RESPONSE FROM THE SMALLER BUSINESSES PRACTITIONER PANEL OF THE FINANCIAL SERVICES AUTHORITY

TO

HM TREASURY CONSULTATION
A NEW APPROACH TO FINANCIAL REGULATION: JUDGEMENT, FOCUS, STABILITY

OCTOBER 2010

INTRODUCTION AND OVERVIEW

1. The Smaller Businesses Practitioner Panel (SBPP) welcomes the opportunity to respond to the HM Treasury Consultation Paper 'A New Approach To Financial Regulation'. We are particularly pleased that the importance of our Panel's work is recognised in the Treasury Consultation, with its proposal to set our Panel on the same statutory footing as the other two independent Panels in paragraph 4.38.

2. The SBPP was set up by the Financial Services Authority in recognition of the need to have a specific Panel to represent the interests of smaller firms to work alongside the statutory Practitioner Panel and Consumer Panel. More details of our role and membership are at Appendix 1.

3. The proposed changes have an impact on smaller regulated firms, with the regulation of most firms transferred to the CPMA, but a good proportion also regulated by the PRA. This consultation is therefore of direct relevance to all firms which are represented by the SBPP.

4. We are alarmed to see that there is little reference in this Consultation Paper to the likely consequences of these proposals on the smaller firms sector. This is despite the fact that smaller firms represent around 90% of all regulated firms – some 15,000 businesses, providing financial advice and other services in towns and cities throughout the UK.

5. These proposals could have a seriously adverse impact on the viability of smaller firms. We are already preparing for significant regulatory changes resulting from the Retail Distribution Review and Mortgage Market Review, as well as initiatives from Europe such as Solvency II. At the same time, the Government's wider plans to reduce the deficit are expected to lead to a

contraction of business, as likely increases in unemployment and cuts in public spending reduce consumer spending to immediate and essential purchases. Such difficult times are likely to result in increasing financial fraud, higher numbers of individuals looking to blame others for their problems, and people getting into difficulty with their mortgages etc. The result will be increased regulatory activity (and costs) with added financial strain being placed on the FOS and FSCS.

6. The added regulatory burden of creating the PRA and CPMA at a time when trading conditions will be difficult is unwelcome. Smaller firms might reasonably expect help and support from the Government to lessen the burden of bureaucracy during difficult economic times, rather than it being increased. We believe the Department for Business Innovation and Skills (BIS) should be asked to comment on the impact of this increase in regulatory requirements on smaller firms.

7. A common concern for smaller firms is the cost of regulation. The transition costs of these proposals are estimated at £50million over 3 years. Firms will be expected to pay additional fees to cover this cost, with no clear overall benefit of possibly avoiding a future financial crisis.

8. Overall, we believe that these proposals are expensive to implement, not practical to put into action at this time, and risk causing damage to the smaller firm segment of the financial services market. Smaller firms are important, as they offer an added range of service to consumers, and increase the competitiveness of the UK financial services industry. We have yet to be provided with analysis or justifiable arguments that these measures will prevent the next financial crisis.

THE BANK OF ENGLAND AND FINANCIAL POLICY COMMITTEE (FPC)

Q1 Should the FPC have a single, clear, unconstrained objective relating to financial stability and its macro-prudential role, or should its objective be supplemented with secondary factors?

9. The Panel acknowledges that the FPC's principal concern should be financial stability. However, we agree with 2.29, that there is merit in providing a clear and transparent exposition of the factors it would be legally obliged to consider.

10. The FPC will be in a powerful position, in the fact that its views can direct the actions of the regulators for all financial firms, with little accountability in the current structure. It is crucial to have the power of challenge from an industry perspective within the FPC's decision making. We would urge that the external members of the FPC have detailed knowledge and understanding of the wider financial services industry – and this must include sectors regulated by the CPMA as well as the PRA. An illustration of the importance of this effective challenge is the decision to let Lehman Brothers fold in 2008, during the last financial crisis. The decision was made in isolation based on the assumption that Lehmans would not have a material

effect upon the retail banking sector as it was primarily a wholesale bank.. If there had been effective internal challenge of that decision the level of contagion in the banking system, and the exposure of retail banks' to Lehmans may have been highlighted. The decision may still have been made, but with a fuller knowledge of the implications and the extent of the impact than seems to have been the case.

