markets which will be regulated by the Bank of England, although this has not as yet been taken up by the Government as part of the new legislation.

## 5.3 Prudential

The Panel has had regular updates on a wide range of prudential matters over the course of the year. We encouraged the FSA to continue to be vigilant and fully engaged on the areas of concern to the UK arising from the European Union's prudential agenda, as well as to consider fully the wider implications of implementation of the Independent Commission on Banking Report.

***Recovery and Resolution Plans***

We have had an active engagement with the FSA on their development of recovery and resolution plan proposals over the year. We have been keen to emphasise that although the UK working ahead of the rest of Europe enables the UK to help to shape the debate, the FSA should not go too far on this line. The UK must not proceed too far until it is clear that there will be no conflict between home and host regulatory requirements for groups. We would be very concerned if the final proposals resulted in a lack of international coordination.

We have warned the FSA about the downside of setting additional onerous requirements on top of FSB and EU requirements, and also suggested that the FSA should coordinate directly

with other national regulators, beyond a recognition that the regulators will share plans as appropriate for subsidiaries. The Panel welcomed the FSA's recognition of proportionality in its consultation paper (CP 11/16), although suggested that this should not only be in terms of size, but also in terms of different business models.

Although we welcomed the FSA's emphasis on identifying critical economic functions, we were worried about the vagueness around how firms would assess what is 'critical'. Given that economic functions will drive much of the work around RRPs, we said that the FSA would need to provide guidelines around how to identify these functions, what they are and what activities within these are regarded by the regulator as the most salient.

We also pointed out that the regulator must remain sensitive to possible unintended consequences of Recovery and Resolution Plans. The Central Clearing Party model relies on the CCP taking immediate action to liquidate or hedge market risk at the point a firm either becomes insolvent or otherwise can reasonably be expected to become unable to meet its liabilities. Any delay to that action exposes the central counterparty to the vagaries of market volatility. It will therefore be vital that the development process of RRP is sensitive to the potential impact of new rules on the external market.

The Panel was also supportive of the FSA's approach to CASS and RRPs, although we pressed for more work on international coordination. We registered concern about the mismatch between insolvency law and customer asset protection, and so welcomed the FSA's plans to undertake a wholesale review of the client asset regime, covering the interaction with insolvency law later in 2012. We also pointed out the need for further consideration of the CASS regime providing too limited a definition of the segregated customer pool. The Panel suggested there should be equal weight given to foreign jurisdiction segregation as there is to UK client assets: the system operates multi-jurisdictionally and so international equivalence and cooperation is fundamental to improving client protection.

***Solvency II***

The Panel has continued to follow the development of UK transposition of Solvency II. We have continued to highlight the total costs which we noted grew to an estimate of £1.8bn for one off compliance costs in the summer of 2011. This is much higher than HM Treasury's original estimate. Practitioners have also faced difficulties with understanding the steps they will need to take for compliance with Solvency II and have requested further provision of information and planning assumptions from the FSA. As transposition continues, it is important that all transposition proposals are as clear as possible so that firms can begin to rely on them as, for example, they invest substantial resources into necessary IT infrastructure and systems development.

We have also registered a concern about the overall layering of capital requirements and the wider implications of the revised capital requirements. We will continue to follow this over the coming year. Further, the Panel has flagged with the FSA the need to ensure the FSA's actions on Solvency II introduce a true level playing field in insurance regulation across Europe and that the UK regime does not put the UK at a competitive disadvantage by 'gold plating' the Directive.

The Panel plans to continue to engage with the FSA Solvency II policy and implementation teams as further technical requirements come out of Europe and require transposition and implementation planning.

***CRD***

The Panel has been particularly interested in the plans for roll out for UK Banks and Investment firms of the harmonised European Common Reporting requirements (COREP). The requirements, first discussed in 2006 and amended by new requirements of CRD II and CRD III, will create a new standard across Europe in capital adequacy reporting from 31 December 2012. We encouraged the FSA's stance in supporting UK interests and concerns in COREP discussions with the EBA, although we have highlighted a particular concern in the Panel about the storage and protection of sensitive data under this new system.

