Annual Report
2012/13

Members of the Smaller Business Practitioner Panel in March 2013

Chairman's foreword

From 1 April 2013, the Smaller Business Practitioner Panel has become a statutory Panel to represent the interests of smaller firms to the Financial Conduct Authority (FCA). We will be building on the work of the FSA's Smaller Businesses Practitioner Panel, and this annual report provides a review of the previous Panel's work. I am grateful to Guy Matthews, who chaired the Panel until 31 March 2013.

Looking forward, the focus of the Panel's engagement will be on the way that the FCA develops in its first year of operation. We have supported the FCA's plans for sector-based supervision, but plan to monitor the FCA's assurance that it will take a suitably proportionate approach towards smaller firms in each sector. We will also look at the development of the FCA's policy in areas such as transparency, consumer responsibility, and competition.

We will be keen to see that the FCA ensures that its role in prudential regulation will not be overlooked. It must be remembered that the FCA will be responsible for the prudential regulation of around 23,000 financial services firms in the UK. Although these are the firms who are unlikely to pose a significant risk to overall financial stability, there will nevertheless need to be effective prudential safeguards in place to protect the integrity of the system and consumers. In addition, the place of the FCA in international negotiations on prudential requirements as they affect its regulated community must not be overlooked.

We will wish to look at coordination issues between the FCA and PRA as they impact on smaller, dual-regulated firms. We want to help to guard against smaller firms being caught up in any conflicting requests from the different regulators, and will be looking to avoid an excessive burden on dual-regulated smaller firms.

We will continue to engage in debate on the cost-effectiveness of regulation and how the costs of such regulation are apportioned among the regulated community.

I am grateful to my colleagues on the Panel for their support and look forward to active engagement with the FCA over the coming year.

Andrew Turberville Smith
Chairman, FCA Smaller Business Practitioner Panel

1. Introduction

Panel discussions in 2012-13 were dominated by the progress towards the new regulatory system, and particularly the design and development of the FCA. However, the Panel also pursued its other priorities, including cost effectiveness of regulation, engagement with small firms, and the balance of responsibilities between firms and consumers. We set out an overview of the key points in this annual report.

2. DESIGN AND DEVELOPMENT OF THE FCA

During this year, the Panel has engaged regularly with the FSA (Financial Services Authority) on its transition to be replaced by the PRA (Prudential Regulation Authority) and FCA (Financial Conduct Authority), and particularly with those building the new structures for the FCA. Our ongoing theme has been the need for proportionality and for the FCA to manage the expectations of consumers, firms and politicians by setting out clearly the risk appetite of the new regulator – including some reference to the need for consumer responsibility alongside the albeit greater responsibilities of firms. We have also emphasised the need for a clear explanation of the cultural change in setting up the FCA – both for those who are regulating and for the firms who are being regulated.

2.1 FCA supervision

We have been fully supportive of the FCA's planned approach to supervision according to sector of the industry. This should mean that supervisors have a better understanding of the sector in which the firms are operating. This should lead to a greater appreciation of the implications of the requirements, and more ability to provide effective challenge to regulated firms.

On the other hand, we have urged the FCA to consider how the smaller firm voice will be incorporated into the FCA's operations to ensure that it acts in a proportionate manner in its dealings with smaller firms. Although this Panel has been made a statutory Panel to represent the interests of small firms at

a strategic level, we have nevertheless asked for some kind of 'small firms' champions to be embedded into the organisation in order to consider the impact on small firms at a working level. These people would act to promote the smaller firm perspective, and for instance provide a greater understanding about the comparative level of resources available at small firms when planning supervisory activity.

2.2 FCA prudential supervision

For the 23,000 firms that will be prudentially regulated by the FCA, it will be important that the FCA's role as a prudential regulator is publicly acknowledged, without all the focus being on the conduct aspect of the FCA's role. We have emphasised that the FCA must be actively engaged in the development of European and international prudential requirements, and not delegate it all to the Prudential Regulation Authority (PRA). This is particularly so for the 2,500 MiFID investment firms who will be solely regulated by the FCA under the new CRD IV regime, and for whom it will be critical to achieve proportionality.

