



***FairPensions Response to HM Treasury Consultation,
'Reforming Financial Regulation: Building a Stronger
System'***

April 2011

Introduction

FairPensions (FairShare Educational Foundation) is a registered charity established to promote Responsible Investment practices by pension providers and fund managers. FairPensions champions greater transparency and accountability to the millions of people whose long-term savings are managed by institutional investors and other professional agents. FairPensions believes that Responsible Investment helps to safeguard investments as well as securing environmental and social benefits.

We work primarily with pension funds and their investment managers, and as such our comments focus primarily on questions relating to the FCA. However, we are concerned to ensure a level playing field for both beneficiaries of trust-based occupational pension schemes and individual policyholders saving with an insurance company. In this regard we also make some comments about the proposed PRA, particularly in relation to the proposed governance and accountability arrangements.

We enclose a copy of our recently-published report, *Protecting Our Best Interests: Rediscovering Fiduciary Obligation*. Much of the discussion and recommendations of this report is relevant to the issues considered in this consultation paper. The fiduciary relationship is the foundation of consumer protection in the capital markets, and it is vital that this is put at the heart of the FCA's approach to firms' culture and governance. As such, we refer to relevant sections of the report in our response below.

General comments

We note the government's concern that under the current tripartite system, *"the linkage between firm-level and systemic stability issues has fallen between the institutional cracks"* (para 1.11). We welcome the attempt to address this. However, it is important to make sure that the new system does not create new 'cracks' with dangerous implications for financial stability. In particular, it is as yet unclear who will be charged with responsibility for the important post-crisis agenda of responsible ownership by institutional investors, identified by the Walker Review and currently being overseen by the FRC and FSA through the Stewardship Code. This is particularly relevant to the large number of firms to be regulated by the FCA, which, as the consultation paper notes, *"will not individually pose a threat to financial stability, but... may, individually or alongside peers, play a significant role in particular markets or sectors"* (Box 4.E, p69). The UK corporate governance model places a great deal of emphasis on shareholder oversight as a substitute for intrusive regulatory oversight of listed companies. If this is to continue being the case, it is vital that shareholder oversight itself is subject to clear regulatory supervision. Neglect of this issue could itself pose a significant systemic risk. We would welcome clarification from the government of where this agenda will sit within the new regulatory architecture.

Our other key areas of concern, on which we expand below in our responses to individual questions, are:

- Understanding of fiduciary duties among firms who manage others' money leaves much to be desired. Ensuring that fiduciary standards are achieved in practice is a key part of the challenge facing the new regulatory system, and one which we hope will be at the forefront of the FCA's priorities in particular.
- The present review presents an opportunity to ensure a level playing field between different forms of saving, such as between trust- and contract-based pension arrangements, which are currently subject to completely different regulatory regimes. The role of insurance companies in personal pension provision deserves particular attention.
- The new regulators must do far more than the existing bodies to reach out beyond regulated entities and engage with consumer representatives and civil society. In light of the context for this review, the government must be particularly alert to avoiding the risk of regulatory capture. In this regard we are concerned by the decision to abolish the Consumer Panel for the PRA and to retain only a requirement to consult with industry.
- We welcome the proposed focus on transparency and disclosure, although we think it is important that this remains firmly focussed on its purpose of promoting consumer empowerment and public accountability, and does not become another opportunity for regulatory capture through an excessive focus on transparency to regulated entities. However, given the complexity and long time-horizons of many investment products, we also think it is important to bear in mind the limitations of consumer choice and market discipline in achieving efficient outcomes. Transparency must therefore be supplemented with robust regulatory action.

The Prudential Regulation Authority

Question 5: What are your views on the (i) strategic and operational objectives and (ii) regulatory principles proposed for the PRA?

In relation to the proposed regulatory principles, please see our response to Question 11.

We welcome the government's decision not to require the new regulatory bodies to have regard to the desirability of facilitating innovation. As indicated in our previous consultation response, we agree that in view of the events which have precipitated the current review of the regulatory architecture, this would be wholly inappropriate.

We note the government's concern to ensure that "*unnecessary regulatory burdens are minimised or eliminated*" (para 3.10). Whilst 'unnecessary' burdens are by definition undesirable, we would again refer to our comments in response to Question 11 below, noting the government's stated position that regulations to tackle systemic financial risk will be exempt from the policy of 'one-in, one-out' and the deregulatory thinking that underlies it. Again, the

context for this review of the regulatory architecture would make such an approach entirely inappropriate. In contrast to the government's position on regulation in other sectors, there appears now to be widespread political consensus that the problem in financial services has been too little regulation rather than too much. We trust that the new system will reflect this recognition, and are encouraged by indications to this effect elsewhere in the consultation paper.

Question 6: What are your views on the scope proposed for the PRA?