Implementation of CRD II and III comes amidst the backdrop of further revisions to the CRD to reflect Basel III standards in CRD IV – please see section 3.3 of this report for further details on CRD IV.

***PRA Supervision***

We have had some dialogue with the Bank and FSA over the year on the plans for PRA supervision. We registered some concern following the publication of the PRA Approach documents about the expectation that firms must have wide data sets available at short notice. This could have significant systems implications for firms, although it is not yet clear what data firms will be required to produce and how often this will need to be done. We are concerned that, although cost benefit analysis work will continue as part of the policy development process, the results will not always be included in published documents and also at the possibility that EU requirements will be gold plated in the UK. This latter concern, in particular, could adversely impact UK competitiveness. We accept the principle that all banks active in the UK should be subject to the same prudential requirements but the detailed proposals as to how this would be applied to international banks are currently unclear. The PRA strategy states that firms will be expected to comply with the spirit as well as the letter of the rules but there is currently a lack of clarity about how retrospection will be avoided and how consumer responsibility will be applied.

## 5.4 Governance/systems and controls

***'Shadow Directors' and approved persons***

The Panel warned the FSA Board that there was a concern in the industry that the FSA needed to consider whether the FSA was coming close to being at risk as a shadow director at firms as a result of attendance at Board and other firm meetings, particularly when this was combined with the FSA's increased intrusiveness on specific decisions.

We also highlighted concerns about the time taken to provide outcomes from the approved persons process. This can leave senior people, and firms wanting to employ people in significant roles, in limbo for considerable periods of time as they await FSA decisions. We understand that the FSA is trying to improve this, but believe that more needs to be done in communicating with firms about what is required to speed up the process, as well as streamlining the system in the FSA.

***Section 166 Skilled Persons Reports***

The Panel has been concerned at the FSA's increased use of skilled persons reports under Section 166. Although the total number of Section 166 reports is not unduly large, it is increasing and this work can be expensive for firms. We asked that if the FSA continues to make increasing use of Section 166 reports, there should be more transparency about the process followed in commissioning this work, including relevant triggers. We urged the FSA to keep under review its policy for the use of Section 166 and other similar tools. We also suggested the FSA considers making a communication to firms to explain the details with respect to the processes followed.

***Bank Executives and Boards – Avoiding Downside Risks***

The Panel considered some early ideas of how the FSA might implement a commitment in the RBS Report to consider regulatory action to ensure that bank executives and Boards give due weight to downside risks. The Panel agrees that this is an important and complex topic that needs to be properly considered and debated, as such action can carry broader downside risks in a number of areas, and it is vital that Boards are able to attract talent. The FSA and future regulators will need to consider exactly what the final outcome is expected to be from such actions and how the new link to existing legislative requirements for Board members and companies.

## 5.5 The running of the regulatory system

***FSA Business Plan***

The Panel engaged early in the process of development of the FSA Business Plan and Budget for the forthcoming year. We raised concern about the potential cumulative effect on the industry from year on year regulatory cost increases and recognised that this must be balanced with the importance of effective regulation.

The Practitioner Panel and the Smaller Businesses Practitioner Panel took the unusual step of making a formal response to the FSA's consultation on fees and levies in March 2012. This was specifically to highlight the Panels' concern about the increasing costs of regulation.

***Rules, Principles and Guidance***

All of the FSA's independent Panels have registered concern about the FSA's general guidance process over this year. We were pleased that as a result, the FSA agreed to incorporate some Panel consultation into the guidance process before publication of the consultation. While acknowledging that guidance is technically of a different nature to rules, it has a potentially significant impact on firms and so the Panels regard this as an important area in which to have dialogue with the FSA.

***Financial Services Compensation Scheme (FSCS)***

We have become increasingly concerned about the funding model for the FSCS going forward. The recovery costs to be borne by industry over the next few years could potentially have an extremely significant effect on firms, depending on decisions about the timing of amounts requested.

