



6 September 2011

Our ref: ICAEW Rep 82/11

Your ref:

Isabel Summers
Transport, regulation and competition
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Dear Isabel,

A new approach to financial regulation: the blueprint for reform

ICAEW is pleased to respond to your request for comments on your consultation paper entitled *A new approach to financial regulation: the blueprint for reform*.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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ICAEW REPRESENTATION

A NEW APPROACH TO FINANCIAL REGULATION: THE BLUEPRINT FOR REFORM

Memorandum of comment submitted in September 2011 by ICAEW, in response to HM Treasury's consultation paper *A new approach to financial regulation: the blueprint for reform* published in June 2011

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INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the consultation paper *A new approach to financial regulation: the blueprint for reform* published by HM Treasury.

WHO WE ARE

2. ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter which obliges us to work in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 136,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.
3. ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.
4. The Financial Services Faculty was established in 2007 to become a world class centre for thought leadership on issues facing the financial services industry acting free from vested interest. It draws together professionals from across the financial services sector and from the 25,000 ICAEW members specialising in the sector and provides a range of services and a monthly newsletter FS Focus.

MAJOR POINTS

5. ICAEW's views on a wide range of issues were set out in our representation (42/11) on the previous Treasury consultation paper published in February. However, below we comment on a number of new issues raised by the White Paper, and also reiterate a small number of points which we think are particularly important.
6. Regarding the tools potentially available to the Financial Policy Committee (FPC), we believe that careful consideration is needed as to how these dovetail with existing legal frameworks and requirements, and other policy initiatives, whether derived from European rules or domestically.
7. We note that one-half of the recommendations issued following the first meeting of the interim FPC broadly related to financial reporting. Three factors should be borne in mind in that context: (1) responsibility for international accounting standards as used in the UK, and their interpretation, lies exclusively with the IFRS Foundation (subject to the EU 'endorsement' process); (2) the responsibility of directors for accounts as set forth in the Companies Acts; and (3) the desire of the BIS and FRC to see accounts become shorter and more accessible.
8. The best way to reconcile these considerations may be for bodies such as the FPC and the future Prudential Regulation Authority (PRA) to request that any desired 'additional' public disclosures be made as part of Pillar 3. This would allow extra information to be made available to those with particular interests while limiting 'clutter' surrounding published financial statements. That said, it is important that Pillar 3 disclosures do not take on a life of their own to the extent that they become difficult to tie back to published accounts and, potentially, lead to 'two versions of the truth'. Regarding the confidence which can be attached to Pillar 3 disclosures, it would be possible to design assurance procedures around many forms of Pillar 3 information should that be desired by market participants.
9. ICAEW believes that more explanation is required of the proposal to extend the section 166 skilled persons regime to non-regulated listed companies. We are not clear as to the rationale

for this. In our view applying an FSMA process to non-regulated entities could potentially have rather dramatic implications – at an extreme, turning them into quasi-financially regulated firms. In our view if there is a strong reason to contemplate a change of this kind, the proposed new powers should be considerably more constrained than in the draft Bill, and there should be specific checks and balances. It would also be necessary to set out how the new powers would interact with those of other official bodies, eg the Serious Fraud Office.

10. In view of the scale of change to the regulatory structure and processes envisaged, we believe that the legislation should place a statutory duty on the Chancellor to commission an independent post-implementation review of the effectiveness and efficiency of the new arrangements after they have been in operation for (say) three years¹. This should focus particularly on the efficacy of proposed innovations such as the performance and objectives of the FPC, the increased emphasis on judgement in regulation, and the more proactive and interventionist approach of the Financial Conduct Authority (FCA).

RESPONSES TO SELECTED SPECIFIC QUESTIONS

Q1: Do you have any specific views on the proposals for the FPC as described in paragraphs 2.6 to 2.24 and in Chapters 3 and 4?

11. As noted above, it is important that any FPC actions which relate to published accounts are consistent with the existing architecture for financial reporting. ICAEW believes that generally it would be most appropriate for the FPC and the future PRA to focus on Pillar 3.
12. In that context, we note that the draft Bill envisages that directions by the FPC will be subject to a tool being assigned through secondary legislation, and that section 9G (8) (p64) states that a regulator cannot be directed to act outside its powers. However, no such checks and balances surround the 'Recommendations to other persons' envisaged in section 9P (p67). While in principle such 'recommendations' are precisely that, in practice they are likely to be seen as highly persuasive. We therefore believe that at a minimum the Bill should state that such recommendations must not suggest that those to whom they are addressed act inconsistently with their legal obligations.

Q7: Do you have any views on the proactive regulatory approach of the FCA, detailed in paragraphs 2.91 to 2.110 and in Chapters 3 and 4?