11. It is crucial that the FPC looks at financial stability in the context of other factors that may be affected by its decisions. From a smaller firms' perspective, there is a perceived danger that an unrestrained objective relating simply to financial stability potentially focuses just on the very largest financial services firms. Although these will of course have the most significant impacts affecting stability, the knock on effects are felt by all smaller businesses and therefore must be taken into consideration.

Q2 If you support the idea of secondary factors, what types of factors should be applied to the FPC?

12. There must be clear secondary factors to ensure that the FPC takes into consideration the impact of its decisions on the whole spectrum of the regulated community (including both the PRA and CPMA), and the consumers of financial services. We are concerned that, under the current proposals, the FPC may decide that the way that firms were operating was causing potential financial instability. This could cause the FPC to direct a regulatory change in the PRA and/or CPMA that would have a huge impact on the way that firms do business, but with no requirement to consider the wider impact of their decisions. Although we recognise that the FPC will not have the activities of small firms as its main focus, nevertheless, it must not make decisions which will unnecessarily penalise them.

13. We suggest secondary objectives for the FPC that highlight the need for proportionality and risk based regulatory scope and pay regard to the need for competition in the industry. The FPC should also take into account the diversity of size of financial services businesses, which is an important component of the current levels of competition and consumer choice in financial services.

Q3 How should these factors be formulated in legislation – for example, as a list of 'have regards' as is currently the case in the Financial Services and Markets Act 2000 (FSMA), or as a set of secondary statutory objectives which the FPC must balance?

14. It is our view that, due to the potential significance of the factors to smaller financial services businesses, they should be statutory objectives rather than 'have regards'. This will help to remove any ambiguity in respect of any provisions in respect of the wider financial community.

15. We suggest that the FPC has similar secondary objectives to the PRA and CPMA to ensure coordination. It could be an adaptation of the current "have regards to" of the FSA – particularly looking at the following principles: that the burden or restriction should be proportionate to the benefits; the need to

minimise the adverse effects on competition, and the desirability of facilitating competition between those who are subject to regulation.[1]

16. With the split of regulatory authorities, there will need to be a new secondary objective for the FPC as well as the PRA and CPMA, that directs each body to have to take into account the potential impact on the other bodies' core objectives.

PRUDENTIAL REGULATION AUTHORITY (PRA)

Q4 The Government welcomes respondents' views on:

- **whether the PRA should have regard to the primary objectives of the CPMA and FPC;**

17. We believe that the PRA must have regard to the primary objectives of the CPMA and FPC: smaller firms who will be regulated by both the PRA and the CPMA will have additional costs and work pressures in providing separate and yet coordinated returns, information gathering, ARROW/supervisory visits. There is not, and should not be a strict dividing line within a firm's culture between its duties relating to prudential risks and conduct risks, and yet firms will have to split out these concerns for the different regulators.

18. For example, smaller firms such as Credit Unions (as a category of firms likely to be scoped by the PRA and CPMA) will have maximum interest rate levels that are driven by the prudential rules, but may also have similar tensions between conduct and prudential requirements in terms of the ability to sustain increased costs and deal with competing regulatory requirements and burdens.

19. An example of potential conflict of the requirements is in the regulation of consumer lending. It may be the case that the CPMA, in wishing to help consumers, would want lenders to be more flexible in their treatment of consumers; for example in allowing people to swap to interest-only mortgages from capital and interest mortgages when facing temporary problems with keeping up payments. However, from the prudential side, the capital provisioning required for loans that are swapped to interest-only due to difficulties, is greater than that if people applied for a new interest-only mortgage. Therefore, a smaller firm with tight capital requirement limits, may not be able to be as adaptable to consumer needs as the CPMA may want them to be, due to limitations from the PRA.

20. There is a significant potential for conflicting requirements from regulators, particularly in priorities and also in timescales for action. This must be

[1] Financial Services and Markets Act 2000 Section 2 – The Authority's general objectives.

minimised by ensuring that each of the regulators has a statutory duty to take into account the requirements of the others.

- **whether some or all of the principles for good regulation currently set out in section 2 of FSMA, particularly those relating to good regulatory practice, should be retained for the PRA;**

21. The principles for good regulation currently contained within Section 2 of FSMA must be maintained as a minimum.

22. We believe the principles should in some cases be strengthened. From a smaller firm perspective, there has to be a sense of proportionality into how firms are regulated, and so the Government must ensure that there is a balance in the regulatory approach. Although Cost Benefit Analysis may be more difficult to carry out in the prudential arena, there must be a strong pressure on the PRA to take into account proportionality and overall consequences for the different sectors and smaller firms, as set out in our answers to the further points.

