Smaller Businesses Practitioner Panel

Financial Services Authority

Annual Report

2010/11

Chairman's Foreword

This year has seen substantial changes proposed for the structure of financial services regulation in the UK, and also the implementation of significant changes to the regulation structures in Europe. Regulatory focus, as you would expect, has been on financial stability after the crisis that we have just lived through. The changes have therefore concentrated on the larger firms with the greatest impact on consumers and economy. However, smaller firms have inevitably been drawn along in the wake of these changes.

The Smaller Businesses Practitioner Panel has taken an active part in the debate on regulation restructuring over this year. Our aim has been to ensure that smaller businesses are not overwhelmed by demanding and unwieldy regulation, but instead given the room to flourish and grow as a vital contributor to the diversity of financial services in the UK.

At the same time, the FSA has been pursuing a business as usual agenda, and continuing to develop major policy changes such as the Retail Distribution Review and the Mortgage Market Review, as well as to implement EU driven changes such as Solvency II. We have again looked to engage in debate as early as possible in the development of policies to ensure the needs of smaller firms are taken into account.

This annual report sets out our opinions on the key issues that we have pursued over the year. Our key theme has been to maintain awareness of the costs and burdens that ever-increasing regulation and changes to regulation put on smaller businesses. There must be a full and proper consideration of the costs and benefits of any increase in regulation, as it must be in everyone's interests to have a cost-effective, and proportional system of regulation in the UK.

I took over as Chairman of the Smaller Businesses Practitioner Panel during this year, and would like to thank all of my colleagues on the Panel who have worked with me over this period. I would also like to thank those members of the Panel who stood down from the Panel during the year – Keith Morris, Phil Gray and Simon Bolam. All of them made significant contributions to the work of the Panel, and I would particularly like to thank Simon Bolam for his Chairmanship of the Panel.

Guy Matthews
Panel Chairman

Introduction

The Smaller Businesses Practitioner Panel (SBPP) works to represent the views and interests of smaller regulated firms to the FSA. It was set up by the FSA to supplement its statutory commitment to establish a Practitioner Panel (and Consumer Panel) to represent views to the FSA. It was recognised by the FSA that it would be difficult for a single Practitioner Panel to represent the views of all types of practitioners – particularly from smaller firms who are subject to many different issues than larger firms. The need for a separate smaller businesses panel has now been recognised more widely, with proposals in the Government's ongoing consultations on regulatory reform, for the SBPP also to be made a statutory requirement for the Financial Conduct Authority (FCA).

Members of the SBPP are selected to represent the major sectors of regulated firms. The current Panel has members working in banking; credit unions; financial planning; friendly societies; general insurance underwriting and broking; investment management; mortgage broking; and stockbroking. The members of the Panel over this financial year are listed at Appendix 1.

Strategy for the SBPP

In June 2010, the SBPP for the first time devised a formal strategy and agreed key priorities that it would proactively pursue over the coming year. This was presented and agreed with the FSA's executive committee over the Summer of 2010.

The Panel's overall objective was agreed to be as follows:

> ***To work to ensure the regulatory environment enables smaller firms to be commercially viable and to flourish, so contributing to the wider economy and providing a broader choice for consumers.***

The Panel's key priorities are set out below, and provide a structure for this annual report.

1. Ensuring the needs of smaller firms are taken into account in the restructuring of financial services regulation in 2010-12.
2. Minimising the cost and burden of regulation for smaller firms.
3. Providing a smaller firms' voice in major UK regulatory developments such as RDR and MMR.
4. Highlighting smaller firms' concerns in EU initiatives and prudential requirements such as Solvency II.
5. Helping to develop the effectiveness of FSA smaller firms supervision.

Restructuring of UK regulation

When the Chancellor of the Exchequer announced in June 2010 that the Coalition Government would restructure the regulation of financial services, the Panel decided that it should take an active part in the debate. We have focused on ensuring that the needs and requirements of smaller firms are fully taken into account. We have engaged in debate with trade associations, the FSA, Bank of England, politicians and Government. We have used this experience to contribute to the debate with formal written submissions to the Treasury Select Committee and HM Treasury on behalf of smaller firms.

Treasury Select Committee Inquiries

We responded to the Treasury Select Committee's Inquiry into whether the Government's plans for the restructuring of regulation were appropriate or suitable with the following key points:

1. Smaller firms represent around 90% of regulated businesses by number, and yet the Treasury Consultation did not refer to the impact on smaller firms.
2. The Government's proposals will have a significant cost and burden impact on smaller firms. These firms are already dealing with regulatory changes such as the Retail Distribution Review, and wider trading pressures from the economic downturn. The disruption involved in regulatory change itself is disproportionate to the benefits.
3. These changes are seeking to solve problems which have essentially been resolved through changes at the FSA and to the Tripartite system. The changes will be disruptive and costly and seem not to offer any commensurate benefit in regulation.

