The Leviathan is still at large

An open letter to Mr John Tiner, Chief Executive of the FSA

A Report by the CPS Review Team

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This report is based on a collation by the research team of the independent views of many senior financial services industry practitioners. These views were expressed in interviews in a personal capacity in response to a wide ranging set of questions, and through letters and submissions made to the team. The views and opinions here expressed do not represent those of any single person involved in the project, but do represent an attempt to distil, from all the many views expressed, a consensus about how the financial regulatory regime might now go forward in the best interests of the industry it regulates.

The team is extremely grateful to all the respondents in the research who gave generously of their time and wisdom. It goes without saying that this report would not have been possible without them.

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John Tiner,
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Dear Chief Executive,

You have now seen the Financial Services and Markets Act through the last two years, and many throughout the industry applaud the vigour and straightforwardness of your approach to a huge task, and the energy of your team at the FSA.

But many senior industry leaders have a number of important and urgent messages to give you about how you go about it. They have asked a Centre for Policy Studies research team to pass on this report, and they feel confident that you will listen with your usual attention. They also trust that you will include them in your thinking about how to lead the FSA in 2005 and beyond.

Industry leaders believe that, if these concerns are not addressed, then the UK will lose its pre-eminence as a world financial market leader, and will lose its reputation as the best regulated industry in the world.

Meanwhile, can we convey the gratitude of many for getting on with the job?

Yours sincerely,

The CPS Research Team

SUMMARY

- The Financial Services Authority, which came into formal existence in 2001, is one of the most powerful, and one of the least accountable, institutions created in the UK since the war.
- Its lack of accountability has nurtured a sense of disengagement and growing disillusionment within the financial services industry.
- The industry also feels that the FSA is vulnerable to political direction and influence. The FSA is seen as being unable to defend the industry it is intended to support against political or public criticism. This has created a sense of insecurity about future regulation. The ability of the industry to plan and to innovate is severely undermined.
- The industry fears that the FSA is an increasingly defensive and risk-averse organisation. This has contributed to a culture of prescriptive and increasingly complex regulation.
- Such a culture is damaging to all the industry – but most of all to the small business sector. Innovation is at risk of dwindling, competitiveness falling and consumer choice declining.
- The characteristics needed to succeed in the global capital markets include the following: expert, responsive, lateral-thinking, proactive, unbureaucratic, fast-on-the-feet, decisive, cost-conscious, imaginative, outward-facing and open. The industry expects its regulator to mirror these characteristics. The industry's expectations are not being met.

- Industry concerns over the FSA can be grouped under five main headings:
  - concerns over the FSA's culture and its communications;
  - concerns over the quality of FSA staff
  - concerns over regulatory capture by consumers;
  - concerns over the costs and burden of regulation; and,
  - concerns over competitiveness at home and abroad.
- Reducing the scope and reach of regulation, however desirable in themselves, will not provide the solution. Rather, a far deeper response is needed, and wanted, from the FSA.
- To this end, the principal role of the FSA must be revised to: "foster in partnership with the industry, a healthy, competitive and innovative financial services industry."
- Other recommendations (detailed in Chapter 3) include:
  - advocating a "light touch" regime, subject to broad principles, and supported by regularly updated Guidance, adapted for the business and market needs of each market sector. This is in contrast to the current climate of ever-more prescriptive rules, micro-management and combative enforcement;
  - revising the FSA's accountability to make it much less dependent on the Treasury, and more accountable to the industry that it serves;
  - addressing the ever-increasing indirect costs of regulation and their effects on the competitiveness of the industry both at home and abroad;
  - recognising the skills, sophistication and ability of senior management to manage their own business risks; and removing many of the prescriptive compliance burdens under which they labour;
  - clearly differentiating between wholesale and retail market sectors. This will demand functional separations within the regulator of far greater sophistication than at present;

- applying a robust, consistent and proportionate investigation and enforcement regime, concentrated on senior management failures which put the interests of consumers and the market at risk;
- quantifying and reducing the administrative burden of regulations;
- removing responsibility for consumer education from the FSA's remit; and to assign the responsibility for policing financial crime to the relevant criminal prosecution authorities;
- addressing the FSA's sometimes bureaucratic, defensive and risk-averse behaviour, and developing a culture of partnership with both the industry and consumer representatives.

▪ In conclusion, the FSA's original aim to be the "world's best regulator " misses the point. Instead, the FSA should aim, by being the world's best regulator, to regulate the world's cleanest, most competitive, most innovative and most successful financial market. Nothing less will do.

CHAPTER ONE

INTRODUCTION

> "The FSMA has created an unprecedentedly powerful institution, upon whose self-restraint, and skill in the execution of its powers the City will now become uncomfortably dependent."
>
> Martin McElwee and Andrew Tyrie MP, *Leviathan at Large*, CPS, 2000

> "The declared aim of the FSA is to be a world leading regulator respected for its effectiveness, integrity and expertise both at home and abroad."
>
> *A New Regulator for the new millennium*, FSA, 2000

> "Effective regulation is about… promoting markets which are efficient, orderly and clean, ensuring the retail customer gets a fair deal, and making the FSA a more professional organisation."
>
> Callum McCarthy, APCIMS Annual Conference, November 2004

> "The FSA supervisors, in dealing with our firm, seem to view us as sand in the FSA engine."
>
> Comment to the CPS Review Team

THE FINANCIAL SERVICES AUTHORITY (FSA) is one of the most powerful, and one of the least accountable, institutions created in the UK since the war. Indeed, during its inception, Martin McElwee and Andrew Tyrie MP warned that:

> "the regulatory regime being introduced… could seriously damage the financial sector in this country. Jobs would be put at risk, business would be lost to foreign competitors and consumers would pay more for financial products."[1]

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[1] M McElwee and A Tyrie MP, *Leviathan at Large*, Centre for Policy Studies, 2000.

They went on:

> "Ultimately it will be the consumer, even more than those who work in the industry, who will lose out. Everyone who has a bank account, a pension, an insurance policy, a mortgage or an investment could be adversely affected… the essential balance between regulation and its economic effects has not been adequately established."

Five years later, it is time to ask whether these forecasts were accurate. Also, to what degree does the lack of proper accountability matter? What is the effect on the industry of the FSA's exercise of its "unprecedented" powers"? How can these discomforts be eased? And how can a culture of partnership be created to replace the state of dependency between the regulator and the regulated? What is perceived to be the damage of heavy handed regulation to both the industry and the consumer of its products? What can be done to stem it? In short, how can the "essential balance" between regulation and its economic effects" be restored?

Perceptions matter

This report is a digest of the open, and often personal views of senior figures, including those representing Trade Associations, across the financial services industry.

The material gathered is candid, and necessarily anecdotal. It was presented with a striking urgency of purpose, by senior professionals who are looking for a better relationship with the FSA. It is about perceptions (sometimes dismissed by the FSA as "myths") and expectations of what financial regulation should deliver, and the management of those perceptions and expectations, by the FSA. The views expressed here represent a balance of opinion about the present state of the marriage between the regulators and the regulated.

THE FOUR OBJECTIVES AND SEVEN OPERATING PRINCIPLES OF THE FSA

The Four Objectives

The FSA must, so far as reasonably possible, and in its own discretion, act in a way which is compatible with these objectives.

The four Statutory Objectives of the FSA are:

- ensuring market confidence;
- developing public awareness;
- the protection of consumers;
- the reduction of financial crime.

The Seven Principles

The following seven regulatory principles to which the FSA "must have regard" in discharging its general statutory functions (including its determination of policy) provide the operating framework for the regulators:

- the need to use its resources in the most efficient and economic way;
- the responsibilities of those who manage the affairs of authorised persons;
- the principle that a burden or restriction which is imposed on a person, or on the carrying on of an activity, should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction;
- the desirability of facilitating innovation in connection with regulated activities;
- the desirability of maintaining the competitive position of the UK;
- the need to minimise adverse effects on competition that may arise from anything done in the discharge of those functions;
- the desirability of facilitating competition between those who are subject to any form of regulation by the FSA.

What this paper does not address

This paper is not about deregulation and does not seek to present "deregulation" of any particular area of regulation as a solution in itself. Nor does it attempt to consider in detail any technical aspects of current regulation which many would wish to see changed. This is already the subject of much other work elsewhere both outside and inside the FSA.

This paper does not include any review of the workings of the new Mortgage and General Insurance regulation regimes, although the general sentiments expressed here are already proving relevant to these two new areas of the FSA's responsibilities. Nor does it attempt to re-examine every issue that is already well documented in the comprehensive NOP research for the Practitioner Panel.

The paper focuses on "domestic" issues, and the daily concerns of senior industry figures in the UK, four years into the operation of the Financial Services and Markets Act (FSMA). These, interestingly, were the issues which respondents were most eager to discuss. It does not therefore, at this stage, address the growing regulatory burdens that are coming from the European Union.[2] It is, however, clear that the need to address domestic issues will only grow in response to the complex and growing demands of the EU.

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[2] The burdens being imposed on the UK financial services industry by the European Union will be the subject of a later CPS paper. In regards to the EU, respondents did express two main concerns: that the single market for financial services is not effective, with major barriers to competition, distribution and entry and significant anti-competitive practices still prevalent; and that the new EU Commissioner for the Internal Market, Charlie McCreevy, was planning further regulatory initiatives instead of reviewing the current state of competition in the market for financial products. See also David Lascelles, *The City and the EU: there must be a better way,* New Frontiers, December 2004.

Finally, it does not address numerous issues arising from the present operation of the Financial Ombudsman Service (FOS). This is a subject of great concern to many respondents. However, as it is presently the subject of a major consultation and review, it has not been considered within the scope of the current report.

The need for regulation is accepted

> "Markets require rules, but rules can kill markets, so efficient markets require efficient rules."
>
> Sir Nigel Wickes, *The Arrival of Meaningful Regulatory Impact Analysis,* Corporation of London Paper, July 2004

The need for proportionate and competent financial regulation is accepted across the industry. Previous legal controls, through both statute and the common law, did not provide a sufficiently flexible or coherent framework for a complex, global, financial services industry. Indeed, the present UK model of statutory regulation is a model which is being adopted by other jurisdictions worldwide.[3]

There was no evidence of anyone seeking a divorce from the regulator, although some among the hedge funds and private equity participants considered that a return to non-intrusive "old-Bank of England" style supervision coud be one way forward. Nor was anyone seeking a wholly "new start", or to engage in any more blue-sky thinking about the nature of regulation. Many respondents were eager to draw attention to the efforts that the FSA is making to acknowledge and respond to a number of structural problems about how it regulates.

Respondents also appreciated statements from the senior management at the FSA which make clear that regulation needs to be based on a partnership with the industry. The following three principles, restated in the Chairman's forward to the 2005/6 Business Plan, were widely welcomed:

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[3] A survey in July 2003 of market participants by the Centre for the Study of Financial Innovation, *Sizing up the City,* placed London well ahead of New York, Paris and Frankfurt in terms of its regulatory environment.

- "a concern to make the market work effectively, as the best means of providing benefits to both consumers and providers; of financial services and therefore
- a commitment, where we have discretion, to intervene in markets only where there is a market failure and where regulatory intervention is likely to be cost effective; and
- a risk-based approach, which accepts that some failures neither can nor should be avoided."

Callum McCarthy, Chairman's Foreword, *FSA Business Plan 2005/06*, January 2005

These are important words and are in principle fully supported by everyone we spoke to. The respondents wanted to see them translated into reality.