- **whether, specifically, the requirement to have regard to potential adverse impacts on innovation or the competitiveness of the UK financial services sector of regulatory action should be retained; and**

23. The requirement to have regard to the potential adverse impact of regulation on innovation or the competitiveness of the UK financial services sector must be retained. Smaller firms have a key role to play in fostering competition and consumer choice by providing niche services and business opportunities.

24. As the PRA will be part of the Bank of England, it must have a strict requirement to maintain the range of availability in the market across all sectors of financial services. An example of the need for flexibility and awareness of competitiveness is in the context of the private client asset management sector. This sector handles substantial amounts of client assets without the same level of prudential supervision as banks. A pure macro – prudential approach will result in most of these firms never being properly considered. However, the amount of assets that this sector holds is large (£335 billion according to APCIMS). The PRA must have a responsibility and ability to act flexibly in different sectors of the industry: if there was a problem in this sector, then taken together they add up to a material impact – especially as issues in the sector tend to be systemic due to common dealing, clearing and settlement systems dependencies.

- **whether there are any additional broader public interest considerations to which the PRA should have regard.**

25. Much of the justification on moving the PRA to the Bank of England in the consultation rests on the greater expertise at the Bank: 2.14 states that for central banks the ‘depth of their staff’s experience in the functioning of financial firms and markets’ gives them a competitive edge. However, this

has until now been concentrated on banking, and yet the new responsibilities of the PRA will cover a much wider spectrum of financial services companies.

26. Therefore, the PRA must have a broader public interest duty with regard to the range and diversity of the financial services industry as suggested for the CPMA (4.12). If this is not specifically stated, we believe that the tendency of the FSA to a 'one size fits all' approach, with a concentration on problems in the largest banks, is likely to be maintained and possibly increased in the PRA. This could lead to significant problems for non-bank firms, particularly smaller firms. There must be specific expertise in the PRA to be able to assess the prudential risks in the full range of smaller firm business models in all sectors under the PRA.

Q5 Is the model proposed in paragraph 3.16 – with each authority responsible for all decisions within their remit subject to financial stability considerations – appropriate, or would an integrated model (for example, giving one authority responsibility for authorisation and removal of permissions) be preferable?

27. We advocate one integrated system for as many aspects of the regulatory system as possible. As firms have an integrated approach to their prudential and conduct risks, it would be simpler to have a joint assessment, and should lead to more cost effective regulation to the benefit of firms and consumers alike. This is particularly the case for smaller firms.

28. We welcome the commitment (3.27) to review IT applications required by the new regulatory system "in its entirety". We urge coordination of IT systems between the PRA and CPMA to ensure technical requirements from the two authorities are synchronised and not changed unnecessarily. IT systems are typically expensive and create additional workloads for regulated firms: both in amending their own systems to enable reporting, and also in management time to resolve difficulties. The FSA's implementation of the new GABRIEL system only a few years ago was fraught with problems, and we would warn against any changes unless they are absolutely necessary. Major changes are likely to increase costs and aggravation at a difficult time for all UK financial services firms.

29. Where an integrated model is not possible, there must be close cooperation at working level, to avoid conflicting regulatory requirements and a non-level playing field developing.

Q6 Is the approach outlined in paragraph 3.17 to 3.23 for transfer of regulatory functions and rule making sufficient to enable the PRA to take a more risk-based, judgement-focussed approach to supervision?

30. We fully support the idea of regulators applying their judgement in assessing firms, but only on the basis of clear and agreed principles. We are concerned that 1.17 states the aim to 'rebalance the operations of the prudential regulator away from rules and more towards the exercise of judgements....supporting the creation of a new regulatory culture within the

PRA', without any reference to the principles on which such judgements will be based.

31. Any judgement-based approach from the PRA (and possibly CPMA) without any agreed guidelines cannot be allowed to prevail when there are European legal structures which apply to the UK – much of it set through maximum harmonisation directives. In today's global economy, the UK cannot have a subjective and uncertain regulatory regime that could unfairly disadvantage UK firms. We suggest that any judgement based regulation particularly in the prudential arena should be set within a clear context of reference to European and international requirements.