We welcome the government's response to the Treasury Select Committee's observation that the reforms must go beyond banking and that there must be clarity about which firms will be regulated by which regulator.

We are pleased that insurance firms have been identified as a particular area where further work is needed. In the particular case of insurance firms acting as retail pension providers, there will be a need for clear lines of responsibility and effective co-ordination between the PRA and FCA to ensure that key issues, such as investment governance, do not fall between the cracks of the new regulators' responsibilities. Chapter 2 of our report raises the issue of regulatory inconsistencies between trust- and contract-based pension provision. We believe that the present review offers an opportunity to ensure a level playing field between providers and an equal level of governance and protection for all savers, regardless of the form of their pension provision.

Question 10: What are your views on the Government's proposed mechanisms for the PRA's engagement with industry and the wider public?

We disagree with the government's decision not to retain a standing consumer panel for the PRA, and would urge that this be reconsidered. Retaining a requirement to consult with industry but not with those whose capital and financial wellbeing is at stake seems at odds with the government's stated aim of creating a more robust and effective regulatory system. As the government appears to recognise at para 4.68 of the consultation paper, the interests of consumers do not begin and end with consumer-facing activities. The paper notes that making a firm distinction between wholesale and retail activities would be a flawed approach. We believe that making such a firm distinction between the management of systemic risks to financial stability and the protection of consumers is equally flawed. Moreover, requiring the regulator to consult with regulated entities but not with any other stakeholder groups heightens the risk of regulatory capture, which would be fatal to the new regime's ability to fulfil its stated objectives. We urge the government to reconsider this decision and to provide for some form of wider consultation and engagement by the PRA.

Please see also our response to Questions 11 and 12.

The Financial Conduct Authority

Question 11: What are your views on the (i) strategic and operational objectives and (ii) regulatory principles proposed for the FCA?

As the consultation paper points out in paragraph 4.1, restoring trust is crucial to rebuilding a stronger financial system. We therefore welcome the focus on enhancing trust and confidence and the emphasis on consumer protection, including the intention that the definition of ‘consumer’ will be widely drawn to capture all relevant service users.

However, we are somewhat concerned that the operational objective of “*facilitating efficiency and choice*” is placed ahead of that of “*securing an appropriate degree of protection for consumers*”. At the launch of our recent report on investors’ fiduciary duties, the chair of a leading asset management firm observed that the mantra of ‘choice’ has given consumers thousands of different funds to choose from, but has not delivered the one thing which research suggests savers really want: a system they can trust.¹ We agree that the operation of competitive markets is important for savers. However, as the government recognises at paragraph 4.26 of the consultation paper, the nature of financial products is such that the exercise of consumer choice may be less effective than in many other sectors. As a recent OECD paper pointed out, “*Given the complexity of investment matters and the long horizon of pension matters, expectations [that market forces will lead to efficient outcomes] may seem unwarranted.*”²

If there is to be a trade-off between the proposed first and second operational objectives, it is therefore vital that the second – effective regulation to protect consumers – takes priority. We trust that this is the government’s intention, given the FCA’s overarching strategic objective of protecting and enhancing confidence, and the stated aim that it will be a ‘consumer champion’. However, the first sentence of paragraph 4.21 could be read as suggesting that the current first operational objective is intended to take priority over the other objectives. Consequently, we would suggest that “*facilitating efficiency and choice*” should be positioned as the FCA’s third objective rather than the first and that it be made clear that this repositioning reflects the FCA’s intended order of priorities.

These comments are also relevant to the proposed third regulatory principle that ‘*consumers are responsible for their decisions*’ and the fifth principle of ‘*openness and disclosure*’. FairPensions champions consumer empowerment in financial services, and we therefore agree that “*informed and capable consumers exercising power through market discipline can be far more powerful than regulatory action*” (paragraph 4.26). In particular, we strongly support measures to improve transparency and to ensure that information

¹ See for example FRSA, ‘*Tomorrow’s Investor*’, Dec 2010, p9.

http://www.thersa.org/_data/assets/pdf_file/0009/366948/RSA-TI-report-Pensions.pdf

² Stewart, F. and J. Yerno, 2008, ‘*Pension Fund Governance: Challenges and Potential Solutions*,’ OECD Working Papers on Insurance and Private Pensions, No 18, OECD publishing

relevant to the fulfilment of investment agents' duties to their clients is made available to the market as a whole.