The FSA is one of very few regulatory agencies which is funded not by the taxpayer, but by the industry it regulates. This has certain consequences, one being that the regulated firms are determined that their regulator should not become "just another government department", something many now fear to be an inevitable result of the FSA's approach to its responsibilities. The FSA also has a unique dual responsibility not only to foster and maintain confidence in the financial services industry and the regulatory system, but also to foster and maintain confidence in those very financial markets themselves. No other regulator has quite this role in relation to its constituency.

The industry has great good will towards the regulatory system and the FSA. It wants to be regulated, and regulated well, a point made over and over again by respondents, and to the NOP survey for the Practitioner Panel. But it wants the FSA to be different and it wants more of a say in how this will be achieved.

In this context, there was much about regulatory methods that was criticised. And these criticisms were, in the main, not specific to one particular regulation or another. They stemmed from disquiet with the culture and ethos of the FSA, and from its lack of transparency and accountability to the industry it serves.

Merely reducing the scope and reach of regulation, or taking welcome management measures to slim down rule books, or staff numbers, or compliance costs, or the demands of the money laundering regime (all desirable objectives to achieve), will not provide a whole solution to the problems that the relationship faces. Rather, a far deeper response is needed, and wanted, from the FSA.

Finally, it should be stressed that the great majority of the respondents held Callum McCarthy (the current Chairman of the FSA), John Tiner (the current Chief Executive Officer) and other senior executives in high regard. The pressures faced by the FSA in its early years were also widely acknowledged: a complex legal structure, massive organisational change, and a steep learning curve were all identified as challenges that had been successfully met. Indeed, it is clear from scrutiny of major announcements made by senior FSA staff in the last six months, that the new senior management of the FSA recognises and acknowledges many aspects of many of the themes discussed here. The Practitioner Panel Report has also acknowledged the work being done by the FSA to:

> "…make ourselves better regulators both by minimising costs and being smart and more prioritised in our actions."
>
> Kari Hale, Director of Finance Strategy and Risk, 25 November 2004.

That much has been achieved is not in doubt. The question is what else needs to be done.

CHAPTER TWO

FIVE CONCERNS

Anecdote or hard data?

Callum McCarthy, the Chairman of the FSA in a speech in October 2004 to the Centre for Finance and Investment at Exeter University gave a stern warning: the FSA in making rigorous assessments of compliance and other costs and benefits to the industry of regulation will not rely on "ad hoc studies which confuse anecdote with fact".

This may of course be the correct approach for academic research. But it takes no account of the commercial effects on the industry of perceptions about rising costs and the power of anecdote in influencing their daily business decisions. Not all aspects of the regulated relationship are measurable. One of the most important, that of trust and confidence of the industry in its regulator is immeasurable"

Perceptions matter. Anecdotes shape behaviour. The absence of hard data does not in itself negate a concern.

If the problems identified here are dismissed as unscientific, or as merely anecdotal, then the real concerns of many leading professionals will be vindicated. For the most important issue at stake is confidence in the regulator. This is an intangible concept, little referred to in the regulator's self-examination processes. The concern is that, imperceptibly but insidiously, this confidence could leak away. Achieving its objectives, as so regularly and earnestly described by the FSA, should not be the key measure of its success.

FIVE CONCERNS

Industry leaders' principal concerns can be grouped into five very broad categories:

- concerns over the FSA culture and its communications;
- concerns over its competence and the quality of its regulation;
- concerns over regulatory capture by consumers;
- concerns over the costs and burden of regulation; and,
- concerns over its impact on competitiveness at home and abroad.

All these concerns were set against the background of an overall unease, and feeling of powerlessness, about the FSA's accountability and transparency. They were also underpinned by a growing frustration among many senior figures consulted, that talented people were no longer prepared to work in an industry stifled by bureaucracy; or that high quality staff would only take on senior positions if they were backed by expensive contractual protection.

Regulatory culture and communication

It was widely believed that the culture of regulation is changing. Over time, it is feared that this will affect confidence in the place of London as a leading financial centre. The industry needs to be confident that its regulator is there to complement and serve the markets. The FSA is felt to be remote, to be inflexible and risk-averse, to be increasingly pervaded by a "civil service mentality", and to lack a sense that it is there to serve the industry, and not the other way round. Increasing risk-aversion in government and regulatory agencies is seen as an insidious danger to the competitiveness of all UK businesses; and it was one about which the financial services industry is particularly concerned.

The FSA also appears on occasion to be reluctant to respond to criticism. One example is the brief response made by John Tiner to the widely expressed concerns about the perceived disproportionate focus on consumer protection:

> "We do not accept that the FSA is disproportionately focused on consumer protection to the detriment of our other objectives. We are absolutely clear that we pursue consumer protection in conjunction with our other objectives of maintaining market confidence, raising consumer awareness and helping to reduce financial crime."
>
> Quoted in Press Release in response to the Practitioner Panel Report, December 2004

This statement reinforces at least two of the "intangible" concerns of respondents; first that, while the FSA may listen, it does not really hear. Second, that it considers that the achievement of its own objectives to be a proper end in themselves, and that their achievement, must, unarguably, equate with Good Regulation.

Regulatory competence and quality

Respondents felt that the FSA, at every level, needs to be expert, responsive, lateral-thinking, unbureaucratic, proactive, fast on its feet, decisive, cost-conscious, imaginative, outward-facing and open. After all, these are the characteristics needed to succeed in the global capital markets. The industry, not unreasonably, expects its partner to understand this, to demonstrate that it understands this, and to reflect this in its own characteristics.

When offered the opportunity to speak out about any subject affecting their relationship with the regulator, the majority of respondents first wanted to speak about their day to day contacts with the FSA on compliance and supervisory matters. Here, many felt ill-served and powerless to achieve change. This was leading to a breakdown in confidence.

It was widely felt that, with the exception of those at the most senior level, the quality of the regulators is declining. The concern is that this decline will, slowly but inexorably, cause the industry to develop "avoidance strategies". To an extent, this is happening already: much financial activity is shifting to largely unregulated territories (such as private equity and hedge funds). A halt to this decline, and a recognition that it is a problem, is needed. The

growth of fund supermarkets to service a consumer appetite for risk is another interesting development.

> "The FSA is looked on like some sort of traffic warden. It is now thought to be OK to try to "fox" the regulators, or that regulatory avoidance schemes should be devised like tax avoidance schemes."
>
> Deputy Chairman, major foreign banking corporation

Consumer Capture

There was a concern that the relationship between the industry and the FSA is being forced into imbalance by "consumer capture". This concern now leads to defensive business decisions being made inside institutions about what products to sell, how to sell them, and to whom. Indeed, when members of the Treasury Select Committee describe the purpose of financial regulation as "consumer protection", it is clear that the regulatory balance is becoming unsettled.

> "Recently the industry perception is that there appears to have been a shift from *caveat emptor* to *caveat vendor*."
>
> *Report on Financial Regulation,* CBI, October 2004.

> "Consumers see the FSA's job as being blamed and paying up."
>
> Regulatory partner, City Law Firm

> "The FSA seems to hold the view that investments are rarely mis-bought and often mis-sold."
>
> Patience Wheatcroft, *The Times*, 11 December 2004.

No one is well served by this. Financial markets cannot deliver their primary function as the suppliers of finance to business if the regulator, or the consumer, or the government comes to see the FSA's predominant task and principal responsibility as that of consumer protection. This can only result in a more and more expensive risk-averse system, where the additional costs will inevitably be borne by the consumer. This imbalance, becoming characterised as a "them and us" culture, needs to be redressed, in the interests of all.

Costs and burdens of regulation

It is perceived that there is too much regulation, that it is unnecessarily and wastefully complicated, that it is too expensive, and that this situation can only get worse, especially when EU regulatory requirements (even un-gold-plated) are included.

Many senior figures in the industry, understandably and lamentably, appear to be becoming obsessed with the daily detail of surviving the barrage of regulation, and the costs and management time associated (or perceived to be associated) with this. This inevitably deflects their attention from the primary task of managing innovative and competittive businesses, and leads to a need to make "compliance risk-averse business" decisions.

The increasing burden of regulation also leads to the risk, some would say inevitability, that financial institutions are pricing themselves out of parts of the mass markets for savings – the very markets that need encouragement.

The impact on the industry's competitiveness

It is perceived that the increasing costs and burdens of compliance are having a serious effect on the UK's competitive position in the global financial services market, whatever the findings of the Office of Fair Trading 2004 review may say to the contrary. It is also having a serious effect on competitiveness amongst the domestic market, to the evident detriment of smaller firms, and ultimately to consumers.

CHAPTER THREE

PROPOSALS FOR REFORM

THE FOLLOWING PROPOSALS, some radical, some more modest, could all be implemented within a reasonable time frame and at a reasonable cost. Indeed, some are already known to be being addressed in part as a result of the Treasury review, and by work going on inside the FSA. Some can be achieved within the existing FSMA framework, some would, and should, require legislative change. They are all intended to be practical and are based on the suggestions made in the course of the research. The reforms proposed on accountability follow a model similar to that in other regulatory bodies and suggest a body equivalent to the National Audit Office for the FSA. They are representative of the broad change of emphasis which respondents said is needed to ensure that the UK retains its pre-eminent position in global financial markets. Many echo the predictions and prophecies made by McElwee and Tyrie,[4] in putting forward amendments to the FSMA. The respondents' views came with five years of practical experience of the regulatory regime in operation and put additional flesh onto to those bones.

The role of the regulator

Under Howard Davies, the first Chairman and Chief Executive of the FSA, the FSA stated that its mission was to be "the world's best regulator". According to the FSA, this has now been changed to demonstrate a new emphasis from policy design to ploicy implementation. The FSA now states that its role is to be the

4 Op. cit.

capable and efficient promotion of efficient, orderly and fair markets, with a fair deal for retail consumers. It will do this through a risk-based approach with market intervention only where there is a market failure. Its 2005/6 business plan sets out the regulatory tactics for this. No mention is made, however, of the partnership with the industry which is vital to achieve this.

A further radical change in emphasis is needed. Being the world's best, most efficient, most capable, most efficient regulator is not enough. The FSA must, instead, place the promotion of a competitive industry at the heart of its culture and remit. As McElwee and Tyrie stated:

> "The FSA's aim is worthy but incomplete; it should also be an aim of the FSA to maintain the competitiveness of the UK's financial sector."
>
> Tyrie and McElwee, op. cit.

This remains the case. Respondents thought it self evident that this should be the prime regulatory task: indeed, the FSA's principal role should be to foster, in partnership with the industry, a healthy, competitive and innovative financial services industry.

Encouraging a healthy, competitive and innovative industry
Such an industry would have the following characteristics:

- an industry with responsible senior management, ensuring that consumer protection is provided through market forces and competitive brands jealous of their reputations, and where risk-taking is not viewed as dangerous but as commendable;
- an industry operating under a "light touch" regime, subject to overarching broad Principles, expressly adapted for the business and market needs of each market sector, and, supported by formal, targeted Guidance on how the regulator expects the principles to be interpreted by the industry. This is in contrast to the current climate of ever-more prescriptive rules, micro-management and combative enforcement, and the perceived inconsistencies and lack of clarity in FSA guidance;

- an industry subject to a robust, but consistent, and proportionate enforcement regime. Serious penalties should fall on responsible senior managers whenever markets have been damaged or consumers' interests harmed. It should not focus on technical or systems issues;
- an industry where competition abroad and competitiveness at home are not hampered by the costs and burden of being regulated, or by the costs (and conflicts) of educating consumers, or of policing and prosecuting money-laundering and financial crime. These responsibilities should be returned to the portfolios of the DfES, and the criminal prosecution authorities;
- an industry where exceptional individuals will continue to put themselves forward for senior management posts in the regulated sector, unhampered by detailed prescriptive rules of behaviour, where they can exercise reasonable autonomy to manage their own business risk and be adequately rewarded for assuming management responsibility for failure;
- an industry which is always, and is always seen to be, prepared to balance the interests of the industry with the protection of consumers, with the oversight and assistance of a regulator that is always proportionate and alert to possible conflicts in achieving this balance.