32. In addition to the European requirements, we support the proposal to use FSMA as a basis for the future powers of the PRA. We would advocate as much similarity as possible between FSMA requirements and those of the new bodies: even minor changes to the style of regulatory requirements impose a burden, particularly on smaller firms, in ensuring adaptations are made to comply with the changes.

33. There must also be maintenance of a similar system to the current one in providing a route for firms to challenge regulatory decisions. The current Regulatory Decisions Committee, and the associated procedures are an important safeguard for firms in allowing an appeal mechanism, and a similar system must be provided in the PRA.

Q7 Are safeguards on the PRA's rule-making function required?

34. All the regulatory bodies must have a degree of external accountability. It is not enough for the PRA to be directed by the Bank and the FPC. There must be an opportunity for practitioners and consumer representatives to consider the wider implications of PRA rulemaking.

35. We consider the current safeguards on rule making functions in the FSA – such as consultation and the duty to carry out Cost Benefit Analysis (CBA) – should be continued in some form for the PRA. We therefore support the application of the principles set out in 3.10 as a minimum requirement of the PRA.

36. From the smaller firms' point of view, we are particularly concerned about ensuring proportionality in introducing new measures and interpreting changes to requirements from Europe. We have expressed concern in the past about the FSA's inadequate use of CBA. We would like to see more emphasis on the assessment of the costs of implementing regulatory changes to ensure that a more risk-based, judgement-focussed approach to supervision is achieved which takes full account of the impact of changes on firms, and that the benefits and risks are clearly articulated.

37. We believe that the current system of independent Panels to provide the FSA with a sounding board on the implications of regulatory changes prior to consultation is important and helps to make regulation more effective. We

therefore suggest that a similar system is maintained for both the PRA and CPMA. We provide more information on this in our answer to Q12.

Q8 If safeguards are required, how should the current FSMA safeguards be streamlined?

38. We do not believe that there should be a streamlining of safeguards for prudential regulation if that means a lessening of external accountability of the demands placed on firms by the regulator.

39. Indeed, we have become sceptical in recent times over the mechanisms employed by the FSA regarding the quality and independence of CBA work and eventual findings. We regard the consultation and quality control processes in developing new regulatory requirements as an essential element of effective regulation which must be enforced within the new regime.

40. We also recommend that PRA safeguards should take EU requirements into account. It would help to lessen regulatory changes, if the principles by which the EU will be developing regulatory policy, are also core aims of the PRA. The EU objectives of delivering stable, secure and efficient financial markets and ensuring coherence and consistency between the different policy areas, such as banking, insurance, securities and investment funds, financial markets infrastructure, retail financial services and payment systems, should be adopted by the PRA.

Q9 The Government welcomes views on the measures proposed in paragraphs 3.28 to 3.41, which are designed to ensure that the operation of the PRA is transparent, operationally independent and accountable.

41. We are concerned that The Bank of England does not have the same external accountability mechanisms as the FSA, and yet it will be an extremely powerful force in the proposed new structure. We are particularly concerned because small firms are likely at best to be minor consideration in its discussions on prudential issues.

42. We believe that, as an organisation that will have an impact ultimately on the viability of thousands of small firms and on the livelihoods of all of its owners and employees, there must be an input to the PRA’s decision making on behalf of practitioners and consumers – which should also contain a smaller firm dimension.

43. At the level of operations, with fewer smaller firms regulated by the PRA compared to the CPMA, we are concerned that the smaller firm voice may become lost within the PRA. We wish to see a specific facility created, similar to the FSA's Smaller Firms Division within the PRA, to protect and promote the interests of smaller firms.

CONSUMER PROTECTION AND MARKETS AUTHORITY (CPMA)

Q10 The Government welcomes respondents' views on:

- **whether the CPMA should have regard to the stability of firms and the financial system as a whole, by reference to the primary objectives of the PRA and FPC;**

44. It is essential that the objectives of the regulatory organisations are coordinated to avoid the potential of conflicting regulatory pressures being put on to firms. A significant number of firms will be regulated by both the PRA and CPMA, and so each must have regard to the objectives of the other, otherwise the firms may be left with the job of balancing competing regulatory requirements.

45. It is essential that the objectives of the regulatory bodies are coordinated. There is an additional risk that the increased number of regulators and related staffs will result in issues "falling down the cracks" between regulators – exactly what they are supposed to be trying to avoid.