4. A new weakness in regulation will be introduced in the divide between prudential and conduct, as the business models of smaller firms are not split in that way, and so hazardous patterns could be missed by supervisors.
5. We do not believe there is enough external accountability in the new system. Significantly more power is being given to the Bank of England, and the powerful new FPC has few checks and balances. The PRA also only has vague proposals for practitioner engagement.
6. We are against any type of 'judgement-based' regulation which is not based on clear and transparent principles.
7. The impact of the regulators' actions on the industry's competitiveness and firms' ability to do business must be a key consideration.
8. We do not believe that the role of "consumer champion" as set out in the Government's first consultation is an appropriate role for a regulator.

We also submitted a joint response with the Practitioner Panel to the Select Committee's subsequent Inquiry into the accountability of the Bank of England at the beginning of April 2011. Our concerns focused on the lack of structured practitioner level engagement in the decision-making processes at the Bank. We suggested that there should be some system for engagement – probably linked to the new FCA Panels – for the Prudential Regulation Authority (PRA), which will be a subsidiary of the Bank. We also questioned whether it is practical for the Governor of the Bank of England to take on responsibility for so many additional aspects in the new regulatory system.

Engagement with Government

During the course of this financial year, HM Treasury has issued two consultation papers on the Government's plans for the restructuring of regulation. The Panel has responded to both of them, focusing on the impact of the changes on smaller firms. The broader impact on regulated firms as a whole has been considered by the Practitioner Panel.

July 2010 consultation

In our response to the Government's first consultation on regulatory reform in 2010, we made clear our concern about the impact on smaller firms. We stated that, in our opinion, the proposals are expensive to implement, not practical to put into action at this time, and risk causing damage to the smaller firms within the financial services market. We pointed out that smaller firms are important, as they offer an added range of services to consumers, and increase the competitiveness of the UK financial services industry. However, we were unconvinced that the measures would prevent the next financial crisis.

We were dismayed that there was little reference in the Consultation Paper to the likely consequences of these proposals on smaller firms. We pointed out that the proposals could have a seriously adverse impact on the viability of smaller firms already coping with other regulatory changes and a difficult economic backdrop. We viewed the initial proposals as incurring an increase in costs, both in the transition and in the new system for those firms who have to be dual regulated.

February 2011 consultation

We also responded to the subsequent consultation from HM Treasury. Although remaining unconvinced of the need for such major regulatory change, we recognised that there had been progress towards a more practical and fair regulatory system.

We welcomed the steps taken to establish regulators which would be balanced and fair in their approach to firms and consumers – and the change of name to the FCA was a key indicator of that. We also welcomed the Government's emphasis on proportionality, as this is crucial in the regulator's dealings with smaller firms. We urged the Government also to take the size of firms into account in its wish to ensure diversity, and so guard against a situation where there is such a burden on firms that only the largest firms are able to survive.

There will be a large number of smaller firms which will also need to be dual regulated by both the PRA and FCA. The dual regulated smaller firms must have as efficient and easy a system as possible for access to and information from the regulators.

We supported the Practitioner Panel's call for there to be some formal structure for engagement with practitioners at the PRA. Some smaller firm representation could then also be incorporated within such a Panel, and it could play a useful role in providing a forum for debate in making prudential regulation by the PRA as effective as possible for larger and smaller firms alike.

Liaison with FSA

Since the proposals for change have been announced, we have had regular engagement with the FSA transition team to keep up to date with the internal developments in the FSA. We have registered concern about the cost of the transition project, although overall we have been supportive of the efficiency of the plans so far to manage the transition of the FSA into the new regulatory structures.

Role of the Panels in future

We were pleased that the Government's proposals on regulation also incorporated a proposal to set up a statutory Smaller Businesses Practitioner Panel for the FCA. Although we have always been treated as if we were on the same level as the current statutory Practitioner Panel and Consumer Panel of the FSA, it will nevertheless be helpful to have our position recognised by being made into a statutory Panel.

Our major concern about the current proposals for the role of the Panels is in the fact that we will only be looking at half of the regulatory system for many of the smaller firms. We have called for there to be some remit for Panels within the PRA to at least engage in debate on the practicalities of PRA regulation and the coordination of requirements between the PRA and FCA.

Cost and burden of regulation

Working to minimise the cost and burden of regulation is a key priority for the SBPP: smaller firms have a smaller base from which to support regulatory costs. Therefore any increases in regulatory requirements are likely to have a more significant impact on smaller firms.

Convergence of issues in 2012

The Panel has been particularly concerned about any additional costs and burdens, as a number of major programmes will converge on being implemented in 2012/13 – including the RDR, MMR, Solvency II, Capital Requirements Directive reporting requirements and regulatory reform, as well as the impact of any wider economic downturn as a result of the current government cuts. We have pointed out to the FSA that this convergence will place a significant burden on smaller firms.