2.3 FCA tone of voice

We have supported the Practitioner Panel in expressing the need for care as the FSA set out the parameters for the 'tone of voice' for the FCA, to ensure that it would be viewed as a fair and reasonable regulator. For instance, we warned against being overly negative about the intentions of firms, which could lead to a disproportionate level of regulatory activity. This would not be in the best interests of the regulator's focus or efficiency and so ultimately, we believe not positive for consumers.

2.4 FCA transparency

The publication of the FCA's approach to transparency requirements in a Discussion Paper in March 2013, was a useful step in setting out the FCA's interpretation of its revised statutory requirements in this area. We encouraged the FCA to commit to publishing information which illustrates good practice as well as bad practice from activities such as thematic reviews. This would enable firms to benchmark their approach against others in their field.

We also suggested that the FCA should build on recent moves to engage in active dialogue on problems and worries between the regulator and firms, for example in signalling to 'proceed with caution' in areas such as interest-only and shared-ownership mortgages. However, we fully appreciate the problems that can be caused by going public on such negative messages, and the need for the FCA always to consider a balanced output to help to build and maintain the confidence which is needed for consumers to engage actively with financial services.

2.5 Enforcement decisions

We have continued to urge the FCA to be cautious with its new power to give earlier notification of enforcement action being taken against firms – through the publication of statements on warning notices. This is especially the case as the ultimate version of the final notice can sometimes be significantly reduced from that stated in the first Warning Notice.

We have also encouraged both the FCA and PRA to maintain a similar system to the Regulatory Decisions Committee (RDC) structure for the FSA. Such a

system has provided an important means of independent challenge to the executive on regulatory decisions for the FSA and so it should be continued.

2.6 FCA and PRA coordination

We have emphasised throughout the process of the development of the new regulatory system, the need to recognise the number of smaller firms which will be dual regulated by the PRA and FCA. The attention has understandably been on the high-impact firms. However, there will be around 1,700 dual-regulated firms in total, as smaller deposit takers and insurance companies have also been swept up in the changes. These smaller firms in the PRA must be treated proportionately. We supported the Practitioner Panel's successful campaign to have a Practitioner Panel for the PRA as well as the FCA for this reason.

One of the particular concerns for dual-regulated small firms is the burden in responding to the demands of two separate regulators. We understand that the new regulators will have different objectives and will not always coordinate on their engagement with firms, such as for the timing of visits. This may cause problems for smaller management teams. We have asked for the FCA and PRA to make clear that smaller firms can request a delay if there was too short a space between the timing of conduct and prudential visits and requests for information.

2.7 International positioning for the FCA

We have pointed out that it will be critical for the FCA and PRA to work in a coordinated manner on EU issues as well as in the UK. It requires both regulators to have a keen focus on the wide regulatory agenda going forward in Europe. This is all the more important for smaller firms who do not have the resources to engage in EU policy developments for themselves. One example was in the political and media focus on new restrictions on bankers' bonuses in CRD IV agreed in February 2013. At that time, it was little mentioned and not subject to serious negotiation, that the payments made in investment firms will also be capped through these measures. This will have far wider consequences on a larger number of firms – who are regulated by the FCA rather than the PRA.

3. COST EFFECTIVENESS OF REGULATION

3.1 Costs of split regulation

We encouraged the FSA to be as transparent as possible in presenting the new costs for the industry for the FCA and PRA. At the same time, we have highlighted the Government's original Impact Assessment from July 2010. This stated that there should not be any substantial increase in ongoing costs in splitting the FSA, with total transitional costs for the FSA and Bank to be in the order of £50 million. And yet, the increase of 15% in the combined Annual Funding Requirement (AFR) for the FCA and the PRA combined in its first year budget was blamed partly as a result of the loss of economies of scale with the split of the FSA.

