

Direct line: 020 7066 9346
Local fax: 020 7066 9728
Email: enquiries@fs-cp.org.uk

John Tiner
Chief Executive
Financial Services Authority
25 The North Colonnade
Canary Wharf
London
E14 5HS

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Our ref: Principles

Dear John

Move to a More Principles-Based Regulatory Regime

The Panel is pleased to have this opportunity to input directly and from a consumer perspective into the FSA's strategic thinking on a move to a more principles-based regulatory regime. I understand that Exco will be debating this issue in September and my colleagues on the Panel and I would be delighted to provide any more information you would like from us, or further detail on the points we have made in this letter, in advance of that meeting. As a Panel we took time at our July meeting to discuss the issues ourselves. We had of course had the benefit of a meeting with both you and Lesley Titcomb in advance of this.

Given that the strategic move to a more principles-based regime has such wide-reaching implications for consumers of all financial services, there are many issues we would like to raise with you. We have set out the key points later in this letter, but more generally I confirm that the Panel supports a more-principles based regime in the wholesale market where there is more likely to be a fair balance of knowledge and expertise between the parties involved – the professionals can look after themselves. This of course is not the case in the retail market where the capability mismatch between consumers and firms and the overall complexity of the issues will quite often need to be addressed by regulatory intervention. There have also been a number of failings within the retail market, such as endowment mis-selling, which have left consumers looking to the regulator to ensure - so far as it can in a non-zero failure regime - that consumer detriment of this kind and/or on this scale does not happen again. We are open minded as to what kind of regulatory structure would do the job best, but the Panel is happy to support the move to a more principles-based regime in the retail market provided that it delivers what is needed for consumers and is robustly enforced.

We are already hearing many references to the FSA focusing on outcomes, not processes and input. We would not see the replacement of thousands of pages from the Handbook by thousands of pages of industry guidance and codes as a

successful outcome. Success lies in achieving real benefits for consumers and firms in a more fluid regulatory environment.

Rationale for Change

There is widespread support for change from European policy-makers as well as the FSA, H M Treasury and parts of industry. Consumer groups too would like to see improvements in the efficiency and effectiveness of the retail markets, which cannot be achieved by regulatory change alone - improved standards of industry behaviour are also needed. There is a perception in some areas that a move to more principles-based regulation is a route to deregulation. But it should be nothing of the kind. It should be driven by a desire for better customer outcomes, as a result of a closer match between firms' working culture and the requirements of the regulatory environment. The results of the FSA's recent mystery shopping exercises clearly show that there is a great deal to be done before this can be achieved.

We are not convinced that proper account is yet being taken of the *benefits* of regulation. It seems to the Panel that the necessary assessment of benefits is falling a long way behind work being undertaken on costs on behalf of both the FSA and others. The work undertaken by Oxera has been focused on methodology alone and could in any event have only limited application. We believe the FSA needs to take a far broader approach.

In our response to HMT's Regulatory Simplification Plan we specifically commented that the Plan was in reality being driven by a desire on the part of the Treasury to simplify regulation for the benefit of firms. Consideration of the retail consumer perspective was notable by its absence. Our concerns on this point could be eased to a degree by seeing a thorough but basic analysis of a move to a more principles based regime as an overall concept. We accept that this could be in rudimentary form, but it would have to include a rigorous and transparent analysis of consumer benefits even where they are not easily quantifiable. Although the FSA's thinking is, we know, in its early stages we believe that such an analysis should be possible and would in any event have had to have been a key part of the FSA's own initial discussions. Given that by necessity (such as various MiFID proposals) many changes are already planned or underway, it may be that the analysis could provide detail in some areas.

Industry Codes and Guidance

As trailed in the 2006/7 Business Plan we are aware that the FSA is researching how it can work with industry codes and other similar mechanisms in "defining" practices and procedures consistent with an FSA rule book based more on high level principles. If this work is to be taken forward it raises serious issues for consumers.

There is an important distinction to be drawn between the FSA working with industry to encourage best practice and the positive endorsement of particular industry codes and guidance as "definitive". The former is a positive step and we believe that constructive dialogue between the FSA and industry plays an important part in raising standards. However, endorsement or approval of industry codes and guidance would be an entirely different matter. Currently the statutory framework of the FSA ensures that there are Practitioner and Consumer Panels to advise the

regulator from their particular perspectives so that the FSA is in a position to take informed, objective decisions on its policies and practices. There is a transparent and structured consultation process which provides all interested parties with an opportunity to participate in the debate. Any industry guidance which carried any kind of endorsement or approval from the FSA and which had not been produced as a result of such an open consultative process would be an unacceptable substitute. We would therefore need to be sure that the production and adoption of such codes met acceptable standards of:

- Governance
- Open consultation
- Review
- Transparency.