Reform of the FSA's accountability and remit

To achieve this, the FSA should become:

- a regulator which has the explicit objective to promote and maintain international competition, to facilitate and encourage domestic competitiveness and innovation, and to minimise any adverse effects of competition;

- a regulator which is fully transparent, fully accountable to its stakeholders, and independent of any one government department. It should be answerable directly to Parliament, to a relevant select committee, and to an independent Regulatory Review Body. The Regulatory Review Body should be recruited by public advertisement and set up by the FSA to scrutinise FSA's competence and cost effectiveness in the exercise of all its functions. It should report on them to Parliament and to stakeholders. The Regulatory Review Body should hold public confirmation hearings for the appointments of the Chairman and Executive Board members of the FSA, and the chairpersons of the statutory Panels;

- a regulator whose Board has "normal" corporate governance powers and responsibilities and whose Board is elected by industry stakeholders and consumers (at present it is appointed by the Treasury);

- a regulator which clearly differentiates wholesale and retail market sectors, and which is ready to be flexible in designing and operating a compliance regime responsive to market demands across all industry sectors. This will demand functional separations within the regulator of greater sophistication than at present. The tanker must become a taxi, able to turn round on a sixpence;

- a regulator which has the explicit objective to demonstrate value for money and to ensure that the costs and burdens of regulation are at all times proportionate in any given market sector.

What specific reforms this will require?
Changes to the remit and culture of the FSA will entail at least the following:

- rule and hand books, consultation papers and bureaucratic processes must be pruned, with those remaining justified by cost-effectiveness analysis and cost-benefit analysis (similar to Regulatory Impact Assessments (RIAs); sunset clauses for rules which no longer add value should be introduced;
- all new rules must have RIA equivalents;
- administrative burdens must be quantified. Formal targets for their reduction should be introduced, with transparent performance measures against the regulator can be measured. The independent Regulatory Review Body will scrutinise all the cost benefit of FSA's work and report to both Parliament and stakeholders;
- the present investigation and enforcement processes, and the added value of a Regulatory Decisions Committee must be reviewed, and the costs anomalies in the whole enforcement process, changed. In particular, in the event of a successful challenge by a regulated firm, it should be made possible for the FSA to be liable for costs.

Reform of the FSA's communication with the industry
The FSA must address its growing disengagement within the industry. It must become a regulator which listens to, and acts upon, the views of its industry partners. It must become a regulator that maintains a transparent and responsive dialogue about market realities and consumer needs, about regulatory priorities, and about its interpretation of its objectives. To achieve this, it must at least:

- have a mandate to consult elected statutory Panels which have far wider powers than presently enjoyed by the Practitioner and Consumer Panels. These Panels,

subdivided into sector panels, should be specifically empowered to participate in policy and target setting, and in plans for necessary legislative change in rules, guidance, principles and codes. The Panels should make recommendations to the FSA Board, which would have publish reasons for any decision not to adopt them.

Compliance relationships

The FSA must, in open dialogue with the industry, completely reshape its compliance relationships to acknowledge the need to serve and partner the industry, not to govern it prescriptively. This will include:

- allocating to each regulated firm an "account manager" of suitable sector experience, seniority and competence;
- ensuring that all industry-facing staff have suitable experience as a requirement of employment at the FSA, to ensure technical competence and comprehension of industry practices and culture;
- embedding the use of confidential intermediaries and industry mentors ("grey panthers") to provide neutral channels of communication.

CHAPTER FOUR

FSA ACCOUNTABILITY AND TRANSPARENCY

THE FSA IS ONE OF THE MOST constitutionally unusual bodies with regulatory responsibilities. In particular, its lack of accountability to the industry appears to underlie a sense of disengagement and growing disillusionment with the FSA.

McElwee and Tyrie warned[5] that the success or failure of the FSA would depend on its skill in the exercise of its enormous powers. The industry now has a great deal of experience of the FSA's exercise of those powers, and has many concerns to air. While it also has many good things to say about its regulator, and about how much it has achieved for the reputation of the UK financial markets, the relationship now needs far more accountability.

The FSA's powers under FSMA

The FSA is a company limited by guarantee, set up under statute. It is answerable to the Treasury, and the Treasury Select Committee. It is obliged to make an Annual Report to Parliament about how it is meeting its four regulatory objectives, and can be made subject to an independent review of its economy, efficiency and effectiveness (the review to exclude the merits of the FSA's general policy or principles in pursuing its objectives). The scope of such a review, its timing, and the identity of the independent reviewer is to be decided by the Treasury. Two statutory Panels may make "representations" to the FSA about the extent to which the FSA's policies and practices are consistent with its four

[5] Op. cit.

objectives. There is also a Treasury "reserve" power to set up an independent enquiry in the event of a serious market failure arising from the conduct of the regulator.

The FSA's Board and Directors are appointed by the Treasury. Board and senior staff appointments are subject to "Nolan" principles. The Board's powers of governance are narrowed by the FSMA, rather than being given full corporate governance powers. They extend only to a general power of review of the use by the FSA of its powers, internal audit matters and remuneration of the executive board members. It now has a split Chairman and Chief Executive role (although their precise briefs remain unclear).

The FSA is subject to scrutiny by neither the National Audit Office, nor the Audit Commission. It is subject to limited scrutiny by an independent Complaints Commissioner, where complaints are made about the exercise of its functions, other than legislative functions. It is a public body susceptible to Judicial Review, if it is alleged to have exceeded its powers. But it has a very wide immunity from suit for civil damages except in the event of bad faith or "misfeasance in public office."

It enjoys wide powers of prosecution for numerous offences, including money laundering and market abuse, and power to bring civil actions in the courts for a whole range of injunctive and restitutionary reliefs including the requirement to pay such compensation as the FSA sees fit. It has wide powers of compulsory investigation, with criminal penalties for failure to co-operate and power to collect intelligence, which it may share, in many circumstances, with other regulatory and prosecution agencies worldwide. It enjoys many potential exemptions from aspects of the Data Protection and Freedom of Information legislation. It has legislative powers to levy fees and to make rules. It has the power to enforce these rules by disciplinary action, fines and disqualification against regulated firms and Approved Persons undertaking "controlled functions" in the Financial Services Industry. Costs, in favour of a regulated person who successfully appeals against a disciplinary decision of the FSA, can only be

awarded by the Financial Services and Markets Tribunal in a case where the FSA has acted completely unreasonably. It has the power to raise fees compulsorily from the industry to fund its regulatory activities, and the Investors Compensation Scheme.

No-one may conduct "regulated activities" in investment business in the UK without being permitted to do so by the FSA, on pain of criminal prosecution or civil injunction.

Very wide powers indeed. The list is long. Accountability to government is catered for by the Annual Report, and the possibility (not mandatory) of independent review from time to time, triggered and defined by the Treasury. Accountability to consumers (who pay charges for products which reflect the cost of regulation of their providers) and to the industry which it regulates (which pays both the direct costs, in fees, and the indirect costs of the compliance regime which the FSA in its complete discretion, imposes) is catered for by the Board of the FSA and by two statutory Panels, the Practitioner and Consumer Panels. These Panels have no power to require the FSA to adopt any particular course of action.

Like any other public body, the FSA is obliged to consult its stakeholders before exercising, for instance, its rule making powers. It then, like any other public body, may exercise its own discretion in reaching a decision. The only "right of appeal" is by way of Judicial Review.

Views on accountability

Respondents were concerned that they are largely excluded from a regulatory process for which they paid and which governed their business life. Some were particularly concerned about the FSA's apparent partiality, its perceived politicisation and the extent to which it has to dance to the Treasury's tune. This perception of the FSA's lack of independence had been reinforced, some felt, by the way in which mortgage advice and general insurance had somewhat summarily been added to the FSA's portfolio. They were alarmed by the effect that the Treasury Select Committee's (TSC) oversight

seemed to have on the FSA's behaviour. Many felt that the FSA seemed overly concerned with defending itself from criticism, and was being disproportionately influenced by consumer pressure exerted through the TSC, to the industry's detriment. The need for such intrusive Treasury influence and control of a regulator funded by a levy on the industry (as opposed to the taxpayer) was questioned. Pleas for the FSA to demonstrate its independence from the Treasury were numerous. A more robustly independent FSA was seen as essential to the restoration of the regulated relationship.

> "There is concern about the political imperatives at the FSA which appear to have been set at a higher level."
>
> Chairman, Building Society mortgage lender

> "HMT and the Government will only ever be negative… the blame culture undermines the process."
>
> CEO, Clearing Bank

> "The Regulator is politicised which is very dangerous."
>
> CEO, another Clearing Bank

> "The primary goal of the FSA seems to be not to run into the sort of political storm they had in dealing with split caps and endowment."
>
> CEO, Pension Fund Manager

> "The relationship of the FSA with Treasury is seen to be very overbearing and unproductive, to the detriment of firms."
>
> Regulatory Partner, City Law Firm

There was felt to be a "disconnect" between the FSA and the Treasury:

> "Its [the link with Treasury] an impediment to coherent regulation."

> "The Treasury and the FSA don't seem to be talking to each other. For example UCITS 2 and 3 have been developed by FSA – no response yet on the tax rules from HMT. Similar problems with property funds, where the tax regime has still not been adjusted."
>
> CEO, Pension Fund Manager

ACCOUNTABILITY

The role of the Treasury Select Committee caused considerable discomfort:

> "The FSA reporting to the TSC means very important aspects of the savings industry which should be covered by the Department of Work and Pensions Select Committee do not get covered."
>
> Society of Financial Advisers

> "The FSA is terrified of the TSC, which is supposed to test the operation of the Treasury. It does not devote time to this, but instead to attacking the industry and FSA bashing. The quality of interrogation is very low. It makes the FSA feel under pressure, uncontrolled and unproductive. This is amateurish PR grabbing. The FSA comes across as insufficiently robust."
>
> CEO, Clearing Bank

> "The TSC has put pressure on Tiner. He is a big boy and should have said 'prioritise'."

> "The FSA should not be frightened of the political spotlight and of championing the industry when it is right, even if the TSC takes a different line."
>
> Pension Fund Manager

> "McCarthy is chairman till 2008. This means he is independent and now has the opportunity to prove that the TSC is not master of the FSA which can determine its own policy."
>
> CEO,Clearing bank

> "The OFT Review of the whole FSMA. Does government intend to land the FSA with more and more?"
>
> Senior Manager Clearing Bank

This last quotation gives voice to a recurring fear: what other regulatory rabbit is waiting to be drawn from the Chancellor's hat when he is next lobbied hard by a consumer interest group, and assigned to the FSA to regulate? This sense of insecurity about the possible future scope of regulation means that the ability of the industry to plan and to innovate is severely undermined.

There was also a degree of mystification about why the non-executives on the FSA Board could not assume a role more in accordance with "normal" corporate governance. Non-executive members of the Board were perceived to have little influence on the conduct of FSA policy. This needs urgent review.

The role of the Complaints Commissioner in scrutinising complaints against the FSA was felt to be of use, in accountability terms, to consumers rather than to the industry, which by definition did not wish to make complaints against its regulator within the terms of reference of the Commissioner.

The Practitioner Panel survey and report process gave few any comfort that it added much either to the FSA's accountability or transparency. Few felt that it was an effective way of communicating concerns to the FSA. What was needed was regular tough scrutiny, by a body independent of both the Treasury and the FSA. This body should be able to set its own terms of reference in consultation with the industry and consumers, and cover the whole range of the FSA's activities, and in particular its cost-benefits.