At this time of increased costs for the industry, we had suggested to the Chancellor of the Exchequer that any money accrued from regulatory fines should be used to support the Financial Services Compensation Scheme, rather than be given to Government. This would have enabled the proceeds of fines to go to consumers who have suffered detriment, while at the same time reducing the burden on those well-behaved firms who have to fund the whole of the FSCS. Although this suggestion was not acted on, there was some concession that at least the FCA's enforcement costs will be deducted from the fines transferred to the Government.

3.2 Effectiveness of regulation

The level of the increases of regulatory fees is an important factor for smaller firms, as they must be able to remain as viable businesses whilst conforming to regulatory requirements. We also want to be assured that that the industry's money is spent in an effective manner. We have emphasised the need for regulation by the FCA to be effective in protecting consumers, whilst not unduly restricting the financial services industry's ability to diversify, innovate and grow. We would like to see spending that enhances the FCA's ability to do its job, for instance by investment in the IT systems from a strategic point of view, to enhance the way that the FCA is able to receive information and to communicate with the vast majority of firms who will not have a relationship manager in the FCA.

3.3 Skilled Persons Reports

We have generally been concerned about the increasing use of Skilled Persons Reports and the premium rates that many of the large audit firms charge for undertaking this type of work. We therefore welcomed the plan of the FCA and PRA to develop a Skilled Persons Panel to increase competition and try to drive down costs.

We believe this is an immensely important step in this area. Firstly because the FCA is encouraging smaller consultancies, beyond the Big Four, to become accepted on the Skilled Persons Panel; this should result in a broader choice of provider – and possibly more appropriate companies for smaller firms – to be available for this work. Secondly, we are pleased that the regulators plan to drive down the rates and so costs of this work. We have suggested that the FCA and PRA set some standard rates for Skilled Person Reports which are a requirement for firms to be part of the Panel. These should be applied when both the regulators and firms contract for Skilled Persons Reports from the consultancy panel.

3.4 Use of section 404 for Arch cru

We took a particular interest in the FSA's plans to use its revised section 404 powers in relation to Arch cru mis-selling, as this was to be the regulator's first use of the new power. We supported the final decision as a reasonable compromise. Our position was based on support for consumers gaining redress for mis-selling, but also a belief that use of the full s404 power would have been inappropriate as the mis-selling was not, in our view, widespread. According to the FSA's estimates, potential Arch cru mis-selling involved less than 3% of the firm population (and similarly a relatively low number of consumers).

We also registered concern about the transparency of the process and clarity about the voluntary arrangements agreed with the Authorised Corporate Director (ACD) and Depositary to the funds to contribute £54m. We urged the FSA to be clearer about how they had calculated this figure and that, where possible, this should be disclosed to the industry.

We had also pointed out the risk that many adviser firms would regard the full use of s404, on top of the pressures of the RDR, as making it not worth carrying on in business. If many more firms took the option of winding up to avoid their liabilities, it would leave the remaining firms to pay a greater proportion of funding to the FSCS. We are hopeful that the FSA's compromise position should lessen the wider consequences on the advisory community. If fewer advisory firms are likely to fail as a result of this action, this would mean less liabilities falling on to the FSCS. It should also reduce the likelihood of carve-outs of cover and premium increases in Professional Indemnity Insurance cover for advisory firms.

3.5 Professional Indemnity cover for financial advisers

We have highlighted increasing problems with the provision of Professional Indemnity Insurance (PII) beyond our initial interest which had been stimulated by the potential impact on PII if the FSA used section 404 in regard to Arch cru.

Systemic problems seem to be developing as risks are perceived to be increasing and at the same time, providers and underwriters do not understand the changes taking place in firms' business models as a result of the RDR. This

has led to some insurance providers withdrawing from the market, and those who remain taking actions such as increasing premiums, introducing exclusions for certain activities, or setting high excesses per policy sold that leave firms with little effective protection.