In addition, there are a number of issues that have not been at the forefront of attention, but will nevertheless contribute to the burden on firms in the next couple of years. For instance, small advisory businesses may become financially unviable as changes in capital adequacy rules will require owners to increase their firm's capital, which may then be wiped out by the need to pay significant contributions to the Financial Services Compensation Scheme (FSCS). We perceive an asymmetry of risks between large firms and smaller firms, as larger firms' losses are borne by their shareholders rather than in smaller firms, where the losses normally must be covered by that firm's management and owners taking a cut in their pay or profit share.

FSA Business plan

The FSA's Business Plan is reviewed by the Panel at a number of stages in its development, as it provides the basis of the FSA's plans for the future.

This year, we again urged the FSA to focus on its core activities and not take on any additional discretionary activities at this time of cost pressures for firms. We felt this was particularly important this year, as the FSA has also had to start the development of plans to transition into the dual regulatory structure set out by the Government. We were pleased that the FSA said that demand from within the FSA to start new initiatives had been reduced and additional costs kept to a minimum.

At the same time, we were concerned about the acknowledgement from the FSA that supervisory activity is likely to decrease over the period of transition. We pointed out that seemingly discretionary activities such as developing work on how the FSA might look at culture within firms should be dropped, rather than day to day supervisory work.

Fees and levies for 2011/12

We registered concern to the FSA with the proposals for yet another increase in the annual funding requirements (AFR) for the FSA, the Financial Ombudsman Service (FOS), the Financial Services Compensation Scheme (FSCS) and the Money Advice Service, then called the Consumer Financial Education Body (CFEB). Although we were reassured that the FSA is committed to reducing costs when possible, we have put down a marker to suggest that for example, post-implementation reviews be used to look at the impact of regulatory changes in the context of their cost-effectiveness for the industry and the regulator.

Following changes to the process made by the FSA last year, we were content that the allocation basis across fee blocks is now more transparent and generally fairer. However, there was still some concern that the proposed increase in certain fee blocks, such as insurance brokers, appeared to be significantly higher than the actual risk justified.

We believe it is incumbent on the FSA to drive down costs and to increase the accountability in respect of expenditure for not only itself but also the other bodies where it has an overarching remit – particularly the Money Advice Service. (See page 11)

Additional FSA initiatives

Despite the assurance of the FSA that they are not planning to embark on any major new initiatives, we have nevertheless been able to highlight areas where we have not seen it necessary for the FSA to spend time and money. For instance, we were concerned by the FSA's initiative to reconsider its approach to assessing culture in firms. The Panel questioned why the FSA needed to undertake such a project after all the work on Treating Customers Fairly, and felt the FSA could not produce any real justification in terms of benefits compared to costs: indeed it seemed that the FSA was undertaking an unnecessary and discretionary initiative which the SBPP did not support.

There were also other examples of the FSA wanting to reach further than strictly necessary during the course of this year as follows:

- The consideration of RDR Training and Competence proposals being extended into non-RDR areas.
- The development by the FSA of a consumer engagement programme seemed a costly exercise with little initial analysis of the costs and benefits of such a programme. We appreciate that this work was put on hold when regulatory reform was announced. However, it is likely to form a significant element in the new FCA, and we would urge cost effectiveness to be a key consideration.
- The production of a regulatory guide on financial crime, setting out the FSA's existing expectations of firms in relation to their financial crime systems and controls. Although this may be useful for some firms, we registered concern that this was not adding to existing financial crime safeguards, but would increase the burden on smaller firms if they all felt that they had to work through the regulatory guide and adhere to all its guidance.

Keeping costs down

There have been a number of initiatives which the FSA has needed to carry through into regulatory requirements over this year. We have been keen to emphasise the need to minimise the costs and burdens resulting from such changes.

We encouraged the FSA to consider proportionality as it set out the requirements for Recovery and Resolution Plans for small as well as large firms.

The introduction of changes to consumer redress schemes following their parliamentary approval in the Spring of 2010 was met with some scepticism by the Panel. We were concerned that if, in the future, the FSA retrospectively decided a firm's actions caused loss or damage to consumers and demanded redress, it could cause unpredictable costs for the industry as a whole and potentially bring pressure on the compensation scheme.

We asked the FSA to consider the impact of past business reviews on smaller firms. There seems to be a very small pool of accountancy firms able to undertake S166 work, and so the FSA needed to encourage more competitive tendering of such work to drive down costs.