46. Our understanding is that, for many smaller firms, their prudential requirements will be monitored by the CPMA, as they do not individually present a significant regulatory risk. This means that the premise that the CPMA can focus on conduct issues is misplaced. It will have prudential responsibility for firms (and, indeed, activities) under its regulatory gaze that are not otherwise prudentially regulated by the PRA. For the clients of those firms, and as an aggregated group, the supervision of prudential soundness will be important, and must be recognised within the responsibilities of the CPMA.

47. In addition, there may be significant problems where firms are regulated by both the PRA and the CPMA, and where some of their activities require prudential supervision by both authorities. Currently a firm regulated by the FSA has one prudential capital regulator, but if the CPMA's rules entail a capital requirement for an activity that is regulated by them for a firm whose other capital requirements are set by the PRA this could mean the firm will require additional capital. This may prove difficult for, for example, an insurance firm that carries risk but also sells directly to the public and is regulated under the Solvency II requirements, which is a maximum harmonisation directive. Although it is unclear at the moment, we are concerned that the CPMA might impose additional capital requirements on the insurance firm, to be calculated separately to match the requirements applied to an insurance broker undertaking similar selling activities.

- **whether some or all of the principles for good regulation currently set out in section 2 of FSMA should be retained for the CPMA, and if so, which;**

48. We support the retention of all of the principles for good regulation currently contained within Section 2 of FSMA. We would advocate that they are strengthened in some cases, particularly in the application of Cost Benefit

Analysis (CBA). We believe that FSMA is severely compromised in its application of CBA, because it requires only costs to be quantified whereas benefits only have to be qualified. A far more robust position is necessary. This should comprise a Market Failure Analysis prior to any new rules being proposed followed by a CBA that quantifies both costs and benefits.

49. From a smaller firm perspective, our overall concern is for there to be proportionate regulation. We urge the Government to ensure that there is a balance in the regulatory approach.

50. These proposals to change the structure of regulation will bring an added burden on all firms – even those who retain only one regulator – as they may have to change systems and priorities to respond to a new regulator's requirements. We urge as much similarity as possible between the old and new systems and priorities. Since the establishment of the FSA, all financial services firms have incurred considerable expense in developing appropriate reporting systems. We would not wish to incur further expenses without good reason.

- **whether, specifically, the requirement to have regard to potential adverse impacts on innovation or the competitiveness of the UK financial services sector of regulatory action should be retained; and**

51. The requirement to have regard to the potential adverse impact of regulation on innovation or the competitiveness of the UK financial services sector must be retained. This is not only the case for firms to be able to operate effectively overall. There is a specific aspect for smaller firms. Smaller firms have a key role to play in fostering competition and consumer choice by providing niche services and business opportunities. Unless regulators are conscious of the need to maintain the range of availability in the market across all sectors of financial services, the impact of action on smaller firms is in danger of not appearing on the regulatory radar.

- **whether there are any additional broader public interest considerations to which the CPMA should have regard.**

52. We do not support the proposed "consumer champion" role for the CPMA. We believe it is inappropriate for a regulatory body to have such a label, especially in relation to smaller firms. The implications here are grave and could be detrimental to competition and innovation. A better approach would be to ensure a reasonable and fair balance between the interests of consumers and the impact of those interests on firms seeking to provide quality services to consumers.

53. We believe that smaller firms also need "champions" to ensure that they can trade successfully in support of high levels of consumer protection. We would like the regulator to have a responsibility to seek a reasonable and fair balance between the interests of consumers and the impact of those interests on firms seeking to provide quality services to consumers.

Q11 Are the accountability mechanisms proposed for the CPMA appropriate and sufficient for its role as an independent conduct regulator?

54. External accountability is a key part of the credibility of the regulator. We therefore fully support the transfer of FSA accountability mechanisms to the CPMA. Indeed, we would wish to see the full range of accountability mechanisms at the PRA as well.

55. It will be vitally important that the voices of practitioners – including those representing smaller businesses – are allowed to be heard in the CPMA's decision making processes, particularly if it is given a role as 'consumer champion'. We have responded in more detail to this under Q12.

56. We also would like to be reassured that appeal mechanisms for firms to challenge regulatory decisions will be maintained. We believe that the current system, including the Regulatory Decisions Committee, will need to be maintained for the CPMA.

Q12 The Government welcomes views on the role and membership of the three proposed statutory panels for the CPMA.