Often the questions on the PII application forms are outdated and so we believe that underwriters will have little chance of assessing the risks faced by an adviser. This, coupled with the changes resulting from the RDR, increasing fines and regulatory actions make it difficult for advisory firms to obtain appropriate cover.

We have highlighted the inherent risk that an inadequate PII market poses to the stability of the advisory market. It seems that the cost of premiums are increasing, whilst at the same time adequate PII cover is increasingly difficult to obtain. Many advisers are being faced with no alternative but to accept PII cover with multiple exclusions leading to the risk of consumer detriment if there is not meaningful cover for a significant proportion of advisory activities. One particular example of exclusions is that many PII policies now exclude cover when the FSCS seek to recover compensation from errant firms, so reducing the FSCS's ability to recover costs and putting even further pressure on industry's contribution to the FSCS.

3.6 RDR and platforms policy

The impact of the RDR on the operation and charges for platforms – the internet-based product information systems that are used to hold, service and compare investments – has been an area in which the Panel has taken an ongoing interest. Indeed, we encouraged the FSA in the previous year to take the time to ensure that it had the policy right, and to ensure that it fully understood the impact of these changes on the business models of platform service providers.

However, we were not expecting the regulator to uncover a major issue in the tax implications of providing cash rebates to consumers. We told the FSA that HMRC's interpretation of the tax impact of current practices in rebating would undermine a significant aspect of the RDR's adviser and platforms charging models, and if applied broadly and retrospectively, could potentially have a significant impact on wide sections of the industry.

Whilst we appreciate that the regulator is not responsible for tax policy, we believe that it should have taken a more active part in discussions with HMRC to help clarify this issue earlier. We were pleased to hear at the end of the financial year that HMRC had agreed not to pursue retrospective tax liabilities for all customers who have received rebates. On the other hand, even the sudden implementation of the new interpretation of the tax situation with immediate effect presents significant challenges for administration and IT systems, as well as potential mis-selling claims.

3.7 RDR and EU legislative proposals

While the FSA implemented RDR from the beginning of 2013, similar legislative proposals addressing the payment of commission to investment advisers have been proposed in Europe in the second iteration of MiFID (the Markets in Financial Instruments Directive). Currently, while RDR does not permit advisers to receive commission, the draft European text would allow commission to be paid provided it is disclosed. The FCA will be required to implement the EU Directive in full, subject to limited exemption which can be applied for ‘in exceptional circumstances’.

Throughout the year, we have continued to monitor the EU legislation and emphasise to the FSA, the danger and consequences of an approach in Europe that is different to that now taken in the RDR. As the Panel has previously

supported the principles for RDR, many would be reluctant to implement a further significant change to apply this aspect of MiFID 2.

3.8 With-profit funds

The Panel has long since been closely following and participating in the debates about the interests of policyholders in those mutual with-profit firms that have declining volumes of with-profits business. We therefore warmly welcomed the FSA's aim in CP12/38 to allow with-profits mutuals that have a viable business plan to continue to provide other financial products after the run-off of their with-profits business.

We have suggested some further rule changes and further regulatory guidance on best practice and regulatory expectations, for example around how best to engage with policyholders on this topic.

3.9 Money Advice Service (MAS)

We have continued to express concern about the value for money of the MAS. We appreciate that the FSA has taken a greater interest in the level of business planning within the MAS this year. Nevertheless we continue to be concerned about the effectiveness of the spending of the industry's money in this area. For example, we noted that there seem to be few quality control checks on the advice being given to consumers and particularly whether the customers who took advice from MAS understood and carried out the agreed actions correctly.