This scepticism about the accountability mechanisms, and the damaging perception of FSA politicisation and lack of real independence, will seriously impede the regulatory partnership. The FSA must make strenuous efforts to secure its independence. This does not mean that scrutiny by Parliament or by select committee should be abandoned: rather, that it should be refined, and a way identified to ensure that the industry's interests are safeguarded, by a depoliticised and more independent FSA.

The Treasury Review of the FSMA

In late November 2004, the Government published the Treasury's two year review of the FSMA. The relatively narrow scope of the review, and the brevity of the FSA's response, are themselves a good indicator of why there is some unease felt about the overall accountability of FSA to the industry it serves. The FSA's low key response to the Review merely underlines this concern.

The Treasury Review promises some welcome relaxations in the financial promotions regime. It supports the Financial Ombudsman Service in going forward, subject to some adjustments, to allow more transparency. It describes some of the improved business practices the FSA has introduced on the handbook, provision of advice and guidance, the reduction in the number and length of Consultation Papers and the improvement in the quality of Cost Benefit Analysis (CBA).

The Review says nothing, understandably, about the FSA's accountability, or about regulatory culture or about "consumer capture". It takes as its starting point a highly successful system, where some adjustments are needed to keep the wheels well-oiled.

The FSA response mentions concerns to ease the costs of regulation as a "key question", in particular for smaller firms. It proposes welcome amendments to the handbook and rules, and further reductions to the number of Consultation Papers. It sets out some improved service standards for processing applications, and makes some generalised commitments about the quality of CBA in developing the handbook. On the Financial Services Ombudsman, there is claimed to be "little appetite" for a formal appeals mechanism. (A review is already under way). The issue of the impact of regulation on competition is dismissed in a "welcome" to the OFT's conclusions that the "FSA's actions are unlikely to have had any overall negative impact on the structure of markets". (The Treasury Review, by implication, rejects the concept that there is any case for a specific "competition objective" for FSA).

The narrow initial scope of the Treasury Review, its cautiously crafted findings, and the low key FSA response may well fuel the frustrations of those in the industry who see growing dangers to UK competitiveness. Taken together, the Review findings and the FSA response could be said to reveal a degree of complacency about how the system should be working – in the interests, not of the government and the regulators, but of the UK financial services industry and its consumers. This complacency is not shared by leading industry practitioners.

CHAPTER FIVE

REGULATORY CULTURE AND QUALITY OF STAFF

THERE WAS ONE TOPIC ON WHICH every respondent had strong views. It came up in every interview. In some cases, it appeared to be the principal, or even sometimes the sole, reason why the respondent had agreed to be interviewed at all. This was the quality and culture of FSA staff, and the effect that constant staff change and restructuring over the life of the FSA has had on the culture and quality of regulation. (These "staff issues" were also central to the findings of the Practitioner Panel survey, and underpin the responses which the Panel received on a whole number of topics.)[6]

"Feedback" on staff performance from consumers is now expected as a norm across commercial life in all service industries. Despite its constantly stated objective to "be easier to do business with", there was little sense that the FSA considered financial regulation to be a service. Few felt that the FSA thought of itself as a service provider.

Respondents felt a lack of any appropriate confidential forum in which to give detailed feedback, positive or negative, about their relationship with their FSA supervisors or those handling enforcement cases. One option for large companies was to speak directly to the CEO or the Chairman of the FSA, or possibly to a Managing Director. Obviously, this is hardly a method open to all the 25,000 firms regulated by the FSA.

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[6] One reason why this came up so regularly is that it was felt to be a difficult subject to discuss with the FSA, and that an intermediary was needed. This, in itself, is a problem which must be addressed.

Nor did respondents feel that introduction of a" business champion" or "relationship manager" for some firms adequately fulfilled this need. All actively regulated firms needeed this facility. They were regularly frustrated and mystified by the apparent arbitrariness and lack of consistency of a lot of their day to day contact with FSA staff, especially where it involved both the supervision and enforcement functions.

The general level of dissatisfaction appears to stem from the perception that many front line staff are inward-looking; risk-averse; demoralised by the constant change; operate in a blame culture; and "have no positives for success".

On culture:

> "Senior people are of the right calibre, but it falls away sharply and it is very difficult for more junior staff to retain an even handed attitude of being fair to their career and to the provider because of constant pressure. They get criticised for failure because there are no positives for success."
>
> CEO,Life Assurance group

> "Morale is low. There is a blame culture. It is not OK to make a mistake which is inconsistent with the ethos of the firms they regulate, which are seeking to cultivate an open transparent risk-taking culture. The FSA is terrified of public criticism and wants to avoid making any mistakes it might have to defend. It would be refreshing if the FSA was prepared to admit it gets things wrong, and behave to us as we have to it."
>
> CEO, Clearing Bank

> "We feel the FSA supervisors are like sand in the engine. They never ask, like for instance the Dublin regulators "What can we do to help you? Can we come round for a chat about it?" We feel that it is the other way round and that the tail is really wagging the dog here. We have no one we can feel we relate to at the FSA on a regular basis. Ringing up Tiner is no solution."
>
> MD, high net worth asset management boutique

"Problems get solved by starting with the detail and working up rather than working out the main issue's big problems and solving them at philosophical level. The FSA approaches regulation by box ticking. It should instead think "is this the action that a reasonable person would regard as sensible?" There is no scope to talk to a regulator like that."[7]

"All regulators have a culture. The FSA's is bureaucratic cumbersome and based round poor internal communications. It needs an overhaul, (which top management has started) and better internal dissemination (which is where the problems arise)."

CEO, Trade Association, speaking personally

"The staff are cocooned, overworked and wrapped up in their own language and concepts."

"The size and character of the FSA organisation now appeals to a local government clerk mentality – it has become a one way street."

On skills

"Educating the regulator is as important as educating the consumer."

Alternative Investment Management Association (AIMA)

"A lot of staff at the FSA are of the right calibre, but this is not universal."

London Investment Banking Association (LIBA)

"The FSA does not attract enough quality people from the industry to work there. If they do, they tend to quickly go native and become managers and bureaucrats first, and regulators second."

CEO, Asset management boutique

"On our supervision team of five, there is only one with relevant industry experience. When the SFA regulated us, four out of five of the supervisory team had direct experience of stockbroking and fund management."

Head of Compliance, large private client investment manager

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7 Note that where no source for the quotation has been given, this has been at the request of the respondent. Again, this is, of course, an indictment of the FSA and its culture.

"They are learning on the job. Where else would they get the experience? Where is FSA training and competence?"

Chairman, Life Company

"There are some very good people at senior levels. The calibre and turnover lower down is hugely frustrating."

Managing Director, Stockbroker

"If the FSA offered higher quality staff able to develop a more positive relationship with firms they would gladly pay 50% more for the benefit."

CEO, Clearing Bank

"The FSA still not seen as a necessary step on a career path for those in the industry or securities law like SEC. Secondments secondments secondments both ways is vital."

Representatives from Trade Associations tended to be more relaxed about the quality of FSA staff. This is probably because they have more daily contact with senior people at the FSA rather than with front-line supervisors and enforcers. They did, however, express many of the same general concerns as those coming direct from the firms. The fact that one trade association Chief Executive made a personal comment about the bureaucratic culture of the FSA which he did not care to make on behalf of his Association is alarming: it suggests that the very bodies who should be able to express industry concerns about the quality of FSA staff are unable to do so.

The Trade Associations did however echo most of the concerns about lack of relevant industry experience, and relevant expert professional qualifications, in what was perceived to be an organisation largely composed of generalists, constantly being moved around for little discernible purpose. The Association of Private Client Investment Managers and Stockbrokers (APCIMS) was the most outspoken on the issue of supervision and enforcement staff quality and culture, and wanted:

"a better regime of exams and qualifications for staff, as well as extensive industry experience, so that respect for them can be rebuilt in regulated firms. Pay the rate to get real practitioners and have fewer of them. If firms who manage the wealth of high net worth individuals are not treated by FSA staff as adults who can well assess and manage their own risks, they will go elsewhere, or not start up in London at all. There have been very few start-ups since the FSA came into being. UK is the sixth largest centre of personal wealth in the world."

Amongst the firms, there was an alarming consistency in their level of dissatisfaction with the skills of some of front-line FSA supervisors, and enforcers. However, they also universally put this down to management inadequacies in relation to training and culture; and to a lack of exposure to industry experience. Less criticised were the personal abilities, or willingness, of FSA staff. These dissatisfactions inevitably increase their unease, described below, about rising compliance costs and the burden of regulation.

Lack of specialist knowledge of the sector they supervise, particularly amongst supervisors, and general commercial inexperience, were regular and vociferous complaints. Calls for a more structured approach to mandatory exchanges of staff with the industry were also universal.

"The quality of staff is always a concern. The latest recruit to our team has only worked at the FSA, as a graduate recruit, and has no investment, insurance or other financial firms experience."

"They are invariable intelligent, but not commercial."

CEO,Clearing bank

"Staff of the right calibre. Yes –but differences of opinion appear to us to be attitudinal rather than capability based."

CEO, specialist asset manager

"With its people and budgetary constraints, the FSA is doing as well as can be expected. Given its breadth, there will never be enough bums on seats to deal with every issue. The FSA has never geared up to deal with

> another pension transfer issue, any more than it has been able to deal with splits. There are not enough people to handle crises."
>
> Head of Regulation, Fund Manager

The FSA asserts that a significant number of staff now joining it come from regulated firms. If this is the case, then many of the respondents would say: "well they must immediately go native, in a blame, and risk averse culture. They do not in any case, appear to be assigned, or assigned for long enough, to our supervision team".

The FSA devotes a budget of several million pounds each year to training to ensure that staff have the skills and knowledge to understand and work constructively with the firms they regulate. It has, it says a wide secondment programme in and out of the industry (the FSA has over 2,500 staff, a number set to increase substantially to deal with Mortgage and General Insurance regulation). To respondents, its staff development philosophy still seemed to focus on developing career regulators within the FSA family, with occasional, if increasing, forays into the industry they serve.

The FSA is also understood to have introduced a wide-ranging internal programme concentrating on staff review and development, and to be making wider use of "Grey Panther" figures to share knowledge and expertise.

However, there is little real transparency about the precise details of how staff are trained and in what, and no explicit mention is made of culture change in referring to these programmes. This contributes to the sense of unease that the FSA is either unaware of, or unconcerned by, its bureaucratic and inflexible reputation. Nowhere does the FSA say that it appreciates and acknowledges the industry's feelings on this, and is working to change it. It merely asserts that the "next [Practitioner Panel] survey will provide a better measure" of how it is doing on this front, as a matter of fact.

Many respondents feel that this culture has only emerged since the FSA was created. It is therefore not a question of waiting for an old guard to die off. They are generally disappointed with the concept of the "career regulator" unless such regulators have

significant recent industry experience. Increasing the graduate intake, and arranging ad hoc outward and inward secondments is not the solution. Respondents understand that changes take a while to filter through, but feel that the FSA's culture and staff expertise must be radically improved.

CHAPTER SIX

COMMUNICATION

IT IS DIFFICULT TO UNDERSTAND at first glance, why many in the industry feel they lack effective lines of communication with the FSA; and why many senior people say: "If I need to know something, or say something, I tend to ring John Tiner to get a direct answer quickly."

No one is accusing the FSA of failing to listen or to publish information about itself. After all, it has two specialist Statutory Panels; the Annual Financial Risk Outlook; the Business Plan; the Annual Report; the Consultation Paper regime; the web site; the help line; the Treasury Select Committee appearances; the regular speeches on policy and priorities made by senior FSA people to outside bodies; and many individual meetings, lunches, breakfasts, dinners, conferences and seminars to "spread the word".