Importantly, it has been unclear which forum will discuss the wider policy issues – the FSA or the FSCS, or the Government. We have been concerned that, without one party taking responsibility, there may be serious unintended consequences. The Panel is pleased that the review of FSCS funding was re-started in October 2011. In the Panel's view one of the most significant matters to consider is the direct link to the Deposit Guarantee Scheme Directive, at least for certain sectors.

***Money Advice Service (MAS)***

The Panel is supportive of the overall objective of MAS, but has registered serious concern about the amount of money being allocated from industry funding for this initiative, without any external control of the spending.

We have asked for a clear plan on how value for money will be monitored and how the outcome of improved consumer education and financial capability will be measured as it is achieved. There was some reassurance that more detailed metrics and performance measures are now being put in place since these are absolutely crucial in measuring the effectiveness of the MAS initiatives. We have called on the FSA Board, as part of its oversight and challenge process, to undertake a thorough review and to inform the Panel if there are any particular areas of concern.

The Panel responded to HM Treasury consultation on MAS taking over the coordination and provision of debt advice. We questioned the rationale for the change in the funding to a direct charge to the industry, of potentially an additional £40million. We asked the Treasury to consider strengthening the accountability and scrutiny of MAS with its expanded role bringing a significant increase in the cost base for this organisation.

## 6. FUTURE PLANS

The overwhelming driver of regulatory policy changes by the FSA in 2012/13 will be the need to enable implementation of the UK Government's plans to replace the FSA, and in implementing changes required by the EU and other international bodies.

Our ambition in the coming year is to engage actively and constructively in the policy debates which will shape regulation for the foreseeable future. We are keen to ensure that, in the drive towards greater consumer protection, there are not unintended consequences which inhibit the industry and so affect the wider economy, or diminish consumer access to a wide range of alternative products and services.

# Members of the Practitioner Panel

## April 2011 – March 2012

| Panel Member | Position |
|---|---|
| **Russell Collins (Chairman)**<br>*Chairman from 1 July 2011 to 31 May 2012* | Partner and Vice Chairman, Deloitte LLP |
| **Graham Beale**<br>*Member from 1 August 2011* | Chief Executive, Nationwide Building Society |
| **Iain Cornish**<br>*Chairman and Member to 30 June 2011* | Chief Executive, Yorkshire Building Society |
| **Joe Garner**<br>*Member from 1 August 2011* | Deputy Chief Executive & Head of UK Bank, HSBC Bank plc |
| **Paul Geddes**<br>*Member from 1 August 2011* | Chief Executive Officer, Direct Line Group |
| **Colin Grassie**<br>*Member to February 2012* | Chief Executive Officer UK, Deutsche Bank |
| **Mark Hodges**<br>*Member to 10 June 2011* | Chief Executive, Aviva UK<br>Executive Director, Aviva plc |
| **Mark Harding**<br>*Member from 1 May 2011* | Group General Counsel, Barclays Bank PLC |
| **Simon Hogan** | Chief Operating Officer for Sales and Trading EMEA, Morgan Stanley |

| Panel Member | Position |
|---|---|
| **Garry Jones** | Group Executive Vice President & Head of Global Derivatives, NYSE Euronext |
| **Guy Matthews** | Chief Operating Officer and Partner, Sarasin & Partners [Chairman SBPP] |
| **Helena Morrissey, CBE** | Chief Executive Officer, Newton Investment Management |
| **John Pollock**<br>*Member from 1 August 2011* | Group Executive Director, Protection & Annuities, Legal & General Group plc |
| **Andrew Ross**<br>*Member to 31 November 2011* | Chief Executive, Cazenove Capital Management Limited |
| **Malcolm Streatfield** | Chief Executive, Lighthouse Group plc |
| **Paul Swann** | President & Chief Operating Officer, ICE Clear Europe |
| **Douglas Webb** | Chief Financial Officer, London Stock Exchange Group |
| **Helen Weir**<br>*Member to 30 April 2011* | Group Executive Director Retail Banking, Lloyds Banking Group |

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