We also noted that the MAS target audience seems to overlap with that for IFAs. In the business plan, the profile of MAS is compared with that of IFAs and one of its customer engagement opportunities is stated as: 'for those who choose not to pay we are a key source of advice'. We are awaiting further information from MAS on this targeting, as we believe it is unreasonable to ask advisers to fund a service which is potentially acting as a competitor to their sector.

We have also asked for further information on the funding structures for MAS, following its decision to demand a greater level of funding from the mortgage

sector, as they have developed more advice tools and so have a greater level of interest in this area. However, we believe that such a strategy can be counter-productive, as many firms may not be so keen to provide links from their websites to the information on MAS if it means that they will help to increase the traffic, and so level of charges for their industry sector.

3.10 Financial Services Compensation Scheme (FSCS)

We have taken a great interest in the work to reform the FSCS Funding Model. In our view, budgeting for FSCS liabilities is one of the most significant challenges for many small firms today, and ensuring that the current system is made more affordable, predictable and fair should be a top priority for the industry and the regulator.

Overall, we were disappointed that the FSCS Funding Review, published by the FSA this year, did not go further in considering more significant changes to the Scheme. In terms of pre-funding, we would have been interested in hearing more about this, but we recognise the FSA's stance that in relation to deposit takers, such a decision would be for HM Treasury rather than the regulator. We will continue to monitor ongoing European level discussions around pre-funding with great interest. Our initial thoughts on this topic are that pre-funding appears to be a sensible way to reform the system as the 'polluter' makes some contribution to the scheme.

In our response to the FSA's formal consultation, we stated our preferred option as being for the Scheme to introduce a product levy for investment products, and a risk-weighted funding system for deposit-takers. We recognised the FSA's concerns regarding product levies, but believe that these can be addressed.

As part of our interest in effective use of regulatory fees and levies, we also took particular interest in the FSCS Business Plan for 2013-14. We were disappointed that the failure of the previous FSCS awareness campaign was being followed up by a further central campaign, albeit with a change of communication format and focus. We believe that the regulatory requirements for messages from firms to their customers is well targeted. We do not think that spending on any general awareness campaign is particularly effective.

4. ENGAGEMENT WITH SMALLER FIRMS

4.1 Smaller firm communications

For smaller firms who do not have a dedicated contact person in the regulator, we continue to emphasise the importance of coordination and effectiveness of general communications. Helping smaller firms to do the right thing is critical to regulatory success. As part of that, we encouraged the FSA to give clear and consistent messages to firms and to continue to invest in free roadshows and seminars for firms around the country. We have suggested that the FCA should consider providing a certain number of seminars for free to each regulated firm – with the possibility of charging a penalty if a pre-booked place is not used.

In our discussions on the development of the PRA and FCA we have maintained our view that active communication with firms must be part of the business model. For the FCA in particular, it must invest both executive time in getting out around the country, and resources in improving the IT so that modern communication tools such as webcasts and regular but targeted contact with firms can take place easily. For instance, the FCA could film the roadshows and make them available on their website.

We were pleased to have early sight of the websites for both the FCA and PRA, and provided input and engaged in detail with the information and layout of these websites and the information provided to firms. The website must be recognised as a vital means of providing accessible information to regulated firms.

We have also taken particular interest in the firm contact centre, where we have been impressed with the quality of staff answering the calls, and the range of subjects on which they provide information. As there will be even more firms within the FCA which will only have the contact centre, rather than being relationship managed, we have pointed out that it will be all the more important that the contact centre maintains and builds on its competencies in future.

4.2 Regulatory disclosure under FCA and PRA

We pointed out that the changes to regulatory disclosure requirements following the change of regulator name would require a longer phase-in period

than that first proposed by the FSA. We were pleased that the period was extended from six months to one year, but the slowness in giving the detail of the exact requirements meant that firms were not able to get materials prepared in advance of the changeover on 1 April 2013. An even longer time period would have been ideal, particularly for smaller firms, for whom reprinting and other notification changes can have significant cost implications.