The current Chairman of the FSA explains his approach to communication and information:

> "My starting point relates to information. The most productive relationship between the regulator and the regulatee is much like the most productive relationship between any of us and his or her boss; namely a desire to avoid giving unexpected shocks – the "no surprises" principle. You can only avoid surprises if the person with whom you are communicating understands the risks you run… accompanied by a discussion of the factors which would affect the outcome – up or down."
>
> Callum McCarthy to the British Bankers' Association (BBA) conference, December 2003.

This is a revealing statement. In this analogy, do we assume the FSA to be the "boss", and the industry "the employee"? If so, it says much about the Chairman's view of the relationship. It is also notable for his acknowledgement that information is not enough without "communication", and an appreciation of others' viewpoint. None of the respondents would disagree with that. But they do not feel that is how the FSA works in practice.

Callum McCarthy repeated these sentiments to the APCIMS conference in November 2004:

> "I should make clear what I mean by "communicate effectively". It means speaking frankly to particular sectors; and, as important, it means listening carefully to particular sectors".

The FSA has recently reorganised itself into "Business Sectors" to facilitate this, and to underline its determination to move from policy design to policy implementation. The FSA has clearly recognised that better communication, not merely provision of information, is vital, and that personal communication may well be necessary. Is this a realisation that "communication by Consultation Paper" has signally failed? Consultation Papers are now being reduced in number and scope, thereby removing an enormous source of complaints from respondents. The FSA must however adopt some more sophisticated and sector-tailored alternatives to get practitioner input.

The Practitioner Panel survey has also identified this need. However, respondents were sceptical that the Practitioner Panel system (even if split into Sector Panels) can meet their needs for regular and constructive input to FSA decision-making processes. They perceived it in any event to be powerless to enforce change.

> "The Practitioner panel is a waste of space. The FSA is more frightened of the Consumer Panel because it can afford to be a lot ruder. Practitioners are not empowered at Board level."
>
> CEO, Life group

"A concern is that the Practitioner Panel is too "downstream" of the FSA process. Perceived not to be in a position to shape the FSA's agenda. Difficult to gauge its effectiveness. Annual survey an insufficient base on which to canvass industry opinion."

CEO, large Unit Trust Manager

"We have a good interface with our lead regulator. However policy is done and dusted by the time it gets to us and it is a waste of time speaking to the Practitioner Panel."

CEO, Clearing Bank

"Too much of the input is from large firms with a vested interest in barriers to entry."

"The Industry doesn't have sufficient input into the FSA and it isn't heeded."

PEP and ISA Managers' Association (PIMA)

But some industry associations have a more encouraging view.

"Lines of communication are open. In the past there were too many areas of policy. The FSA has backpeddled a bit. A rush, after N2 has now stabilised."

LIBA

However the FSA still needs to heed the worries expressed about its continuing remoteness, and its modes of communication.

"Practitioner involvement and debate about industry issues has declined under the FSA. A clear feeling that the Industry has become more remote from the Regulatory Process."

CEO, European Investment Bank

"Take the four statutory objectives – there was very little industry input into this. But if you take issues with industry wide implications, like Basel 2, once the regulator does engage, it does so appropriately. Take consumer education, though, and the industry has had very little input."

CEO, Clearing Bank

Despite "consultation fatigue", there was a sense that industry responses could and did make a difference where the FSA had an open mind, but that there was no real way of assessing when this might be the case. (Best execution was an area said to have benefited greatly from discussion and consultation work.)

There is interest in underlining a more sophisticated approach to the differing sectoral requirements for communicative regulation, by splitting the Practitioner Panel.

> "The Practitioner Panel should be split into wholesale and retail."
>
> CEO,Investment Bank

These concerns about communications were also frequently raised about the quality, and quantity of the FSA's Cost Benefit Analysis (CBA). Involving the industry in the processes of CBA across all market sectors was seen as very important. The FSA is understood to be taking initiatives to include practitioner panel members as participants from an early stage in CBA work, but this must be embedded into a much more formalised system of participation.

> "Make more use of issue and market specific expert groups, to keep the FSA in touch with developments and act as a sounding board for the feasibility of ideas and initiatives before they get into the policy machine at the FSA."
>
> CEO, Asset management group

CHAPTER SEVEN

SUPERVISION AND ENFORCEMENT

Enforcement culture

The FSA's investigation and enforcement policies and methods are a subject of growing interest – and some alarm. In some recent enforcement cases (such as those involving Splits), settlement has been achieved behind closed doors. Others, such as the Legal & General (L&G) challenge in the Financial Services and Markets Tribunal, have been conducted in public.

A fully contested and expensive legal action, with heavy expenditure of time and management resource on both sides, cannot be the only way for the regulators and the regulated to resolve issues of compliance and consumer and market protection. It is to be hoped that the main lesson from the L&G case will be the need to rebuild trust and co-operation between the regulators and the providers, rather than to allow the development of yet more adversarial and expensive legal tussles. This does not deny the right of a firm or individual to resort to litigation, but represents a plea for more creative thinking by both firms and regulators to head off such outcomes.

Regulatory lawyers and their clients, facing enforcement investigations, may now well be considering how in practice the FSA intends to deploy its formal enforcement tools in future, and will be looking for the appointment of a practitioner as Director of Enforcement, following the present incumbent's move to join a regulated institution, after his spell as an FSA senior Director.

Supervision culture

The views of respondents about investigation and enforcement practices also informed respondents' general views on the quality and culture of front line FSA staff in relation to the task of supervision. Views on the quality and intensity of supervision varied depending on the respondents' position as part of the wholesale or retail worlds. It is striking, however, that many of the same complaints of lack of business sector understanding, lack of consistency, and sometimes culturally aloof and arbitrary treatment claimed in relation to some supervision staff, are also raised about the enforcement process.

Supervision: the wholesale-retail split and FSA Structure

The FSA's restructuring over the last year recognises the reality of the wholesale-retail split.[8] This is an important move towards securing appropriate supervision across all market sectors and now needs to be pushed home with even more vigour. However, many argue that it needs to be refined to recognise the completely different skills, techniques and tools needed to carry out prudential supervision, where systemic risk is the sole concern. Many also told us that they also would like to see a specific supervisory context designed for advisers in the "high net worth sophisticated investor" category, which sits uneasily between regimes designed for the wholesale and retail sectors.

It is noteworthy that Hong Kong has rejected the "single regulator concept" because of its conclusion that different types of financial services business, even within the same group, need different and specific regulatory expertise. (This would apply equally in the event of an enforcement investigation).

Issues of sectoral focus were repeatedly referred to by the wholesale respondents:

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[8] "Wholesale" refers to transactions made between financial services companies; "retail" refers to those involved in regulated business resulting in the sale of a financial product to a consumer.

"The FSA may benefit from a return to a sectoral focus since big insurance companies are lumped together with banks which is inappropriate."

Chairman, Commercial Bank

"Having sector leaders, which is completely unmapped territory, in principle looks like a good idea.

LIBA

Some even want a complete recognition of the wholesale-retail split to the extent of:

"The wholesale-retail split is a must, and fundamental to the whole problem. Ideally have two different pieces of legislation and two regulators. A separate regime for wholesale would allow the check and balance of Reputational Risk to senior individuals to be revived. It has been killed off by the single regulatory regime."

Deputy Chairman, foreign banking corporation

"Some of the problems that have been resolved in the past by the FSA being able to differentiate between wholesale and retail are noted as coming under threat from EU legislation across which client categories were often inconsistent."

CEO, Fund Manager

A complete split is unlikely. But the structure clearly needs far more refinement in recognition of these distinctions. An express recognition by the FSA that their stewardship of wholesale and institutional market confidence is a very different activity, and needs very different skills, from those needed to maintain confidence in the retail market, is a desirable first step.

Enforcement

"We need to come to a common level of understanding and trust with the industry. It is not about trapping people."

Andrew Procter, Director of Enforcement on Scoping Visits, November 2004

This is good news. But such good intentions must become apparent at all levels of the enforcement process, not merely in the expression of the good intentions of an FSA Director.

Few of the respondents, apart from regulatory lawyers and a very few of the investment management and brokerage firms, had had direct experience of enforcement. However, whether they had experience or not, good quality enforcement was felt to be an important tool in the FSA armoury.

Yet many were unhappy with the apparent arbitrariness and inconsistencies which they observed. They wanted to see evidence of a more robust but more logically targeted and competent enforcement approach. More "muscular enforcement", in a phrase recently used by John Tiner, the FSA CEO, while not exactly welcomed, was nevertheless seen as necessary, particularly in the use of the powers of disqualification and fines against senior individuals who were in serious breach of rules and principles to the detriment of the rest of the market; or who were in charge of firms allowing the continuing mistreatment of consumers.

> "The responsibility of senior management has not been pushed home. The FSA must act on this. Action against firms does not hit the bottom line. It is important that the FSA has jurisdiction over individuals."
>
> Leading Regulatory Lawyer

The same lawyer, in common with many others, argued that the FSA should be much less wary of fining or banning individuals, which he saw as the most effective – possibly the only-serious enforcement tool. This could be possible within the existing framework by making far more use of the Principles in addressing enforcement issues.

One very senior banker and former regulator agreed with this, and was outspoken about the lack of respect in which the enforcement process is held in the senior industry ranks.

> "It is now seen as OK to try to "fox" the regulators. The removal of most peer group judgement from the enforcement process means it has lost

> respect. Process has replaced action. The use of fines, however large, against firms as opposed to individuals, is useless. The cost is just absorbed, and damage to reputation is NOT long or even medium term. The FSA's contention that reputational damage is important (which it admits to using as a weapon) is wrong-headed The only real enforcement weapon is the nuclear option of de-authorisation of a firm, but with increasingly larger and larger groups, the fear of systemic damage by doing this is too great. Failing that action against individuals is the best solution. It is difficult, but not used nearly enough."
>
> Deputy Chairman, Foreign Banking corporation

In general, the fact that the FSA is both supervisor and enforcer is (perhaps surprisingly) not seen as a problem in principle by respondents. The criticism of the FSA as judge, jury and executioner, often derided as naïve, was in any case not widely made; to the contrary, it was more widely felt that the FSA can legitimately fulfil both roles so long as it does so with scrupulous attention to normal principles of fairness and natural justice, competence and consistency. Above all, it requires a transparent separation of the investigatory role from that of decision-taking on enforcement cases. This separation, though clearly required of the FSA by the FSMA, and acknowledged by it in the announcement of its latest enforcement Review, is often unclear and gives rise to great unease, and suspicion of the process within the regulated community.

The Financial Services and Markets Tribunal

There were varying views about the Financial Services and Markets Tribunal process and whether hearings should be in private. The practitioners, and trade bodies tended to favour privacy, and the ability to preserve commercial reputation until the outcome. Lawyers tended to support the status quo of public hearings. APCIMS was firm in suggesting that there should be an option for hearings to be held in private to protect the commercial needs of the firm until the outcome was settled. This was especially necessary in technical rule breach cases where there had been no consumer

detriment, but where reputational damage from a public hearing, whatever the outcome, could be disproportionate. All parties however were clear that a "costs to follow the event" discretionary provision should be introduced into the Tribunal rules, and that the failure to do this in the FSMA had been damaging to the industry's confidence that they could always achieve fair treatment from the regulator in an enforcement situation.