57. The Panel clearly has a direct interest in this question. We are pleased with the Consultation Paper's recognition of the role the SBPP has played since its creation. All members of the SBPP work to ensure that the very different needs and requirements for the regulation of smaller firms are given a voice within the regulatory structure. We believe that this is a necessary role, and one that will continue in the future structure. It will be good to give that role its full recognition as a statutory panel in the future.

58. We believe that the current FSA framework of three independent panels should be maintained – all with a statutory basis. We believe that they should have a role to monitor and advise on the policies of both the CPMA and PRA. It may be that the Panels will need to break down some of their work into delegated sub groups to allow there to be a necessary amount of specialism in some discussions. However, there is an overall need for members of the Practitioner Panels to take an overview from the position of regulated firms, and for the Consumer Panel to be aware of all the dynamics and levers at play for the regulated community.

59. It will be important that the PRA and CPMA both have a specific duties to consult the Independent Panels on regulatory policies. The Panels must be set up as a key accountability mechanism for the regulators, to ensure the Panels can operate effectively. The Panels should also have the power to challenge both regulators on issues which impact on their constituencies. For example, the practitioner panels should both have the ability to raise issues about fee levies with both regulators. Therefore, if practitioners become concerned that there is unnecessary duplication of activity and costs across the regulators, this should be open to external challenge and justification by the PRA and CPMA.

60. As it is not possible for all sectors to be represented individually on the SBPP, members should, as now, be selected to represent broad segments of the industry. Those members must have the ability and broad knowledge to see the bigger picture and to seek to take into account the broadest interests of their sector. A significant time commitment is required from Panel members, which is difficult for those in smaller firms to commit. It is therefore vital that members are supported through a well-resourced secretariat and research facilities for all the Panels – with access to both the PRA and CPMA. Staff at both regulators should be under a strict understanding of the need to respond to Panel requests for information. The Boards of the regulators and all the senior decision makers must have a responsibility to consider and provide a response to opinions of the Panels.

Q13 The Government welcomes views on the proposed funding arrangements, in particular, the proposal that the CPMA will be the fee- and levy-collecting body for all regulatory authorities and associated bodies.

61. We strongly support any measures which will achieve economies of scale and simplicity of access for regulated firms.

62. We support any proposals for clear and simple funding arrangements, with the CPMA as the central point for fee collection, but no cross subsidy. This should maintain transparency of approach and avoid duplication of costs, whilst also being simpler for firms to administer.

Q14 The Government welcomes views on the proposed alternative options for operating models for the FSCS.

63. We are extremely concerned about the future funding requirements for the FSCS and the pressure that this is putting on to smaller firms across the industry. The current FSCS position is currently unsustainable, as the extension of the scheme and the use of cross subsidy never anticipated the current level of claims due to failures within the deposit-taking sector. The result is that many owners and principals in smaller firms now have to pay compensation from their own income, or pass the levies on to their clients. Of necessity the latter is the more likely due to the regulatory requirement to maintain a viable business. There is almost unlimited potential impact of FSCS on smaller firms. This makes it difficult for firms to develop their business plans and decide on appropriate fee structures, and also obtain PI cover when firms have to carry unlimited risks. And yet, without PI cover the firm is unable to operate.

64. The Panel fully supports the proposal to separate out the compensation schemes and the end of the current cross subsidy between different classes of levy payers. We encourage further development of the idea to separate out responsibilities for different sector compensation schemes. At the same time, we would also like to see the streamlining of the system in any way possible and so we also support the proposal for a single organisation (such as the FSCS) to continue to administer all compensation schemes. We believe that any new scheme should not place additional financial strains on otherwise well run and financially viable smaller firms. There must be a

ceiling, known in advance. This restructuring of regulation is an ideal opportunity to 'cap' the potential compensation liabilities of small firms.

MARKETS AND INFRASTRUCTURE

Q15 The Government welcomes views on the proposed division of responsibilities for markets and infrastructure regulation.

65. We do not have expertise on markets and infrastructure on the SBPP. However, we have an overall view that it is essential as part of the restructure that a strong markets division is created with a primary objective to promote market efficiency and integrity. The wholesale market participants and activities are different from the retail consumers and it is important that the regulation of these areas recognises this fact. On the other hand, it is also important to recognise that the difficulties in wholesale markets and defaults arising from transactions in these areas can contribute to the wider economic difficulties faced by smaller financial services firms and their consumers. Therefore, it is important that the regulation of markets is fully integrated into the overall structure.