We also raised the concern about consumers misunderstanding the role of the different regulators and how this will be identified on publications. We suggested that there was a need to ensure that the messages around what each regulator is responsible for does not result in consumers believing that firms with two regulators are of better quality than those firms with only one regulator.

4.3 CRD and smaller investment firms

We registered concern about the timetable for investment firms to implement the requirements of CRD IV, when it still remained unclear how it will be applied to such firms. We pointed out that in the UK (unlike many of European member states), the term 'investment firm' includes a large number of asset managers and investment service providers, which operate very different business models to credit institutions. We supported the FSA and encouraged it to continue to press for consideration and clarification of the scope of application of the rules to investments firms and a reasonable phase-in period after implementation.

4.4 Solvency II

We have continued to voice the concerns of smaller insurance firms with regard to Solvency II. In particular, we have highlighted the problems from the continuing uncertainty which stem primarily from on-going European negotiations. We plan to continue liaising with the Prudential Regulation Authority (PRA) on Solvency II after responsibility has been transferred from the Financial Services Authority to the PRA on 1 April 2013.

5. BALANCE OF RESPONSIBILITIES BETWEEN FIRMS AND CONSUMERS

5.1 Consumer responsibility

The Panel organised a round-table on the topic of consumer responsibility in February 2013, inviting representatives from the Practitioner and Consumer Panel. The FSA had expressed an interest in hearing the Panel's views on how the future regulator should interpret its 'have regard' to the principle of consumer responsibility.

The primary purpose of the round-table was as a first step in identifying key principles or areas on which the three Panels could agree (especially seeking agreement between the industry and consumer representatives present), and to use this to feed back to the FCA. The debate was constructive, focusing on retail market consumers, and helped to move the debate forward by identifying key issues on which the Panels could recommend further thought by the regulator, and in making progress in creating a high-level framework and common language to help discuss the issues involved.

5.2 Interest-only mortgages

We have had regular engagement with the policy team working on interest-only mortgages, and urged them to take a constructive approach when suggesting that consumers review their re-payment options for their interest only mortgages. Although we appreciated the desire of the regulator to make clear that consumers have responsibilities in planning for the repayment of capital for their mortgage, we also suggested that the industry should be pre-alerted on the timing for this, to enable the industry to have sufficient time to prepare for a sudden influx of queries on this topic.

We believe that the work undertaken in this area has set up a good example of what we hope to be future working practices for the FCA: that lenders are encouraged to take action and work with the FCA and customers to avoid problems developing for consumers in the interest only mortgage market.

5.3 Risks for firms and consumers

We have often provided alerts to the FSA on issues that are developing both within industry sectors and for consumer engagement. For instance, we highlighted the problems with home insurance in flood risk areas and potential impact on the stability of mortgage lenders as well as insurers. We suggested that the FSA should consider contributing to the debate on the action to be taken after the ending of the flood insurance agreement, and that both the FCA and PRA should factor this in to their risk assessments. We pointed out that this is not only critical for the stability of the insurance industry, but also for the mortgage market. The concern is that homes which become uninsurable will contravene the terms of their mortgage agreement and drop in value. If homes fall into negative equity, some people may decide to abandon their home and mortgage, resulting in significant losses for the lenders.