It would also be important to ensure that consumers were made aware of the limitations of the codes and that apparent compliance with a code by an authorised firm would not necessarily mean that consumers could not pursue a complaint with the Ombudsman if necessary. This is linked to another area of much needed clarity, which is the extent to which the Ombudsman and possibly the Regulatory Decisions Committee will take industry codes into account. The greater the significance of the codes, the greater the need for them to have some kind of independent standing. There is also a risk that codes could be regarded as anti-competitive and we would wish to see the FSA covering this possibility in its strategic planning.

It might be that consumer bodies would find themselves having to review and contribute to the preparation of a large number of codes across the retail markets. Steps would have to be taken to ensure that consumer groups were provided with sufficient resources to enable them to participate in the consultation process and there could be resource implications for the Consumer Panel too.

Consumer Awareness

There are probably few consumers with a detailed knowledge of regulation or regulatory structure. Their confidence in the industry, such as it is, is more likely to be based on a general awareness of the regulator's existence and avenues of redress/compensation. We are about to enter a period of change that has serious implications for consumers and we believe this will require a practical and achievable plan for communicating the effect of regulatory changes to consumers. The FSA's 'mortgages laid bare' campaign was an example of a creative strategy getting to the heart of what people need to know and we would like to see a similar, equally focused strategy for the duration of the move to a more principles-based regime. There will also be a need for the FSA to allocate resources to providing information and possibly training to the consumer advice sector.

On a more specific point, I would like to emphasise again that it is vitally important that consumers are made aware that their rights are not fettered by the content of individual industry codes and that compliance with a code would not in itself mean that a firm had behaved in a way which was compliant with the relevant principle.

'Caveat Emptor'

The debate on the rights and responsibilities of firms and consumers looks set to continue, but in the short term at least we doubt that any real headway can be made. The reasons are quite simple. The findings of recent mystery shopping exercises give clear messages that the point at which the industry and consumers meet in the sales/advice process is an area with poor performance and low standards of compliance. In particular we have in mind recent work on the quality of advice in both investments and lifetime mortgages and mortgage disclosure. This is hugely significant. We fail to see how industry can expect consumers to take more responsibility for their financial decisions when they are based on a service which falls short of the minimum requirements set by the FSA. Add to this the almost inevitable uncertainty during the gradual transition to a more principles based regime and the result is enormous potential for consumer confusion and detriment. This is not an environment in which we feel the 'caveat emptor' debate can be pursued much further, but we remain committed to engaging in the process as the market changes and develops.

The Continued Use of Prescriptive Rules

Both you and Callum have made it clear to the Panel that the FSA expects to have to retain a substantial rule book, albeit perhaps half the current size, after any move to a more principles based regime. We also understand that the FSA would not be reluctant to put prescriptive rules in place where the circumstances demanded it. But there is little reference, if any, in recent speeches to the option of introducing new rules other than those effectively imposed by EU initiatives. We believe that the FSA's continuing use of prescriptive rules as necessary should be made absolutely clear.

There is also the question of the analytical process that the FSA would go through in order to identify whether reliance on principles would provide sufficient consumer protection in a particular area. It would in our view be a dangerously short-sighted approach to consider individual cases on the assumption that a prescriptive rule would *not* be required. The result of this would be that prescriptive rules would only be put in place in the event of significant market failure, in other words, after the damage had been done. We believe that the right approach is for the FSA to exercise its option not to impose a prescriptive rule only where it is satisfied that the necessary standards can be met. All areas where there has been a move to a more principles-based approach should be assessed after, say, three years and a decision taken about the success of the approach and whether prescription is required. This should be a transparent process with the issues and decisions made public.

There is still a lack of clarity about the mechanism for removing prescriptive rules. We are familiar of course with the FSA's consultation process, but we are unsure whether each intended change will be the subject of formal consultation.