FSCS Funding Model Review

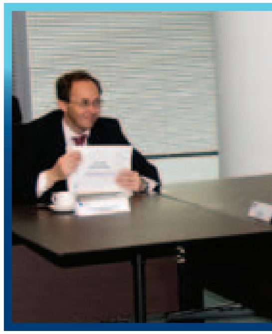
During this year, the Panel as a whole has reviewed progress on the FSCS Funding Model Review (FFMR) and Panel members have contributed to a dedicated working group. Although this review has subsequently been delayed due to the regulatory restructuring and uncertainty about the development of European legislation, the Panel made the following points:

- In general the Panel has been in favour of pre-funding, as it means that all firms have to contribute to the fund – including any firms that subsequently collapse and cause a drain on the fund.
- However, there was a risk that pre-funding could undermine the deposit-taking sector as additional costs would be imposed on all firms, but no amount of pre-funding would be sufficient to fund a failure by a major bank.

- The current cross-subsidy inherent within each class led to a large and unpredictable burden on well-run smaller firms which had not been involved in issues such as mis-selling PPI.
- New entrants to the market should not be ring-fenced from past defaults as this would give them an unfair advantage over existing firms.
- Any new FSCS scheme should aim to incorporate contributions from the wholesale market, as they do derive benefit from it, albeit indirectly.
- The Panel appreciated that the FSCS gave consumers confidence, and was thus of value, but it was important for the system to be fair.
- The implications of passporting arrangements need to be considered.

The wider impacts of FSCS funding

The funding of the FSCS continues to be of concern to smaller firms, and the Panel has highlighted this on numerous occasions over the year. We have been most concerned about the unpredictable nature of FSCS liabilities which make financial planning difficult for firms, resulting in a threat to the firms and potential consumer detriment.



The effects of the recent financial crisis, as well as the large demands resulting from PPI linked defaults and Keydata, has led to the FSCS requiring far greater funding of defaults than has ever been the case in the past. The Panel has pointed out that small firms in particular find it extremely difficult to plan for a material and unquantifiable potential liability to the FSCS with limited financial resources.

A particularly extreme request occurred in January 2011 when there was a huge additional FSCS levy on fund managers to supplement the contributions from intermediaries on the Keydata losses. This was unexpected in its size, and levied with inadequate notice and communication. Further unexpected requirements of this size could cause instability in hitherto well-run and compliant firms.

We have suggested to the Government as part of our response on regulatory restructuring that there should be a change to the responsibilities in this regard: the FSA and FSCS should be required to take more account of the wider impact of FSCS levies or at least publicly acknowledge that smaller firms are being required unfairly to pay compensation for entirely unrelated matters. We have suggested that the new Financial Conduct Authority should take a greater responsibility in considering the impact of FSCS levies on the activities of firms.

Money Advice Service

The Money Advice Service was formerly known as the Consumer Financial Education Body (CFEB) before April 2011. The Panel's discussions over this year relate to it as CFEB.

As a Panel we have registered considerable concerns about the extension of CFEB's remit beyond that of an educational and public awareness body. This could lead to a seemingly unlimited potential for budget expenditure by this body – to be funded solely by industry contributions since government funding has been withdrawn. The result this year was the FSA request to collect an Annual Funding Requirement of £43.7m for CFEB for 2011-12. We do not believe that the CFEB Business Plan was rigorous enough to justify such expenditure, with few measurable objectives set out at this stage.

As stated, there is also a danger that CFEB's planned budget will be insufficient to fund its forthcoming plans as set out for a re-branding exercise and to fulfil its new, broader strategy. We have urged the FSA to exercise its right to carry out a value for money review of CFEB during the next 12 months, as we believe that this organisation may result in considerable expense to industry for minimal consumer benefit.

We were also concerned about the remit of CFEB being stretched into potential overlap with regulated advice. The Government commissioned CFEB to develop a new annual financial health check following the May 2010 General Election. This is due to launch in Spring 2011. We have highlighted the lack of clarity about the regulatory boundary on the provision of the tailored advice planned for the Money Advice Service. We were not convinced that a clear line would be drawn for consumers, as even recommending different types of financial products is something for which regulated financial advisers must undergo extensive training and monitoring.

Major UK policy developments

We have been keen to see the FSA taking a more strategic view of the impact of their policies on the industry, and to set out a vision of the ideal market that they are aiming for, so that progress can be monitored against this goal.

We have taken a particular interest in the impact on smaller firms of the major policy initiatives being pursued by the FSA over the year.

Retail Distribution Review (RDR)

We have continued to engage with the FSA on progress on the RDR, as we have supported the objectives of the RDR overall.

Professionalism

We have supported the FSA's aims to raise standards in the industry. However, the level of qualification needed by all advisers seemed to be excessive and was likely to result in advice of this sort only being available to higher income clients, so increasing social exclusion. We suggested that there should be more flexibility on the timing of the cut off period from which all advisers have to have reached the required standard, and suggested that advisers should not be allowed to engage in regulated activities before completing their qualification, except in monitored training circumstances.

We also appreciated that the FSA was looking at a cost-effective solution, by deciding not to form a specific body called the Professional Standards Board, but using FSA staff in a flexible way. However there was some concern expressed as to whether there should be more of a focus for debate and approval of professional standards, with direct input from consumer and practitioner representatives. We also advised against the FSA verifying the work done by accredited bodies.