The Regulatory Decisions Committee

There is much serious misunderstanding about the role, purpose, and added value of the Regulatory Decisions Committee (RDC), again giving rise to suspicion and unease. This committee is an executive committee of the FSA Board co-opted from among industry peers, with a Chairman who is a senior executive of the FSA. It makes decisions about whether or not to issue "Warning Notices" against firms or individuals, in a variety of enforcement circumstances. Appeal against such Notices lies to the Financial Services and Markets Tribunal appointed by the Department for Constitutional Affairs in consultation with the Treasury.

The RDC is not, as many seemed to presume, an independent or quasi-judicial body. It was set up by the FSA to deliver another "fairness" safeguard for the industry in facing enforcement cases, but its operation is now seen by some as adversarial, long-winded and overbearing. There was considerable dissatisfaction amongst lawyers and firms about the quality of cases presented by the FSA staff to the RDC for decisions on Warning Notices. Some firms, in order to save unrecoverable costs in legal fees and management time, are said now to be choosing not to make representations to the RDC, but to accept a Warning Notice and go straight to the Tribunal.

Following criticism by the Financial Services and Markets Tribunal of the RDC's handling of evidence in the L&G case, the FSA has announced another enforcement Review (having conducted what was said to be an "end-to-end" enforcement Review only last year). This will include a review of the RDC process. This is

welcome as there are many other options for designing a fair, but speedy and less cumbersome decision-taking mechanism within the FSA on enforcement cases.

However, the FSA has now announced the process by which it will allow all those who have already indicated that they have contributions to make to the Review to do so. The process, as usual, requires much expensive up-front effort by the participants in making written representations in the first instance, about a subject where many delicate aspects of the FSA's or RDC's own competence in operating the existing system may need comment and examination. Many will be reluctant to do this "on the record". Some are already saying so. A more sensitive approach would be to hold round table discussions first (if necessary on a confidential basis) to help the FSA to set the parameters and tease out the issues, rather than at the end. This would have demonstrated that the FSA commitment to change the culture of communication by Consultation Paper was real. It might also have provided a new opportunity for the industry to participate, on a partnership basis, in examination of a regulatory problem area.

On enforcement policy, the policy of appearing to "cherry pick" cases whose subject matter conformed with an FSA theme of current interest was felt to be arbitrary, although the need to make examples of certain types of misconduct where there was consumer or market damage, was supported.

There was concern from the lawyers that that quality of case preparation could be being sacrificed to a target culture, to the unfair detriment of firms who had to submit to the process.

> "Speed of case throughput is not the only mark of a competent enforcer!"
>
> Regulatory barrister advocate

Case preparation was often described as inadequate, often necessitating the FSA in reframing the whole case, and/or introducing new evidence if it proceeded to the Tribunal, adding enormously to the expense to firms in defending themselves.

Investigation

While it was appreciated that the FSA could not go into too much detail on any particular case, there was clear concern about the lack of transparency in how and why investigations were embarked on, and their cost benefit in terms of robust outcomes. One example cited was the huge cost and open-ended nature of the Splits investigation. There was also confusion on the lack of transparency about why huge investigatory resources were employed on some cases, but not on other similar cases. CBA at the "enforcement theme selection" stage should be routinely employed and a fully transparent case audit system considered.

Time and again, anecdotal complaints were made about the lack of comprehension by the investigators of the business sector under investigation, meaning long drawn out correspondence, interviews which the firms thought otiose, and goal-post moving in the course of investigations.

Prosecution

There was very little general interest in criminal prosecution as an important enforcement tool, as compared with the use of robust civil remedies. It was thought however, that prosecutions for money-laundering or market abuse had value where the case was a strong one, but that they might better belong with the traditional state prosecution authorities rather than with the FSA as part of the totally unquantifiable objective of "reducing financial crime".

Alternative Dispute Resolution

Finally, it is unclear whether Alternative Dispute Resolution (ADR), and Mediation in particular, is a way forward. Will, for example, the recent "splits" settlement, achieved in part outside the formal enforcement process, have encouraged or discouraged firms in general about how they should proceed in future if implicated as one of a group in major problem cases? It is also uncertain how the FSA's enforcement policy on negotiated no-fault compromises will develop after the splits settlement. A reappraisal is needed of the positive and negative values of ADR to the FSA, regulated firms and consumers.

CHAPTER EIGHT

COMPLIANCE COSTS AND REGULATORY BURDENS

ONE OF THE CLEAREST MESSAGES from respondents (whether from the wholesale or retail side) was the fear of being engulfed by an unstoppable tide of regulatory costs. Direct costs were a concern – but of far greater concern were the ever growing indirect costs of compliance. The repeatedly expressed fear was that, within a short time, this could do lasting and irreparable damage both to the UK's competitiveness and to UK consumers.

The costs and burdens of UK regulation were also seen as a growing barrier to entry to the UK markets. Urgent attention to this problem is needed now.

In October 2004, a CBI Report called for a moratorium on new financial regulation to allow the industry to "catch up" with the new compliance burdens being imposed by the EU.[9] The CBI deputy Director General, John Cridland, issued the following stark warning:

> "The UK financial services industry is one of the best in the world. It is a major contributor to UK employment, output and balance of payments, but that is at risk. A robust regulatory environment is essential. But companies are being battered by the impact of relentless new regulation, forcing a dramatic and wasteful diversion of effort away from the daily battle to keep UK ahead of its competitors. It is vital that companies are given a substantial breathing space and not another onslaught."

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9 CBI, *Financial Services: promoting a Global Champion*, 2004.

The CBI's report provides a timely summary of the serious industry concerns. The Practitioner Panel Report also sets out the concerns of its 3,000 plus respondents about these issues. Almost every trade association has made representations about aspects of the problem to the FSA and to the Government. The problems and dangers were universally acknowledged by all the respondents.

Worryingly, the FSA is very cautious in acknowledging these wider fears of the increase in indirect costs and the increase in the regulatory burden. An FSA spokesperson responded to the CBI warnings by saying that "our general approach is not to impose obligations beyond what is required by Directives". Similarly, the FSA admitted in a short paragraph, in its December 2004 response to the Practitioner Panel report that:

> "One area of clear agreement is the need to focus in a serious way on the costs of compliance. The Report presents a perception of cost rather than a detailed analysis. But, like the Panel, we take the question of the costs of regulation, particularly for smaller firms, very seriously. In recognition of that we announced that one of our priorities for the coming year will be a thorough study into the costs of our regulation, with particular regard to the position of smaller firms."

Again, in response to the Treasury two year review, the FSA has accepted that:

> "A key question for us is: what can we do to reduce the FSA's contribution to the cost of regulation?"

The FSA answers its own question by going on to describe several welcome administrative improvements to the Rules and Handbook, and the FSA's ongoing achievements in centralising, mechanising and speeding up many of the core regulatory business functions. But, crucially, they do not make any more radical proposals than these, and do not admit to any link between regulatory costs and damage to competitiveness. This is not the picture as seen by the respondents, who are clear about the link, and anxious to see it recognised and acted on by the FSA.

COMPLIANCE COSTS & REGULATORY BURDENS

The recent warning by the FSA Chairman that the FSA will not consider anecdotal evidence of rising costs as a precedent to action is worrying. Respondents felt that this was indicative of a lack of urgency on the need to tackle the costs issue.

It must be stressed again that, simply because there is no hard evidence of rising compliance costs, this does not mean that compliance costs are not rising – particularly when anecdotal evidence is abundant. The annual reports of large financial institutions, for example, regularly raise the issue of rising compliance costs as a major risk. There was also a consistency of concern about the rises in "best execution" compliance costs: several respondents mentioned figures of over several hundred percent over the last decade, largely through increased staff requirements and their own costs of training.

Many of the respondents also argued that figures given by other firms were "light". One institution said that CP197 on regulatory reporting had assessed the average costs to firms as likely to be around £48,000, whereas they had calculated theirs at £1.4 million.

> "The costs of responding to the FSA are increasing all the time. This is not just a question of filling forms but an omnipresent hunger for data."
>
> Chairman, commercial bank

> "There seems to be no proper prioritisation of activities. Costs just keep rising and the bureaucratic cost for firms, not only from fees, is hugely increasing."
>
> Deputy Chairman, Foreign banking corporation

> "If the FSA disappeared tomorrow it would reduce compliance costs by three quarters and I believe the impact on the public would be pretty marginal; seven page suitability letters do not help anyone."
>
> Chairman, Life Assurance Company

> "There has to be ever increasing reliance on outside advisers, especially legal, just to keep up."
>
> CEO, Fund Manager

> "A costly computer system enhancement had been needed, to deal with the timely execution requirements, so that the fund manager could note the exact time that an investment decision was made, in order to be able to prove to the FSA that the decision and execution was timely."
>
> CEO, Fund Manager

There are numerous other examples of what is seen to be expensive bureaucracy, apparently required primarily for the defensive comfort of the regulators rather than the benefit of the market or consumers.

The burdens of regulation

The burden of regulation, generally seen to be increasing to the UK's competitive detriment, least troubled the Clearing Bank sector – one of the least heavily regulated at present. Equally, some foreign institutions in London, who were used to European regulators, were also relatively unconcerned.

Some, but not all, of the Trade Associations, with their wider viewpoints were also more sanguine. LIBA, for instance said that the FSA did help London to be seen as a well-regulated international market.

> "I believe the FSA is doing a good job. Before the FSA we dealt with four or five lead regulators. The one stop shop is good."
>
> CEO, Clearing bank

> "The FSA is well intentioned and probably more cost effective than overseas regulators."
>
> CEO, another Clearing bank

> "Probably London is slightly over-regulated, on the positive side it is perceived to be a good marketplace".
>
> Head of regulation, European Investment Bank

However at least two major fund managers felt that:

> "The UK is over-regulated compared to the rest of the EU, and in some respects even more regulated than the US."

> "The level of regulation is too *dirigiste*. You might as well put the FSA on the organisation chart. They are quite intrusive on minor issues. You feel you are being micro-managed."
>
> CEO,Clearing Bank

The feeling, expressed by some respondents, that the FSA is doing "a good job in comparison with other regulators" is not comforting in this context.

Fear of damage to confidence in UK markets

What is clear, whether based on anecdote or hard data, is that the fear of damage to confidence in the UK as a place to do financial services business, and the fear of damage to the UK's competitive advantage are real. It is thought to be caused by a combination of factors around costs, bureaucracy and the perceived sometimes arbitrary burdens of UK regulation. The most urgent concern is that the financial sector will lose its ability, or willingness to deliver innovative products at prices which consumers can afford.

The fear that the ability of larger firms to absorb the costs of regulatory bureaucracy is leading to a damaging competitive advantage for larger firms is real. The fear is real that the FSA is developing a:

> "laager mentality of thinking about what is best for the FSA and not for the industry and consumers."
>
> CEO, Insurance Group

These fears must be recognised as rational, important and in need of attention from government and the FSA.

The recent Treasury Review has announced some welcome deregulatory tinkering with some exemptions from the financial promotions regime. Other essential financial promotions deregulatory moves are to go to consultation, once the Treasury and the FSA have made their selection. There is however no real sign of any major radical deregulatory programme, particularly not one specifically addressing the concerns of many in the market

about the UK losing its international competitive edge, in the face of domestic costs burdens and European gold plating.

Onerous regulation creates a barrier to entry

Increasing indirect costs and a rising regulatory burden are perceived as creating insurmountable barriers to entry to the UK market:

> "The only advantage we derive from the FSA's existence is to create an enormous barrier to entry."
>
> CEO,Life Assurance Group

> "As a new broker we have been really alarmed by the amount of time and resource needed to address the ever increasing burden of regulation."
>
> Start up UK Private Client Broker

> "We could always relocate easily to Switzerland where we have another business if the burden gets too great. We have to use a full time compliance consultant which works well, but is very costly."
>
> Private client high net worth asset manager

The costs of regulation, and unfair competition from larger firms, are perceived to be driving small firms out of business. This reduces consumer choice and is irremediably damaging to small firms' ability to compete. This will become more and more of a problem, now that the Mortgage and General Insurance sector is regulated, causing a huge numbers skew towards smaller firms under the FSA's control.