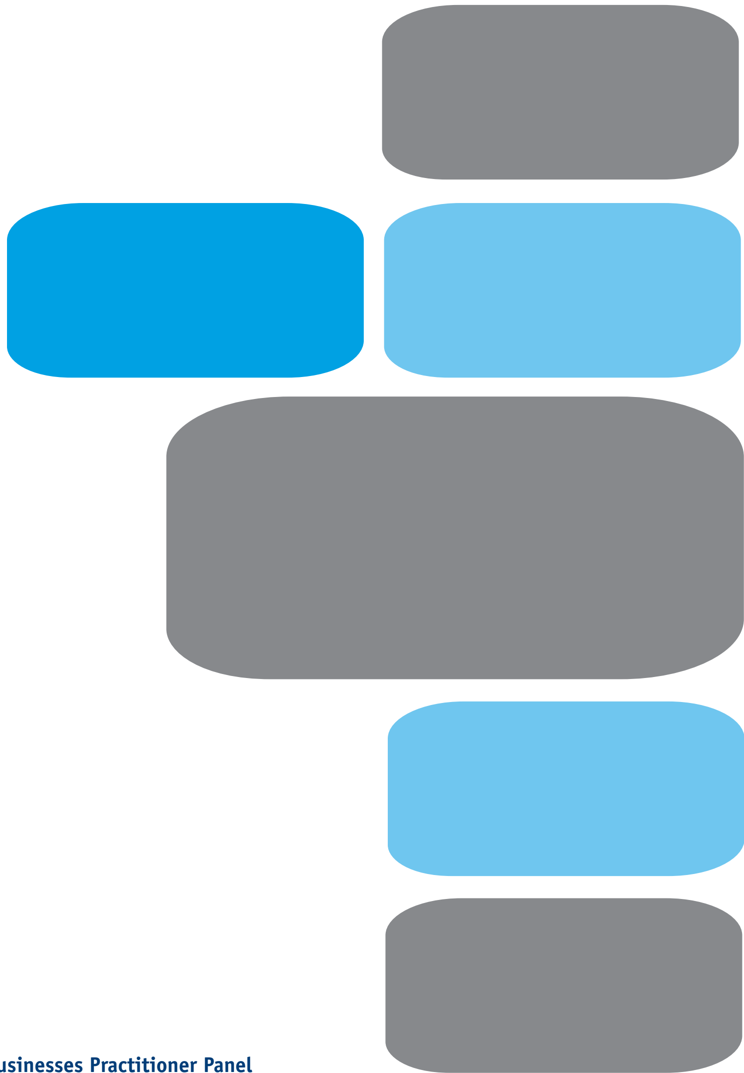
We also highlighted the potential impact on the industry of new legislative proposals for EU Data Protection reform. One example is Article 6 on when it is acceptable to process data. We suggested the FCA will need to help to clarify and then publicise with firms when financial institutions will be subject to regulatory rules that require them to retain records, including data, or whether processing data for fraud detection is permissible under the proposal 'in the public interest'.

5.4 In-house financial incentives

When the FSA looked to publish guidance proposals on in-house financial incentives, we very much welcomed the inclusion of good practice examples. On the other hand, we were concerned that the FSA should be careful not to give the impression that it was against financial rewards being given for good sales practices. We suggested that it should be made absolutely clear in the FSA's guidance proposals, and in the media messages which surround its publication, that the FSA does not want to outlaw all financial rewards for good sales practices.

MEMBERS OF SMALLER BUSINESSES PRACTITIONER PANEL OF FINANCIAL SERVICES AUTHORITY
1 April 2012 – 31 March 2013

Panel Member	Position
Guy Matthews *(Chairman until 31.3.13)*	Chief Executive, Sarasin Investment Funds
Clinton Askew	Director, Citywide Financial Partners
James Bawa	CEO, Teachers Building Society
Dick Carne *(Member from July 2011)*	Director, Asset Management IFA Ltd
Ian Dickinson	Head of General Insurance Compliance and Training, The Brunsdon Group
Peter Evans	Chief Executive, Police Credit Union
Neil Fung-On *(Member from 1.3.13)*	Partner, BDO LLP
Jim Kandunias *(Member from 1.12.12)*	CEO, Esemplia Emerging Markets
Sally Laker	Managing Director, Mortgage Intelligence
Fiona McBain	Chief Executive, Scottish Friendly
Andy Smith	Risk, Governance & Compliance Director TD Wealth International
Ian Templeton	Managing Director & CEO, UIA Insurance Ltd
Andrew Turberville Smith	Chief Operating Officer and Finance Director, Weatherbys Bank Ltd



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