Capital Requirements

Much of the debate on the RDR has focused around the qualifications requirements and adviser charging. However, an area which has received little attention has been the changes to capital requirements. And yet, as we have pointed out, these are likely to have a major impact, particularly on smaller firms. It is not only that firms will have to increase the amount of capital that they hold, which may cause additional strains on the business: it is also that the basis of calculating the amount of capital will change if they move from a commission funded model to a fee based model.

We urged the FSA to consider carrying out predictive work to assess which business models would enable firms to meet the new capital adequacy requirements.

FSA communications on the RDR

We were pleased to be able to discuss plans for a regular newsletter and roadshows for firms about the RDR with the FSA communications team. We suggested that a briefing on capital requirements should be incorporated into the roadshows and that the roadshows should be marketed as providing practical advice to advisers and business owners. We encouraged the FSA to engage, and provide opportunities for one to one advice surgeries, but only if the staff level at such events had significant enough knowledge to provide useful advice to regulated firms.

We also suggested additional information to be contained in the newsletter, such as a timeline for what firms needed to do, by when, to comply with the RDR; and also briefings on capital requirements and when VAT was and was not chargeable.

Treasury Select Committee

We submitted evidence to the Treasury Select Committee's Inquiry into the RDR in January 2011. We highlighted the fact that the FSA seemed to have dropped their objectives of maintaining the sustainability of the sector and consumer access to products and services in developing the RDR. We particularly called for the following:

- The FSA should take the lead in setting out a clear regulatory environment to enable the creation of simplified products and the provision of simplified advice for those products within the same timescale as the rest of the RDR.
- There should be a delay in the RDR to allow the simple products regime to be developed, a broader cost benefit analysis of the whole of the RDR to be carried out, and for the FCA objectives to be set and checked against the expectations of the RDR.
- Professional qualifications should be set at different levels to reflect varying consumer needs and that enable simpler products to be bought without significant regulatory overlay.
- There should be a further delay in the deadlines for any higher capital adequacy requirements. The FSA needs to provide a better justification for the increased level of requirements to ensure that it is relevant to advisory firms. At the same time, businesses need to embed their new business models (which are likely to provoke cash-flow uncertainty) before having to adhere to more rigorous capital requirements, if justification is forthcoming to keep these requirements applicable.

Platforms

We have urged the FSA to undertake further work in this area before formulating the final policy. This is a complex and very important area with a huge potential volume of business. Therefore there must be a detailed review of the implications of any regulatory intervention in this area before acting, to ensure that the desired outcomes are achieved.

We have supported the FSA's wish to review the rules affecting platforms: there is a need to avoid the danger of the RDR's proposals to reduce any bias in the selection of products by financial advisers being undermined by differential product payments being made by platform providers. However, we have remained unconvinced that the FSA has grasped this issue effectively.

Although the FSA has decided that disclosure of commission payments is not enough for financial advisers, it has nevertheless seemed to be content to propose disclosure as a solution for payments from platform providers. This seems inconsistent and damaging, particularly as consumers are even less likely to understand the payment systems set up for platforms than commission payments to an adviser. We have said that if fund managers and product providers are still allowed to give rebates to platforms, it will undermine the whole justification of the RDR. It will prevent clarity of relationships and charges and fail to eliminate product bias, with platforms becoming a powerful force in the market, which could lead to the detriment of consumers and product providers alike.

Mortgage Market Review (MMR)

We have worked this year to promote our view that regulation of mortgages must allow flexibility within the context of safe lending. There must be a balance between consumer choice and suitable products. It must set a clear assessment of affordability, whilst allowing firms to be able to consider the risk profile of individual consumers and not adopt a "one size fits all". We welcomed the FSA's decision to undertake a broad ranging cost benefit analysis of the proposals at the beginning of 2011.

Responsible lending

The Panel suggested to the FSA that affordability was more important than income when considering whether to grant a mortgage to a borrower. This verification will be vital to enable stability to be maintained when economic conditions improve and firms' risk appetites subsequently increase.

We were unhappy that the restrictions on interest-only mortgages might prevent firms from being able to innovate. The nature of the controls around the selling of interest-only mortgages would be crucial to maintain flexibility for advisers in accessing appropriate products for their clients.

Distribution and disclosure

The Panel was concerned that the FSA's proposals to change the requirements for the production of Initial Disclosure Documents (IDDs) and Key Facts Illustrations (KFIs) were unlikely to make a significant difference to consumers. Nevertheless, the introduction of these documents had caused considerable expense for firms. The changes proposed by the FSA meant that those costs now appeared to have been wasted.