Conversely, there is a danger in assuming that enhancing the information available to consumers will necessarily be sufficient to protect their interests. As the paper appears to acknowledge, it is impossible to eliminate the information asymmetries that characterise financial services, and therefore to arrive at the conditions necessary for informed consumer choice to be a reliable tool for achieving fair and efficient outcomes. (Paragraph 4.26, however, seems to suggest that the disadvantages suffered by retail customers might be sufficiently offset through the efforts of the CFEB. Much as we support the CFEB, we think that any such suggestion would be quite unrealistic.) Given these circumstances, we consider that the principle "*consumers are responsible for their decisions*" can be accepted only with significant qualifications. Indeed, legally speaking, fiduciary duties apply to agents responsible for managing other people's money precisely because those people are vulnerable in relation to their agents, and the principle of 'caveat emptor' is therefore inappropriate. Our recent report concluded there is a need for a fundamental review of the way fiduciary duties apply to investment intermediaries – particularly as regards the management of conflicts of interest.

While it is of course important that conflicts are disclosed, this is unlikely in itself to protect consumers from the destructive effects of such conflicts, particularly where individual savers are concerned. It is therefore critical that there is effective regulatory supervision of the management of conflicts, and, where necessary, regulatory requirements to avoid situations which give rise to conflicts. In summary, we hope that these regulatory principles will not become the basis for an overly 'hands-off' approach to financial regulation. In addition, if the focus on consumer responsibility is to be meaningful, there will need to be a much greater focus on genuine transparency and empowerment of consumers of all kinds than has hitherto been the case.

Regarding the second principle of 'proportionality', we wholeheartedly agree that regulation should be proportionate. We suggest that there would be benefit in clarifying that this principle does not mean a presumption in favour of deregulation, as it appears sometimes to be interpreted. In this regard we note the statement by BIS, in announcing the policy of 'one-in, one-out' regulation, that "*regulations... to address systemic financial risks will be excluded from the One-in, One-out system*".³ We have not seen any subsequent reference to this exclusion in government documentation on 'one-in, one-out'. In the wake of the crisis, a clear break with the discredited 'light-touch regulation' of the past is clearly vital to the FCA's objective of restoring public confidence in financial services. We therefore suggest that there would be value in confirmation from the government that 'proportionality' means just that and does not entail a presumption against regulation, and that it remains the government's policy to exclude regulations of systemic financial importance from its deregulatory agenda.

³ <http://nds.coi.gov.uk/content/Detail.aspx?ReleaseID=414871&NewsAreaID=2>

Finally, we wish to comment on the fifth and sixth proposed principles, those of public disclosure and regulatory transparency. We welcome the principle of transparency in the conduct of the regulator's business, and agree that public disclosure is a vital tool for making the new system more accountable than the last. We would caution that this must translate into a real commitment to public engagement and consumer empowerment, rather than a euphemism for regulatory capture through an excessive focus on being 'transparent' to regulated entities. As a civil society organisation defending the interests of savers, our experience suggests that the existing FSA has much further to go in making its activities "*open and accessible... [to] the general public*" as opposed to the regulated community. We would suggest adding to the sixth principle an explicit recognition that openness and transparency should be particularly focussed on stakeholders beyond the regulated community, such as consumer organisations and the general public.

Question 12: What are your views on the government's proposed arrangements for governance and accountability of the FCA?

We welcome the retention of the Consumer Panel and the fact that the government "*expects the FCA to engage more directly with consumers.*" We believe this is an area where much more could be done. As a small charity working to improve accountability to the ultimate beneficiaries of pension schemes, we have found it very difficult to engage with the FSA. In this regard we would reiterate the points made in our response to the previous round of consultation:

Firstly, it is important that the construction of the Consumer Panel ensures that the interests of all relevant consumers are adequately represented, reflecting the wide range of firms that will be overseen by the FCA. In particular, the understandable focus on retail banking and mortgages must not lead to the neglect of pension fund members and insurance policy holders whose assets are entrusted to the capital markets.

Under the present system where panellists are selected through open competition, the only mechanism for guaranteeing this representation is through the panel's engagement with external organisations. This is unsatisfactory, particularly as many organisations representing the interests of ultimate asset owners are not those generally thought of as 'consumer groups', but also include trade unions or civil society organisations. Possible options for overcoming this could include

- Direct representation of consumer representative groups on the panel;
- Requirements that the panel's composition is representative of the full range of consumers affected by the activities of FCA regulated firms;
- Replacing the present requirement in the terms of reference for the Panel to 'have regard to the interests of all groups of consumers' with a more detailed list of groups that ought, *inter alia*, to be considered (including ultimate asset owners such as pension savers); or
- A more formal process for ensuring the panel liaises with all relevant organisations.

We have also observed an acknowledged tendency for the FSA to assume that consultation with the Consumer Panel removes the need for further engagement with consumer groups or civil society, which contributes to the industry bias in public consultations. This is particularly concerning given that the Consumer Panel does not guarantee direct representation of consumer groups. By siloing consumer voices in this way whilst giving regulated entities multiple opportunities to air their own views, the current system may frustrate its objective – and is unlikely to be sufficient for a new body intended to be a “strong consumer champion”.