66. It is also important to note that markets and their operations are crucial to both global and European financial activities as well as the UK economy. We are concerned that if the UK's markets regulatory framework is segmented, its overall market protection and international regulatory effectiveness would be reduced. We believe it will be much more difficult for the UK to have a strong position in European and international negotiations if the UK's nominee does not hold responsibility for all aspects of the regulation being discussed, and so has to defer to others on key aspects

67. We recognise the systemic importance of the regulation of infrastructure provision. However, we would re-iterate our concerns about wide segmentation of responsibility.

Q16 The Government welcomes views on the possible rationalisation of the FSMA regimes for regulating exchanges, trading platforms and clearing houses.

68. Harmonisation of the FSMA regime in this area may well require increased overall regulatory cost, as the Part 4 regime is direct authorisation. There is no detail available to outline the likely regulatory benefit or to provide an indication of the impact for the smaller firms (if any) and so it is difficult for us to comment on this point. However, as noted in the point above, changes in these areas can contribute to increased costs in the wider market, which can ultimately affect smaller financial services firms and their consumers. There may also be wider costs associated with this in the form of secondary legislation reviews.

Q17 The Government would welcome views on whether the UKLA should be merged with the FRC, as a first step towards creating a companies regulator under BIS.

69. We believe that strong, effective and coordinated regulation of markets must be a key part of the restructure. The regulation of the primary market needs to be linked in to the other parts of the financial market to ensure overall stability. We are therefore of the view that success of the overall primary objective would be best achieved if the functions of the UKLA were integrated into the overall markets regulation structure, and not merged with the FRC.

Q18 The Government would also welcome views on whether there are other aspects of financial market regulation which could be made more effective by being moved into the proposed new companies regulator.

70. We believe it is important to have coherent and coordinated regulation of financial markets. Therefore, our view is that all the current aspects of financial market regulation should remain in this financial regulation structure, and not be moved to the proposed new companies regulator.

CRISIS MANAGEMENT

Q19 Do you have any overall comments on the arrangements for crisis management?
Q20 What further powers of heightened supervision should be made available to the PRA and the CPMA, and in particular would there be advantages to mandatory intervention, as described in paragraph 6.17?
Q21 What are your views about changes that may be required to enhance accountability within the SRR, as described in paragraphs 6.21 to 6.24?

71. Any crisis is likely to be considered a larger firm issue due to the systemic nature of crisis management as witnessed in 2008/9. However, there may well be significant fall out from any crisis management affecting smaller firms: if a major product provider collapsed, it may affect thousands of smaller firms who sold the products. It is therefore important that there is a clear system to take into consideration the impact on the wider financial community of any crisis and the actions taken to mitigate it.

72. We are concerned that, despite the responsibilities set out in Table 6.A, it is still unclear to us, who will take the responsibility for whether a major bank or insurance company is allowed to go under, or is provided with external support. The decision making processes and communication are likely to be more complex rather than simpler with the regulator being split.

73. We would also like to highlight the problem with regulators re-writing history with the benefit of hindsight in the aftermath of a crisis. For example, Lehman Brothers were considered one of the strongest covenants for issuing guarantees, and yet after their collapse, advisers who made the best possible recommendations at the time, were pursued by the regulators as

responsible for the advice. Smaller firms and advisers must not be regarded as easy targets in retrospect for operating within the known parameters of the time.

IMPACT ASSESSMENT

Q22 Annex B contains a preliminary impact assessment for the Government's proposals. As set out in that document, the Government welcomes comments from respondents on the assumptions made about transitional and ongoing costs for all types of firm. In particular, comments are sought from all types and size of deposit-taking, insurance and investment banking firms (including credit unions and friendly societies), and from groups containing such firms.

74. We are concerned that the justification of the decision to proceed with these proposals is based on the following assertion: "It is impossible to quantify the benefits of the proceed option in a realistic way…The benefits from reducing the frequency or severity of financial crises such outweigh the additional resource costs." We are not convinced that enough has been done to prove that these measures will reduce the frequency/severity of financial crises. We would like to see a more complete justification of the benefit in regulatory outcomes compared to the cost and burden of these changes, which we believe will be significant for smaller firms.

75. We disagree with the "No" answer to the small firms impact test. The justification in the consultation paper is given as: "Small firms which take deposits or effect or carry out contracts of insurance will be regulated by the PRA and CPMA. The proposed reforms are likely to have some effect on their costs. Most small firms in the financial services industry are not deposit-takers or insurers and will be regulated by the CPMA in succession to the FSA. They are not likely to be materially affected by the proposed reforms."