Product Intervention

The Panel appreciated that the FSA's plans for product intervention were a natural consequence of the regulator focussing on earlier intervention and more intrusive supervision. However, we highlighted a number of risks for the regulator in engaging in such activities:

- It would be important to consider principles around products rather than just processes in order to assess risks. The regulator is not always well placed to decide 'value' and the Panel considered that the most important issue was whether a product would perform in the way it was supposed to. We suggested that additional expertise would need to be brought in to assist in the commercial nature of decisions that would need to be made in respect of products under the new proposals.
- Assumptions used when a product was taken out should be re-tested by firms periodically during the life of the product to consider the impact of any changes in the assumptions on both new and existing customers.
- Following the implementation of the product intervention proposals it would be important for firms to be given some certainty that products would not be subject to later challenge if sold in the agreed way.
- We were concerned that the regulator should set out clearly how the proposed tools and methodologies would differ from those available under Treating Customers Fairly principles.
- Consideration must be given to how such rules will apply in the context of Europe. We would not like to see a situation where products were banned in the UK, but firms could set up in other parts of the EU and sell potentially "toxic" products into the UK market.
- Products are rarely toxic in themselves – problems occur more often because products are developed for certain sectors of the market and then sold more widely to consumers for whom the products are not suitable.

EU initiatives and prudential requirements

The Panel's aim this year has been to ensure that the Panel has a good understanding of future regulation deriving from the EU, to enable members to identify areas of impact for smaller firms and to add value to the FSA's work in furthering EU implementation.

We are grateful to the FSA's international team for providing the Panel with regular updates on developments in the EU and internationally on a quarterly basis.

We have expressed some concern that smaller firms are often overlooked with regard to significant regulatory policies. This is often because smaller firms find it difficult to engage effectively with Europe as all the issues are remote and long-running. The formation of stakeholder groups as part of the new structure of European Supervisory Authorities (ESAs) from January 2011 was an opportunity for suitable representatives to be nominated who could give smaller firms a voice. However, we acknowledge that it is difficult for people who run small firms to make such an ongoing time commitment.

The Panel also raised with the FSA the fact that there is a perception that the FSA tended to front-run in Europe over certain initiatives, to try to influence the thinking of those people who drafted the legislation. The FSA maintained that efforts were made not to implement changes until it was clear which way Europe would go, unless there was a clear domestic need to do so, such as had happened with the changes in liquidity requirements.

We have supported the FSA in successfully remaining focussed on European and international engagement, despite its position being potentially undermined by the UK Government's plans for restructuring which developed during the year. The FSA's achievement of representation on all three ESAs was a credit to their strategy of engagement.

Passporting

We remain concerned about the implications of passporting firms in to the UK. Although we recognise that the FSA is powerless to act in these circumstances, we highlighted the implications of the action that the Irish Regulator took against the Irish Motor Insurance provider Quinn Insurance in April 2010. This firm was selling insurance into the UK. There was a significant risk of consumer detriment, but firms which are passported in to the UK are often not covered by the UK compensation scheme. The Panel pointed out that UK insurers were at risk of losing out twice, as they may be obliged to fund compensation payments, for a firm which was able to undercut them in the market, possibly because it did not have such high regulatory overheads.

Solvency II

During the last year the FSA's European work has continued and the Panel has been working closely with the FSA's policy and communications areas to consider the ongoing concerns and issues that smaller firms have been encountering as the initiative progresses.

Our remit within this area is to focus on the smaller firm needs, and during the last year we have operated through the work of our Panel sub-group. The specific points that have been covered include:

- proportionality;
- cost of delivery for the smaller firm;
- burden of increased technical resource requirements for smaller insurers such as mutual insurers;
- the importance of consistency of UK proposals with other EU state members;
- Capacity of the smaller firm to select internal model approaches;
- QIS 5;
- potential for capital increases at firm level;
- importance of smaller firm engagement within the Solvency II debate/work;
- non-Directive firms and how Solvency II may affect them; and
- the importance of the FSA's Solvency II communications to small firms.

We remain focussed on this topic as it continues to develop and subsequently progress to implementation within the UK. We are concerned more generally about the issue of 'proportionality' and in particular in the context of Solvency II and the smaller firms. This is heightened by regulatory uncertainty at this present time and how it may be affected by forthcoming changes within the regulatory framework. We continue to support the FSA's ongoing work on Solvency II and the regard it has demonstrated for smaller firms' concerns.

Liquidity standards

We registered concern that the European timetable was running behind the UK timetable for liquidity assessments. This was significant as liquidity ratios are a key element for banks and it was unclear what changes would be introduced in Europe. It would have been preferable for the timeframes to be aligned to provide clarity for planning purposes. However, we accepted that this was necessary and the current UK handbook rules would continue to apply, with any changes only being introduced following consultation and a transitional period.

Remuneration Code

We appreciated the desire of the FSA to develop its Remuneration Code as early as possible in the financial year, and yet at the same time, delay final publication until after the final Committee of European Banking Supervision (CEBS) guidelines so that they could be taken into account.