We would suggest either that the role of the Consumer Panel be extended to facilitating wider consumer engagement with the work of the FCA, or that the FCA itself be required to have regard to the need to engage with consumers.

Question 13: What are your views on the proposed new FCA product intervention power?

We would like to comment on the “proactive and preventative” approach which underlies the proposed new FCA product intervention power. We welcome the enhanced focus on intervention and the recognition that the FCA needs to go beyond a ‘point-of-sale’ approach. In response to the concerns raised that “earlier regulatory intervention in the product lifecycle could lead to less choice for retail customers” (para 4.59) we would reiterate that wider choice does not benefit consumers when it comes at the expense of trust in the products available. A product intervention power used sensibly and proportionately therefore clearly offers benefits to consumers which far outweigh any reduction in choice.

We hope that the enhanced focus on ‘early intervention’ represented by the product intervention power will be matched by an equally strong focus on *ongoing* supervision of product governance – including the management of conflicts of interest, the level of fees and charges, and investment governance and stewardship. As chapter 2 of our report observes, these issues are fundamental to outcomes for consumers, but have historically not been treated as consumer protection issues. It is vital that they do not fall between the cracks of the PRA and FCA’s priorities.

In this regard we particularly welcome the proposal that “*all firms will be subject to a periodic review of their governance, culture and controls*” (para 4.56). We hope that this will build and expand on the FSA’s ‘Treating Customers Fairly’ initiative, and that it will include a strong focus on firms’ understanding of their fiduciary duties to their clients, their management of conflicts of interest, and the extent to which they possess a culture of putting clients’ interests first. Again, chapter 2 of our report finds that, although many asset managers describe themselves as fiduciaries, this is not always matched by a sophisticated understanding of what this means in practice, particularly in relation to the duty to avoid conflicts of interest. The fiduciary relationship is the foundation of consumer protection in the capital markets, and it is vital that this is put at the heart of the FCA’s approach to firms’ culture and governance.

Finally, we particularly welcome the government's recognition that it would be unwise to make too firm a distinction between the regulatory approach to wholesale and retail markets, since "*retail consumers have as much of an interest in the quality of wholesale conduct regulation as institutional investors or corporate clients, given that this is where their savings and pensions are ultimately invested*" (para 4.68). We are pleased to see that "*dealing with these interactions and linkages will be part of the FCA's role as an integrated conduct regulator*", and look forward to seeing further details of how this will be achieved.

Question 14: The government would welcome specific comments on:

- **the proposed approach to the FCA using transparency and disclosure as a regulatory tool;**
- **the proposed new power in relation to financial promotions; and**
- **the proposed new power in relation to warning notices.**

We wish to comment only on the first of these. Notwithstanding our comments in answer to question 11, we agree that transparency is a vital regulatory tool and a necessary (although not sufficient) condition for a properly functioning market. This applies both to disclosure of enforcement action by the FCA and, perhaps more importantly, to disclosures by firms themselves to consumers and to the market as a whole.

Our report raises, in particular, the importance of disclosures on conflicts of interest (chapter 2, pages 35-43) and on the voting and engagement activities of firms authorised to manage investments (chapter 6, pages 121-123). These are both vital to giving consumers visibility on how their agents are serving their best interests. Our own research has found significant weaknesses in leading asset managers' disclosures on their policies to manage conflicts of interest.⁴

Transparency is important for individual as well as for institutional clients. It is disappointing that the FSA appears to take the view that there is no point requiring firms to provide certain information to retail customers since they are powerless to act on it. For instance, the new requirement to disclose a firm's commitment to the Stewardship Code has not been applied to retail investment providers, on the basis that "*in practical terms, we see limited potential for individual retail investors to direct the stewardship practices of asset managers.*"⁵ While we agree that individual consumers may find it more difficult to exercise their consumer power, the answer to this must be to supplement transparency with effective regulatory supervision. We hope that this more robust approach will be the one taken by the FCA.

⁴ FairPensions, December 2010, '*Stewardship in the Spotlight*'.

⁵ FSA, November 2010, *Handbook Notice 104*, p20

Question 17: What are your views on the mechanisms and processes proposed to support effective coordination between the PRA and the FCA?

We agree that effective co-ordination between the PRA and FCA will be vital to the success of the new regulatory framework. Whilst endorsing the government's objective to allow the PRA and FCA flexibility on how they engage with each other rather than laying down an overly bureaucratic and inflexible process, we do believe there would be value to setting out some of the substantive issues where co-ordination will be necessary and which must therefore be included in the Memorandum of Understanding. We trust this is the government's intention at para 5.13 of the consultation paper. As indicated above (see general comments), we believe that the exercise of shareholder oversight is one area where co-ordination between the PRA and FCA will be important. The regulation of insurance companies is another (see response to question 6).