Financial Ombudsman Service

The Ombudsman Service provides vital support for consumers and also helps to underpin consumer confidence in the financial services markets. I have already referred to the significance of industry codes and guidance and one of many key

issues to be established in the move to a more principles-based regime is the extent to which the Ombudsman will be taking these into account.

More generally the Ombudsman will be playing an even more significant role than at present in interpreting the principles. Both consumers and no doubt industry will be looking for some consistency and predictability in interpretation and there is a risk that there will be a temptation to apply Ombudsman rulings across the board. This might stifle the flexibility that the FSA is intending to give to firms in a principles-based environment. What the Ombudsman decides is appropriate in one set of circumstances may well be completely inappropriate in another. There is also a possibility that the Ombudsman might in effect be writing rules instead of the FSA. This is not necessarily a new issue for the Ombudsman Service, but the perception could be more damaging in this period of change and is something that should probably be addressed quickly.

Enforcement

Much has already been written about the enforcement of a more principles-based regime. We have not yet had the opportunity to discuss enforcement issues with the Director of Enforcement – Margaret Cole will be visiting the Panel in September – but there a number of key issues we would like to raise here.

At the beginning of this letter I set out the Panel's general support for a move to a more principles-based regime, provided that that it delivers what is needed for consumers and is robustly enforced. The role of Enforcement Division is going to be even more important (and no doubt more criticised) in future. The real crux of the matter is that an additional 'layer' has been added to the analytical process. In general terms, while at present the question of compliance with specific requirements is more or less a matter of fact, in a more principles-based regime there is the additional question of interpretation of the principle. By definition the flexibility afforded to firms by the greater use of principles means that individual cases and probably individual firms will each have to be looked at anew, with the possibility of using earlier proceedings as a precedent being more remote. From a common sense point of view it seems that more time and resources will be spent discussing and weighing different interpretations than would have been spent establishing matters of fact.

In addition there will be greater emphasis placed on the responsibilities of individual members of firms' senior management. As a general rule we have been told that pursuing enforcement action against individuals is usually more time consuming than enforcing corporate responsibility and that individuals are far less likely to settle than firms. The legal question of the enforceability of principles per se is not one for the Panel, but we do have concerns about the FSA's appetite for carrying forward enforcement cases where they are likely to be more expensive and time consuming than many of the cases being dealt with today. For example, the FSA has been quite open about its interest in settling cases early. As individuals are unlikely to want to settle, will there be a temptation to drop action against individuals in favour of an early settlement based on corporate responsibility? We acknowledge the benefits that early settlement of cases can bring for consumers. Nevertheless we would not wish to see this used as a bargaining chip by individuals trying to distance themselves from the consequences of their actions.

Of course it is not practical to set targets for enforcement action, as each case is entirely different. We do however expect to see evidence of senior management being held to account and of the FSA taking on cases where it believes that a firm has acted in breach of the principles, even when the resource cost is high.

Supervisory Change

There are a number of issues for the FSA to consider about the way in which it meets its statutory objectives in the new regime. We are aware that discussion of these issues has already started within the FSA. However it is not yet clear to us how the FSA will help small firms with no direct supervisory relationship with the FSA to understand and interpret the principles. Collectively these small firms have dealings with large numbers of consumers and there is a clear need for the FSA to communicate effectively with these firms. This will be a real challenge for the organisation.

As you know the Panel has always strongly supported the use of mystery shopping. This will we feel become increasingly important in a more fluid market where individual firms will have the flexibility to interpret the principles in whichever way they feel appropriate for their business. We see mystery shopping as the single most important tool available to the FSA to understand consumers' experience in the marketplace and to establish whether firms are complying with the principles at the firm/consumer 'interface'. We expect the FSA to use mystery shopping and other consumer research a great deal more than it has done to date. It has been said that in absolute terms, mystery shopping is an expensive tool. In comparison to the amounts lost by consumers in pensions and endowments mis-selling the cost is negligible of course, but we are mindful that the increased use of mystery shopping and consumer research will have an impact on the FSA's budget. We will be interested to see how this cost has been factored into the analysis that we would like the FSA to produce. It seems quite possible that ultimately a more-principles based regime would be more costly for firms and therefore consumers than the current regulatory structure.

Finally, I confirm that it is the Panel's intention to publish this letter, together with your response.

Yours sincerely

A handwritten signature in black ink, appearing to be 'J. Howard', written over a horizontal line.

John Howard
Chairman
Financial Services Consumer Panel