We emphasised the importance of proportionality of implementation, and the desire not to read across automatically exactly the same requirements to other sectors, and to wait until any measure was specifically required.

European Asset Management Regulation

We discussed with the FSA its implementation of changes resulting from the Alternative Investment Fund Managers Directive (AIFMD) and the Undertakings in Collective Investments in Transferable Securities Directive (UCITS).

We were pleased that the FSA had worked with relevant trade associations to enable a proportionate implementation of AIFMD for smaller investment firms. We asked that communication of pending changes by the FSA through announcements and workshops would be helpful for smaller firms, particularly those that were not members of trade associations.

The Panel also pointed out that it was important for the regulation and taxation position to be coordinated if firms' behaviours were to be influenced. It would be unfortunate if the UK missed the opportunity to bring alternative investments onshore through AIFMD, although it seemed unlikely in the current financial conditions that HM Treasury would be willing to take a short term tax loss even to achieve a longer term gain.

The general concern in the industry that some firms would relocate their fund ranges from the UK to Dublin and Luxembourg for tax and regulatory reasons was raised with the FSA by the Panel in view of the forthcoming implementation of UCITS IV. However, the FSA hoped that this would not be the case but noted that tax policy was a matter for HM Treasury and not part of the FSA's remit.

Smaller firm supervision

We believe that a key part of our role, as well as looking at the broader policy areas, is to help the FSA to improve the consistency and quality of supervision when directed at smaller firms. An important element of this is the way that the FSA communicates with smaller firms. As smaller firms do not, in most cases, have dedicated supervisors, it is all the more crucial that the FSA provides effective and targeted communications which assist firms in ensuring that they comply with the requirements of the regulator without being unnecessarily burdened with irrelevant or complicated information.

As part of our role in this regard, we engage in a smaller firms update discussion with the FSA Director in charge of smaller firms at the beginning of each monthly meeting.

Review of small firms' supervision

The Panel was supportive of the FSA's review of smaller firms supervision which commenced at the beginning of 2010, and resulted in its new small firms supervision proposal being discussed with the Panel in May 2010. It was recognised that the FSA had increased its knowledge of firms and improved its targeting of resources through use of a risk profiler. This enables the FSA to better segment the regulated population and to adopt a different approach depending on a firm's classification. We welcomed the FSA's use of this tool and suggested that the risk profiler categories should be made available to firms in order to increase understanding.

The Panel noted that the improved sector and market analysis to be provided by the FSA as a result of the additional data gathered about firms could be very positive for smaller firms, which could look forward to receiving additional advice and assistance as part of their interaction with the FSA. We expressed some concern that intensive and intrusive supervision must not take the place of a supportive approach but the FSA replied that it was intended to be an intensive but educative approach. We supported the plan for the FSA to become more intrusive at the gateway, but for the ongoing process of supervision to become smoother both for firms and for the FSA.

Supervision of smaller firms and regulatory restructuring

We have engaged with the FSA in its initial transition plans to supervision in the new regulatory structure from 2012/13. We have highlighted some concern that the planned structure for the FCA is along sector lines, without a specific smaller firms focus, and we have yet to see any smaller firms strategy for the PRA. Although we appreciate that sector based supervision may well enable firms to receive more appropriate supervision by staff who understand the areas in which they are operating, there is still a difference for those smaller firms who are supervised at arm’s length.

We will continue to highlight that consideration must be given to the needs of smaller firms, at the process level as well as at the policy level. For instance, we support initiatives which can help small firms such as the interactive online permissions application system which is tailored to request only the required information for that type of firm.

FSA communications with smaller firms

The Practitioner Panel Survey has continuously shown that interaction with the FSA resulted in firms seeing the regulator in a more positive light. We therefore welcomed the new supervisory approach introduced in 2010, under which the FSA aims to give firms all the support they need as long as they engage with the FSA.

We have been keen to assist the FSA in reviewing the future of roadshows and wider small firm engagement, which needs to be developed to reflect new priorities. We have emphasised that the FSA must also consider the practical needs of firms in organising its communications – from not arranging meetings starting at 9am for people travelling long distances to London, to providing examples of “beacon firms” who are able to share their experiences with other firms.

We have also made specific requests for further information to be provided by the FSA. For example, in providing guidance on the provisions in threshold conditions in respect of capital and resources, and more firm-friendly guidance for stockbrokers on ICAAP.

Enforcement

During the year, we noted that the level of resource working on small firms' enforcement cases had decreased by some 12% with a shift in focus to larger firms. We were somewhat reassured to hear that, despite this reduction in resource and only a small number of cases involving smaller firms being referred to Enforcement, this did not represent a lack of interest in small firms. A number of firms had cancelled their authorisations shortly before assessment or before they were subject to follow-up visits. In addition, alternative supervisory tools are also often used, including asking firms to voluntarily vary their permissions or to carry out past business reviews. These aspects would not, however, be published in the same way as enforcement action.