The reluctance of consumers to pay for advice (and so pay indirectly for ever growing compliance costs) is damaging small firms' ability to stay in the market. A *de facto* reduction in consumer choice, for a number of reasons, is now seen as inevitable.

The complaints about the huge and disproportionate burdens (to the perceived benefits for markets, firms and consumers) in costs in management time, training, systems development and

responding to constantly changing requirements in relation to anti-money laundering were too numerous to document. It is accepted by the FSA that these burdens need relieving. The industry wants to see this given immediate priority

The list of fears and concerns about costs and competitiveness is a long one, and its elements are well known to the FSA. Given the volume of anecdote about competitiveness and the costs, burden and quality of regulation, and its universality of theme, it seems otiose to provide more by way of extensive quotations from the respondents. Rather the FSA should acknowledge that perceptions and anecdote about the cost of regulation are in themselves a threat to UK competitiveness. It should open a dialogue with the industry to hear their detailed complaints, and then act on them.

The gulf in understanding about what defines reasonable compliance costs, can be illustrated by one recent case. On 10 January 2005, the *Daily Telegraph* reported that:

> "Norwich Union Chief warns FSA insurance regime will add average 12 more pages of paperwork to each Norwich household policy. Each Norwich Union policy will cost an additional £2.80. These costs will be met in the main by increased premiums. A survey by Ducocorp has revealed that 92% of insurers believe that the FSA has substantially underestimated the cost to the industry of complying, and that 96% of senior managers believe that "many firms" will miss the deadline."

The FSA response was that the changes are designed to protect the policy holder, and that the cost of compliance is estimated to be around £215 million: "not great considering the size of the industry". These comments illustrate the cultural failure of the FSA to appear to understand the commercial interests of the industry it regulates. As the Norwich Union spokesman retorted:

> "Whilst we welcome any regulatory structure that reassures customers and offers them greater transparency, we believe there must be a balance between the regulation imposed and the benefits its brings".

Would not this sentiment have sat better in the mouth of an FSA spokesman, as an indication that the FSA appreciates the level of concerns over compliance costs? And the need to be proportionate in its zeal for consumer protection?

CHAPTER NINE

CONSUMER PROTECTION AND EDUCATION

NONE OF THE FSA'S OBJECTIVES is more amorphous and immeasurable than that of "Consumer Protection – securing the appropriate degree of protection for consumers". No other objective has such significant room for progress. None is so broad in potential scope and cost, as is the obligation for the FSA to "promote public awareness" of the financial system.

The FSA devotes an enormous amount of sophisticated and careful thought and a significant proportion of its budget to its role in promoting financial capability. As John Tiner said in his Mansion House speech of November 2003:

> "At the heart of the FSA's role as a regulator, is the consumer. The reasons why consumer protection features so highly in the objectives of regulators around the world have been well rehearsed and mostly revolve around that asymmetry in the firm-consumer relationship. In the UK we can also observe some persistent malfunctioning in the market – pensions mis-selling, mortgage endowments, precipice bonds. Of course consumers must ultimately take responsibility for their financial decisions, but in doing so are entitled to rely on their financial advisor or provider treating them in a fair way."
>
> John Tiner, Mansion House, November 2003.

None of our respondents disputed the principle described here. None denied that there have been major setbacks caused by many examples of negligence and culpable mis-selling, leading to consumer abuse. None denied that serious issues of mis-

governance have occurred which have harmed consumers. But all thought that the pendulum has swung too far in concern for the consumer and that serious attention needs now to be given to the restoration of a balance.

Many wanted to withdraw the task of overseeing consumer education and promoting "financial literacy and capability" from the FSA's remit. Some went further. In the context of their concern to rebalance the need to ensure effective markets with the protection of the "retail customer", a number of respondents wished to see the reworking, or removal altogether, of the objective of consumer protection. Few would think this presently a practical, or a correct outcome. But the fact that it is mentioned at all demonstrates the polarity of views on the issue of consumer protection.

> "The FSA should drop its consumer remit. It is not appropriate for the regulator to be a consumer protection unit. Take out the consumer remit from the FSMA."

There was also some confusion about whether the FSA actually had a statutory duty to undertake consumer education and financial capability (some thought it did) rather than merely a discretion, which could be adjusted to needs.

All respondents readily acknowledged, though, that education of consumers, however desirable, was an enormous long-term task. The question is whether it should be part of the FSA's remit. As the Sandler Report has noted:

> "It would take a considerable level of resource applied consistently over many years to make an appreciable improvement in standards of financial literacy across the board. In any circumstances it would be unrealistic to expect the majority of consumers to be transformed into experts on retail savings."

Many were determined that the task of consumer education was actually in conflict with the regulator's principal purpose of fostering the development of a clean innovative and competitive industry. The FSA cannot be both supervisor, enforcer of discipline

and giver of Guidance to the Industry, while at the same time educating consumers about products and their rights of redress in the event, for instance, of misselling. Consumer pressure for "more" education and assistance would inevitably take more FSA time and resource. Abandoning its consumer education role would help to rebalance the relationship between industry, consumer and regulator.

Consumer education was not seen as either a necessary or a logical aspect of consumer protection. Development of financial literacy and consumer education should be the responsibility of mainstream government, as part of the National Curriculum. Many in the industry were happy to commit resources to helping government in the task, but most were clear that this should not be part of their regulator's brief.

> "We don't feel that consumer education should be an FSA responsibility. It makes them too much all things to all men."
>
> Managing Director, fund manager and private client broker

> "The industry should deal direct with consumer education, not under the nanny tutelage of the FSA. The Industry should properly explain its own products and take on responsibility for consumer literacy."
>
> MD High Net Worth Broker and Fund Manager

> "Consumer education: this objective, as interpreted by the FSA is not a proper use of its time and creates a conflict for the regulator in trying to be educator and adviser to consumers, and enforcer and supervisor of regulated firms. Consumer education is a government job, helped by the industry."
>
> Deputy Chairman, Foreign Banking Corporation.

> "Consumer education is not a mainstream activity of the FSA. The timescale involved here are extremely lengthy."
>
> "We disagree with (the FSA's) conclusion, which is to devote more money, focus and resources to it. We recommend reeling this objective of consumer awareness from the FSMA."
>
> Sandler Report

The concept of consumer protection

> "We want to allow the retail customer to achieve a fair deal through a competitive and efficient market where customers buy wisely and suppliers sell responsibly, and where regulation is unobtrusive or even unnecessary."
>
> Callum McCarthy, December 2003 to the BBA

Following the Practitioner Panel Report in December 2004, which provided a wealth of evidence about the Industry's concerns that the balance was going wrong, John Tiner said

> "The FSA is not disproportionately focused on consumer protection to the detriment of our other objectives."

The time lapse between the two statements is significant. The need for Mr Tiner to say this indicates that there is a growing gulf of perception on this issue, which will, if not addressed, cause retail providers to vote with their feet.

> "The FSA shows a great zeal for playing safe, which leads to the danger of excluding large numbers of people from the market. It all comes down to a judgement about how much responsibility individuals should have to buy products and suffer consequences. A guarantee and a projection of returns are different things. When products extend into retirement, the uncertainty is high. The risk is that the FSA is driven by risk aversion to pay compensation, thus reducing returns to other policy holders."
>
> Chairman, Lfe Company

Almost every respondent had a view and theory on how and where the balance between industry and consumer interests should be struck. These were fuelled by resentment about how the various mis-selling issues have been handled, and a perception that consumers have been encouraged by the FSA to take advantage of the industry in circumstances where it cannot defend each and every claim for compensation, within an increasingly avaricious compensation culture. They were not comforted in this

by the apparently ungoverned approach of the Financial Ombudsman to making retrospective judgements.

Nor were they on the whole comforted by the light touch, less prescriptive, "principled" approach to Treating Customers Fairly, being promoted by the FSA. Many thought that this would not redress the balance adequately. Others suspected that the concept was too intangible against which to assess their business risks in developing products, and in promoting them to IFAs.

> "The FSA is too defensive about this. The concept of caveat emptor is dying and has to be revived. Retail consumers increasingly see the FSA's function as "paying up and getting blamed", and that they themselves have no responsibility in the process. This merely means that all the costs are passed back to the consumer, making UK products the most expensive and increasingly the most uncompetitive in Europe."
>
> Specialist regulatory lawyer

> "What does treating customers fairly mean? It is too uncertain. No one comes to work to treat customers unfairly."
>
> CEO, Life Group

> "I believe the FSA is being captured by consumers. Pro-consumer statements sell, pro-provider statements do not sell. Can you imagine the FSA saying anything to protect the provider?"
>
> CEO, Life Assurance Group

.

> "The concept of caveat emptor has been replaced by caveat vendor."
>
> CBI report, October 2004

> "The conflict between large scale retail providers wanting detailed prescriptive regulation, and smaller retail businesses being unable to cope with highly prescriptive requirements (although they like the security they offer) needs to be resolved by a much simpler "ten commandments" style principles approach."
>
> Former Managing Director, large fund management group

This last statement illustrates the need for an immediate shift to a far more principle-based, as opposed to rule-based, regulation, supported by targeted formal Guidance, to protect the smaller retail firms, and to restore a level playing field amongst competitors. The conflict between the larger scale retail providers wanting detailed prescriptive regulation, and smaller businesses being unable to cope with complex prescriptive regulation, needs to be addressed. Larger businesses support prescriptive regulation because it gives them a competitive advantage over small businesses. Prescriptive and increasingly complex regulation is killing off small business thereby negating consumer protection by harming consumer choice and denying consumers access to local accessible user friendly advice. Networks have not been able to provide a solution and are now in decline. Ever more complex waiver arrangements to allow flexibility in customer relations are not the answer.

CHAPTER TEN

SENIOR MANAGEMENT RESPONSIBILITY

THE RELATIONSHIP BETWEEN THE FSA and senior industry managers and leaders was much commented on. It was felt by a majority of respondents that a less prescriptive, less intrusive, but more sophisticated and more flexible approach to the regulation of senior people, is required. The growth and vibrancy of talent moving into private equity and hedge fund management activity, was seen in part as a response to the disproportionately costly bureaucracy of the Approved Persons regime.[10]

The concept that senior managers should take responsibility for managing their firm's risk in relation to its regulatory responsibilities was regarded as axiomatic. However, as a regulatory concept, it needed sectoral refinement, and supervising with a much improved understanding of the risks faced by, and goals aimed for, each regulated business. The key to this was more refined principle-based regulation.

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[10] With some exceptions, conduct of regulated business under FSMA requires a firm to be "permitted", and to be managed and run by, "Approved Persons". An Approved Person must be adjudged to be "fit and proper" by the FSA to carry out the specific function or functions (known as "controlled functions", of which there are 27) for which the firm has applied. Each time a firm wishes to assign an Approved Person to a new controlled function, a fresh application must be made. There is no "grandfathering" system between regulated firms, and fresh applications are needed when an individual moves firms.

The indirect costs to the industry of complying with the Approved Persons, and controlled functions regime as it currently stands, is a constant source of concern. While the FSA is currently understood to be reviewing the regime, radical relaxations in the level of bureaucracy applied to senior managers are demanded.