76. We have calculated that around 800 smaller firms will need to be regulated by both the PRA and CPMA – this includes small deposit takers, insurance firms, friendly societies and all credit unions. This is a significant number of firms who will be subject to dual regulation. It is not just the amount of the fees that will need to be borne by these small firms, it is the possibility of having to produce differently formatted information for each regulator, setting up new systems to deal with the different regulators' requirements, responding to communications and requests from regulators, and hosting separate regulator visits. For instance, in a small firm, preparation for and the hosting of a regulator's visit takes up a considerable amount of the chief executive and other senior staff time: to double those requirements will take a sizable chunk of resource away from the core business.

77. For those smaller firms which will be regulated solely by the CPMA, we remain concerned about transitional costs and potential ongoing costs. The assumption that there will be no increase in costs for those who are only regulated by the CPMA is justified in the Impact Assessment firstly because

certain rule changes will happen regardless of regulatory structure (due to Europe etc) and secondly because other rule changes will be subject to CBA. However, we have been challenging the FSA over the past few years over the effectiveness of their cost benefit analyses. We would like to register our concern that if the new CPMA is charged with becoming a consumer champion, it may feel justified in bringing in new requirements where the cost outweighs the benefits, and there will be little internal counter-argument within the regulator to say that too many of these requirements will undermine the viability of smaller firms.

78. We are also concerned that the quality of regulation at the CPMA may be diminished, particularly for those smaller firms who will have prudential regulation carried out by the CPMA. With the splitting of the regulator in two, there is a danger that the supervisors with an interest in and greater understanding of prudential issues will all move to the PRA, as that will be the place with more opportunities in prudential supervision. This could leave the prudential supervision at the CPMA as seen as being of lesser importance, and so less able to attract quality supervisors.

79. The transitional costs are expected to be "in the order of £50 million spread over about 3 years". This is a significant additional cost in regulatory fees, and will be accompanied by internal costs at each firm as they need to amend systems and procedures to adapt to the new regulators. Any additional costs are more difficult for smaller firms to absorb.

80. We also challenge the Impact Assessment statement that the proposal will not have an impact on competition. We believe that there is a very real danger of an adverse impact on competition from these proposals. Smaller firms are in danger of going out of business with new regulatory structures and requirements being put into place in 2012, just when firms are having to cope with wider changes in regulatory requirements arising from the Retail Distribution Review, the Mortgage Market Review and Solvency II. Smaller firms are key contributors to the diversity and competitiveness of the financial services marketplace in the UK.

APPENDIX 1

ROLE AND REMIT OF THE SMALLER BUSINESSES PRACTITIONER PANEL

1. The Smaller Businesses Practitioner Panel (SBPP) was set up by the Financial Services Authority (FSA) to represent the views and interests of smaller regulated firms and to provide advice to the FSA on its policies and strategic development of financial services regulation.

2. Our members are drawn from smaller firms operating across the main sectors of regulated business.

3. We consider several factors when deciding on the definition of "smaller" businesses and take a flexible approach to the application of criteria. A firm may have – in relative terms – a minor market share or small number of employees in the context of its industry sector. In addition, the firm's financial position and whether the firm is owner-managed may be relevant.

4. We work to ensure that the interests of smaller financial services firms are taken into account and their importance to a healthy, successful and vibrant marketplace are properly reflected in the policies of the FSA.

5. The names of the members of the SBPP as at 18th October 2010 are as follows.

Panel Member	*Position*
Simon Bolam *(Acting Chairman)*	Principal, EH Ranson and Company
Guy Matthews *(Appointed Chairman from 1.11.10)*	Chief Executive, Sarasin Investment Funds
Clinton Askew	Director, Citywide Financial Partners
Ian Dickinson	Director, Brunsdon LLP
Paul Etheridge	Chairman, The Prestwood Group
Peter Evans	Chief Executive, Police Credit Union
Sally Laker	Managing Director, Mortgage Intelligence
Fiona McBain	Chief Executive, Scottish Friendly Assurance
Keith Morris	Chairman and Chief Executive,Sabre Insurance
Andy Smith	Special Projects Advisor, TD Waterhouse UK
Andrew Turberville Smith	Chief Operating Officer and Finance Director, Weatherbys Bank Ltd