The Panel had previously expressed concern that fines levied against small firms were disproportionately high. However, we are pleased that the new, transparent method has aimed to address this. This has meant that fines for small firms are now more proportionate. The FSA has introduced discretionary overrides to ensure that levels of fines are fair and has said that it will keep the figures under review.

Thematic work

Each year we see the results of some of the FSA's thematic work as it affects smaller firms. This year, we particularly looked at the work on asset management. We expressed concern that, for some asset management firms controlling large amounts of client monies, regulation by periodic interview seemed unduly light. However, the FSA had been constrained to not make the requirements any more difficult for firms than they were under the current system. They had therefore looked to reduce any potential issues through thematic work.

We had welcomed previous FSA action to tackle high pressure selling of small capital shares by some stockbrokers. They had noted that a number of firms had now moved to selling contracts for differences (CFDs) and resource had been shifted to address this issue. The thematic work on CFDs had identified concerns in a number of areas including suitability, brokers' qualifications, and churning. Some firms had agreed to voluntarily vary their permissions as a result of this project and the Panel had urged the FSA to consider a more intrusive approach with firms that undertook this practice.

Responding to FSA initiatives

Our role as a Panel also includes responding to requests for advice and opinions from the FSA on a range of policy initiatives. We will respond to the FSA's agenda by reviewing written policy papers. We also meet regularly with senior FSA staff including the Chairman and Chief Executive, which provides an opportunity for two way dialogue on priority issues.

We commented specifically on the following issues.

Financial promotions

The Panel welcomed FSA action on financial promotion on websites. We advised that some previous bad practice had now been discontinued by the sites. However, we were pleased to hear that the FSA would check again about 'fronting' whereby people take out motor insurance on behalf of others who have a higher risk rating and would therefore be liable for higher premiums. This sometimes follows inappropriate advice from comparator websites, which could result in prejudicing policy contracts and therefore unidentified consumer detriment.

We also suggested that it was important for the FSA to stay on top of the growing market in Exchange Traded Funds and structured products which were increasingly being used, despite concerns on the amount of due diligence that could be done for these products.

Client assets

The Panel was pleased that the FSA had taken proactive action after it found significant issues in a large number of firms in compliance with the client assets segregation rules. However, there was some concern about the proportionality of the regulatory response and the burden of client money rules, particularly on smaller general insurance intermediaries.

Changes to FSA Penalties Manual

We welcomed FSA action proposing changes to Decision Procedure and Penalties Manual (DEPP) and Enforcement Guide (EG) to include a prohibition on authorised firms paying fines imposed on their employees. This is something that we had complained about for some time, as a practice that was possible in larger firms, and so distanced individuals in larger firms from taking responsibility for compliance problems which they should have overseen.

Publication of complaints data

The FSA's publication of complaints data continues to cause concern, as little contextualisation is given with the publication of the information. Even though small firms would not be directly affected, many advisory firms would be recommending firms which were subject to the new requirements. We appreciate that the FSA tried to develop metrics to provide some context for the levels of complaints, but it was too difficult to achieve. We urged the FSA to carry out a post-implementation review of this initiative.

Future plans

We will be undertaking the first annual review of our formal strategy in the early Summer of 2011. It is likely that we will continue to focus on the same key elements:

- restructuring of financial services regulation in 2010-12;
- minimising the cost and burden of regulation for smaller firms;
- UK regulatory developments such as RDR and MMR;
- EU initiatives and prudential requirements such as Solvency II; and
- smaller firms supervision.

In all our work, the Panel will seek to reflect the viewpoint of smaller firms and to highlight the needs of smaller firms in making an effective contribution to UK financial services going forward.

Appendix 1

Members of the Smaller Businesses Practitioner Panel

April 2010 – March 2011

Panel Member	Position
Guy Matthews *Chairman (from November 2010)*	Chief Executive, Sarasin Investment Funds
Simon Bolam *(Chairman to May 2010, Acting Chairman September to October 2010)*	Principal, EH Ranson and Company
Phil Gray *(Chairman June to August 2010)*	Chief Executive, Beverley Building Society
Clinton Askew	Director, Citywide Financial Partners
Ian Dickinson	Principal Director, The Brunsdon Group
Paul Etheridge	Chairman, The Prestwood Group of Companies
Peter Evans	Chief Executive, Police Credit Union
Sally Laker	Managing Director, Mortgage Intelligence
Fiona McBain	Chief Executive, Scottish Friendly Assurance
Keith Morris *(Member to November 2010)*	Chairman and Chief Executive, Sabre Insurance Company
Andy Smith	Risk, Governance and Compliance Director TD Wealth International
Ian Templeton *(Member from December 2010)*	Managing Director, UIA (Insurance) Ltd
Andrew Turberville Smith	Chief Operating Officer and Finance Director, Weatherbys Bank Ltd

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