Respondents from the wholesale markets argued in some cases, for the total removal from application to them of the Approved Persons regime. To them, the current regime is seen as an increasingly irrelevant and disproportionate burden on a sophisticated market, representing an actual danger to the market it seeks to nurture. They want the flexibility to develop their own self-regulatory mechanisms, through codes of conduct, without regulator prescription. They need and want to be completely responsible for their own risk management.

Retail firms, on the other hand, wanted to retain the regime. The Approved Persons regime was felt to be a useful consumer and industry safeguard to keep out "undesirables", and to assist them in the task of responsible risk management. However, they too called for a sector specific approach (as opposed to the current one-size-fits-all approach). This was felt most strongly by those managing investments for high net worth individuals, many of whom argue for a completely separate "business sector" of their own, somewhere between wholesale and retail on the necessary scale of regulatory intervention, with far less intrusion into how they deal with their sophisticated clients.

> "We would want it to be the responsibility of senior managers to ensure that they employ appropriate staff."
>
> Senior manager, Investment bank

> "We don't find the controlled functions regime too bad, and like Approved Persons. It is all too complicated however, and once approved, it should be made much easier to change functions or employers with a grandfathering system, in the absence of adverse information. It helps to keep dubious people out of the industry."
>
> Senior Partner, stockbroker and asset manager

SENIOR MANAGEMENT RESPONSIBILITY

If the heavy bureaucratic requirements of the Approved Persons regime were lightened, respondents were clear that, in return, senior managers must – and would – take on greater responsibility and accountability for the behaviour of their staff and company. This is understood and accepted across the industry. The existing corporate governance regime does not need gold-plating by the FSA to achieve this aim.

> "Senior Management accountability should work through the existing corporate governance system. It is adequate and does not need gold-plating with more FSA rules."
>
> Regulatory partner, City Law Firm

> "In a properly organised institution, with proper governance and policy frameworks, I don't see how the FSA's senior management regime should differ."
>
> CEO, Clearing Bank

> "Is the FSA too prescriptive in relation to a firm's business? Firms should have more freedom in relation to operational and business affairs. Any risks to the FSA's objectives are balanced out by having effective senior management regimes."

> "Senior management should be accountable for all failings."
>
> Head of Regulation, Fund Manager

A further concern with the Approved Persons regime is that the approach is too mechanistic, with the result that the FSA is in practice laying down who they approve as directors of financial services businesses. This was felt to be inherently less flexible and sensible than previous Bank of England "fit and proper" guidance.

Most respondents also made pleas for the FSA to change its cultural approach to the treatment of senior managers. They felt that people in senior management positions nearly always have far greater commercial expertise than the individuals from the FSA with whom they have to deal. They also felt that day to day examination of their activities, and detailed and time consuming training and competence requirements were superfluous. There

were also concerns that the FSA staff were doctrinaire, made *ex post facto* judgements, and had a tendency to lecture senior managers.

On training and competence, some found:

> "It is frustrating, when I am running a sophisticated business, to attend a training course, on my responsibilities, given by relatively junior people from the FSA, and heavy on form over content."

> "As a senior manager I feel patronised by being made to sit in a Training session and be lectured from PowerPoint slides about my responsibilities by relatively junior FSA staff."
>
> Managing Director, Asset management boutique, and pension fund manager with 20 years experience

Comments about the need to ensure consistency of approach between supervisors, and between supervisors and enforcers were repeated in relation to senior management responsibility. Clear, consistent, unambiguous and regularly updated Guidance from the FSA and its supervisors is an essential component.

Respondents were worried that the intrusive regulation of senior management was deterring talented executives from taking on senior management roles:

> "People are being put off taking senior roles and are taking early retirement to escape the bureaucracy, or only taking on the jobs backed by hugely expensive contractual protections."

> "People tend to side-step (being on) the Board now. There is a sense that the situation is unfair and weighted against them. There is no upside. It significantly drives up remuneration. Rewards of non-executives are going up as well because the FSA regards them as having more of a policing role than they do. For example, as chairman of the Audit Committee. I would not accept regulatory responsibility for another company. However, the question is where you draw the line – someone must be culpable where there is negligent failure. There can never be protection against fraud or cock-up."
>
> CEO, Fund Manager

SENIOR MANAGEMENT RESPONSIBILITY

> "I don't know what this [senior management responsibility] means. If it means even if I discharge my job responsibly and with reasonable regard to risk, and follow appropriate policies and consult with colleagues, I can still be fined, this is unreasonable. I will however take responsibility if I fail to do these things, and I would expect the Board to take the same view if they fail shareholders. We must have more clarity of definition."
>
> CEO, Clearing Bank

Respondents accepted that a principle-based approach by the regulators to senior management responsibility would need to be balanced by a much tougher enforcement approach to those managers who fell short of their responsibilities and endangered the system, the market or consumers.

> "You must have someone to hang out to dry. It is the only way to get a sea change in management attitudes."
>
> Head of Regulation, Fund Manager

AFTERWORD

In announcing the Treasury review in November 2004, the Financial Secretary to the Treasury said:

> "I am confident that the range of reforms and improvements outlined will ensure that the UK's regulatory environment remains at the forefront internationally, and a model of best practice."

This is not enough.

The UK financial services industry, and the consumers of its products, need more than this. The FSA must aim, by being the world's most efficient and competent regulator, to regulate the most competitive cleanest, most innovative and most successful financial market in the world. Nothing less will do.

APPENDIX

METHODOLOGY

Context of the research

Immediately after the research period of this paper, an important statement was made by the Financial Secretary to the Treasury. Then, in December 2004, the biannual survey of practitioner opinion by the statutory Practitioner Panel was delivered to the FSA Board, and a long report on its findings issued on 16 December 2004. Both these statements have been considered, in writing this paper, together with FSA policy statements throughout the period, and, aside from the independent representations made to the team, some relevant independent research, such as the CBI paper *Financial business: promoting a global champion, October 2004*. Account has also been taken of, the FSA annual *Financial Risk Outlook*, published January 2005 its 20004/5 and 2005/6 *Business Plans*, important statements intended to inform the industry and the world, of its regulatory priorities. It also in February 2005 announced a review of its enforcement processes, following the Financial Services and Markets Tribunal decision in the Legal and General case.

The survey

This paper is based on the original research undertaken between April and November 2004 by a team of volunteers with a close interest in the capital markets and all aspects of financial regulation. The team included senior investment bankers, lawyers, asset managers, and former regulators, with broad experience as financial services practitioners. Many of the team have been active in the financial services industry since the Gower

report lead to the 1986 Financial Services Act. Some 150 firms, leading individuals and industry bodies were invited to participate, and many gave written or oral responses. Others volunteered, without specific invitation, written and oral responses. The invitation went to a cross-section of senior representatives of all major sectors, with the majority of responses coming from the wholesale sector, and the expressed intention of the invitation was to canvass a range of opinion from senior practitioners about their firms' relationships with their regulator. The following table lists the respondents with whom the team had lengthy in-depth discussions. Note that the preference of the great majority of the respondents for the interviews to be conducted on a non-attributable basis is in itself a comment of the state of the relationship between the regulator and the industry.

Type of Organisation	Level of Interview
Commercial Banks	Five interviews, two with CEOs, on with a Deputy Chairman and two with senior executives
Fund Manager	One interview with a CEO, four interviews with senior executives and one interview with a Head of Regulation
Independent Experts	Six interviews, several with long track records in senior industry positions
Research Institutions	Three interviews, at CEO or chairman level.
Law Firms	Four interviews with regulatory specialist partners and one with a specialist associate
Life Assurance Groups	Five interviews, including two with CEOs, one with a Chairman, one with a non-executive Director, and one with a senior executive
Mortgage Lender	Two interviews with senior executives
Private Client high net worth advisers and brokers	Seven interviews, including two with senior partners,three with senior executives and two with compliance directors
Barrister	One interview with a specialist in contentious regulatory discipline
Investment Banks	Five interviews with senior executives, in four Investment Banks
Trade Associations	Nine interviews, including five CEOs and four Senior Executives

SOME RECENT CPS PUBLICATIONS

THE PRICE OF PARENTHOOD **£7.50**

Jill Kirby

For many ordinary families – particularly two parent families with only one earner – the price of parenthood is too high. A couple on average income with two children pay over £5,000 a year more in tax than they receive in benefits. If they break up, they can receive nearly £7,000 a year more in benefits than they pay in tax. Why, asks the author, does the state subsidise family breakdown when it is so damaging for all concerned? America experienced a similar pattern of spiralling welfare costs but took radical steps to reform welfare in the mid-1990s and has since reduced welfare dependency by more than 50%. Jill Kirby concludes that in order to rebuild family life and cut welfare dependency, Britain must learn some of the lessons of US welfare reform – and support rather than penalise two-parent families.

"Rarely can there have been a more glaring example of a government lost in a fog of its own making than the extraordinary affair of family taxation, as exposed by the Centre for Policy Studies" – leading article in the *Yorkshire Post*

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Philippa Roe and Alistair Craig

Britain is a world leader in developing PFI projects. However, if we are to remain ahead of the pack, and export best practice to other countries, reform of PFI is now necessary. For, despite clear evidence that PFI has provided good value for money for the taxpayer, a number of criticisms have been made. For example, the uses of PFI to classify a project as "off-balance sheet" should be stopped; equally the Public Sector Comparator (the means by which a value-for-money comparison is made between the private and public contractor) should be abolished and replaced, where possible, by sector-specific benchmarking. The authors also recommend greater transparency in government liabilities for PFI projects; enhanced public sector expertise in negotiating PFI contracts; and the introduction of compulsory tendering for all the professional advisers to PFI transactions.

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Social services and the NHS are failing the 49,000 severely disabled children in this country. Care is fragmented, seemingly arbitrary and often inadequate. It is time to give disabled families more control over their own lives. To this end, the money spent by social services on 'assessment and commissioning' tasks (over a quarter of the total spent by social services on disabled children) should be paid directly to disabled families. In addition, the supply of respite and residential care homes should also be liberated by modernising the regulatory approach (through the adoption of the ISO 9000 quality control system) and by providing a more attractive fiscal regime. These proposals are consistent with the broad direction of public sector reform: they are based on giving greater choice to disabled families and greater freedom to suppliers of care to respond to that choice.
"An important and eloquent pamphlet" – Minette Marrin in *The Sunday Times*

"It comes to something when some of the most practical and insightful recommendations for improving the lot of families with disabled children come not from the political left, but from the right" – leading article in *The Independent*

WHY BRITAIN CAN'T AFFORD *NOT* TO CUT TAXES **£5.00**
Lord Blackwell
The main political parties are asking the wrong question about tax. The right question is not "can we afford to cut taxes?", but "can we afford ***not*** to cut taxes?" For cutting taxes is not only desirable both morally, economically and in terms of wealth creation. But, crucially, after a period of huge increases in public sector spending, it will also impose an essential discipline to constrain the further growth of the public sector. Blackwell proposes five reforms: raising income tax thresholds to £7,500, and introducing transferable allowances for parents with children; rescinding the £5 billion of taxes taken from pensions; increasing ISA limits to £20,000; abolishing inheritance tax; and reversing the increase in employers' national insurance contributions.
"Stopping the insidious economic damage done by bad and excessive taxes ought itself to be a key economic policy objective… If you start from that point, Lord Blackwell says, instead of assuming that spending is sacred and tax cuts are, therefore, impractical, you begin to think differently" – Patience Wheatcroft in *The Times*

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The Centre for Policy Studies is one of Britain's best-known and most respected centre-right policy research centres. Its Chairman is Lord Blackwell, a former Head of the Prime Minister's Policy Unit with extensive business experience. Its Director is Ruth Lea, whose career spans the civil service, the City, and the media (ITN). She was also the Head of the Policy Unit at the IoD.

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