13. We agree with the Government that there have been a number of episodes in recent decades which have given rise to very significant consumer detriment, which points to the need for a new regulatory approach. However, we remain concerned about various aspects of the future regulation of wholesale financial markets in the UK. The June 2011 FCA Launch Document reminds readers (para 2.5) that these markets are extremely large in global terms.
14. One risk is that the centre of gravity of the FCA will become the protection of retail consumers, and that wholesale markets will receive insufficient attention. A second risk is that these markets will come to be viewed primarily in terms of any relatively direct linkages from them to retail consumer products.
15. A third risk is that the very broad proposed definition of a 'consumer' (as described in Box 1 of the Launch Document) could lead to approaches best suited to retail regulation being inappropriately applied to wholesale market transactions among professional counterparties. (We are in any event unsure of the policy and/or legal reasons why the Government is proposing such a wide definition of 'consumer', and believe this should be explained).

¹ This would be in the spirit of the Government's intention that Ministers should be required to conduct a review of domestic legislation implementing a European directive every five years.

16. The proposed establishment of the Markets Panel goes some way to alleviating these concerns, but we believe that further steps are necessary. For example, the amended FSMA could require the FCA to 'have regard' to relevant differences between wholesale and retail markets, and that a minimum proportion of the FCA Board members have significant wholesale markets experience.
17. Turning to the approach to retail regulation, we believe that public debate is required about what the future landscape of the retail financial marketplace should look like, particularly for non-advised sales – taking into account trade-offs of the kind outlined in Hector Sants' speech to the FCA launch conference.
18. We agree that a more proactive and interventionist approach is warranted. This reflects not just current levels of consumer complaints, but also the likelihood that subdued macro-economic conditions and historically low real interest rates will lead to consumer detriment as both providers and their customers focus on a 'search for profit / yield'.
19. A prerequisite for the proposed more interventionist approach will be for the FCA, in consultation with consumers and the industry, to articulate a clear view of what a well-functioning retail marketplace would look like. That would provide a benchmark, shortcomings from which would call for FCA action. Since in many instances there will be no clear 'bright lines', publicising examples of good and bad practice is likely to be helpful.
20. In ICAEW's view 'responsible providers' is a key feature of a properly functioning market. There are some requirements on firms which should be a 'given', especially that all the key terms of a retail financial product should be highlighted in a straightforward manner. Proactive intervention should be able to enforce this if necessary. However, as regards product design itself, there may be difficult decisions for the FCA to make regarding how to approach a product which could be appropriate for some consumers, but which could be damaging to many others. It also needs to be borne in mind that even straightforward financial products can be inappropriate in some contexts – eg 'rainy day' savings balances should not normally be invested in relatively price-volatile assets such as an equity index.
21. Potential government liability also needs to be borne in mind. There is a risk of the authorities being held accountable, with the benefit of hindsight, for any failure to ban products which turned out to create significant consumer detriment, even where this was not apparent when the products were being sold. The FCA could be given legal protections, but history suggests that the government may eventually make ex gratia payments. One implication is that the FCA could be too ready to ban products.
22. A decision also needs to be taken on the extent to which the FCA should intervene not in the design of a product per se, but rather the way in which it is used commercially by the provider. For example, should the FCA aim to prevent practices through which retail savers and borrowers often find themselves moving over time into a less-advantageously priced 'back books'?
23. ICAEW believes that 'responsible consumers' should accompany responsible providers. In part this is a matter of consumers being assisted by regulators to appreciate the trade-off between risk and return. The FCA should go further than the FSA in helping retail customers understand this – especially at times like the present when the real returns to low risk assets are generally low. It might be possible for the FCA to publish estimates, perhaps on a monthly basis, of where the efficient risk-return frontier (ie the trade-off between risk and return) lies.
24. Finally, we note the importance of attention being given to how the approach proposed for the FCA (and indeed other parts of the proposed new regulatory structure) will dovetail with existing and prospective EU requirements.

Q8: What are your views on the proposal to allow nominated parties to refer to the FCA issues that may be causing mass detriment?

Q9: What are your views on the proposal to require the FCA to set out its decision on whether a particular issue or product may be causing mass detriment and preferred course of action, and in the case of referrals from nominated parties, to do so within a set period of time?

25. We agree that the FCA may be better placed than the FOS to deal with any instances of ‘mass detriment’, and that the FCA should address such cases promptly. However we were not sure what purpose is served by creating a group of ‘nominated parties’. If this includes only other parts of the regulatory structure, such as the FOS and the Panels, then the proposal does not seem to do much more than set out a particular mechanism for co-ordination. Extension to other bodies, such as consumer groups, might be beneficial if it gave them greater legal protections when providing information to the FCA – and if so presumably the list of nominated parties should be drawn to encompass all bodies with a substantive role in representing UK consumers of financial products.

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