FairPensions™
The campaign for **responsible** investment

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Financial Regulation Strategy
HM Treasury
1 Horse Guards Road
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Sent via email to financial.reform@hmtreasury.gsi.gov.uk

Friday 15 October 2010

To whom it may concern,

FairPensions welcomes this opportunity to respond to the consultation *'A new approach to financial regulation: judgement, focus and stability'*. FairPensions is a project of The Fairshare Educational Foundation, a registered charity (no 1117244) established to promote Responsible Investment by UK pension schemes and fund managers, and to ensure that ultimate asset owners are well served by institutional investors and other professional agents in the investment world.

FairPensions is a member organisation. Our members include organisations representing the beneficial owners of pension schemes, such as the National Federation of Occupational Pensioners, UNITE and Unison, as well as thousands of individual pension fund members.

Introductory remarks

Effective regulatory oversight of corporate governance and, one step up the chain, oversight of investor behaviour is essential to the protection of beneficiaries' assets and the long-term health of the financial system. FairPensions has a history of engagement with post-financial-crisis reviews of this issue, including the Walker Review and the FRC's consultations on the Corporate Governance Code and the Stewardship Code. All our responses are available on our website at: http://www.fairpensions.org.uk/policy.

Clearly, the objective of reorganising the regulatory architecture must be to improve its capacity both to mitigate systemic problems at an early stage and to respond to crises when they do occur. We recognise that the focus will inevitably be on bank supervision. However, the new framework's effectiveness in supervising institutional investors will also be key to its ability to deal with systemic risk and prevent another crisis. As BIS Minister Edward Davey recently remarked in a speech to the Association of British Insurers,

> *"These issues – promoting strong boards and engaged shareholders – are particularly important when considered in the context of the financial crisis. After all, the failings of the financial institutions, their management and owners, were an important factor in bringing about the crisis. And the Government recognises, of course, that significant changes are also needed to regulation. This is why the Government is consulting on the future of UK financial regulation."*

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In our view, this recognition must go beyond the proposal for a new Companies Regulator. It is important that responsibilities for supervising investment firms and occupational pension schemes are divided in a sensible and effective way, and that, in attempting to resolve the weaknesses of the tripartite model, the government does not create new gaps in supervision. In particular, the agenda of promoting active investor stewardship, including through the work of BIS and the FRC's Stewardship Code, must be supported and not undermined.

It is also vital that the voice of consumers is not drowned out by that of industry. The proposed CPMA is a welcome move in this respect. However, it is crucial that questions of consumer protection do not become siloed into the CPMA, and that the interests of ultimate asset owners are represented and reflected across the regulatory system. Risks to consumers are not limited to consumer-facing activities: poor corporate governance, conflicts of interest and inadequate risk management ultimately affect consumers just as much as high interest rates or unfair overdraft charges. Consumers with pension savings in the capital markets are particularly vulnerable, since they increasingly bear the investment risk associated with their savings, and are not subject to the same government guarantees as bank savings in the event of catastrophic losses.

In light of these general comments, we respond below to specific questions insofar as they are relevant to our remit.

Q4/10: The government welcomes respondents' views on… whether, specifically, the requirement to have regard to potential adverse impacts on innovation or the competitiveness of the UK financial services sector of regulatory action should be retained.

We agree with the argument expressed in the consultation paper that "the case for making global competitiveness and innovation in financial services part of the responsibility of a regulator charged with ensuring the safety and soundness of risk-taking financial firms needs to be reconsidered." As the paper points out, there is a strong argument that a concern for competitiveness and supporting financial innovation contributed to the regulatory failures leading up to the financial crisis. We would go further and say that this argument is almost incontrovertible. If the government is serious about responding to the failures of recent years, it must be made clear that the regulators' responsibility is to the health of the wider economy and the protection of consumers – and not to the industry it regulates. We therefore do not believe that the requirement to have regard to potential adverse impacts on innovation or global competitiveness should be retained for either the PRA or the CPMA.

Indeed, this requirement may not itself be in the interests of genuine competitiveness. In the long term, the best way for the regulator to promote competitiveness must be to restore the trust and confidence of market participants and ultimate asset owners which has been so badly damaged by the recent crisis. This requires confidence that the regulatory approach is more robust and less conflicted than that which preceded the crash. Removing the requirement to have regard to adverse impacts on innovation and competitiveness would send a strong signal that this is the case.

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Q7: Are safeguards on the PRA's rule-making function required?
Q8: If safeguards are required, how should the current FSMA safeguards be streamlined?

In this regard we would comment only on our own experience that, within the current FSA rule-making framework, consultation processes have a tendency to become less a safeguard than an opportunity for intense industry lobbying and, potentially, for regulatory capture – thus damaging rather than enhancing the safety of the system as a whole.

This is not necessarily an argument against any safeguards or consultation – merely a factor which we would urge the government to bear in mind when designing the new mechanisms. Removing the requirement for regulators to have regard to adverse impacts on competitiveness and innovation would help to minimise this risk. It would also be advisable to explore means of ensuring that public consultations gather representations from a range of interests and views, rather than simply those of regulated firms – for example, through statutory consultees or a requirement for the PRA proactively to solicit responses from other parties with an interest or with independent expertise, such as consumers, civil society or academics. These stakeholders often have far more limited resources than regulated entities, and so find it difficult to monitor or engage with consultation processes in the absence of such support. In our experience, consultation responses tend to be overwhelmingly dominated by industry voices, with the result that strong initial proposals by the FSA are watered down or abandoned altogether.

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

We wish to make two brief points about the Consumer Panel. 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 CPMA. 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 CPMA 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.

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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 (see response to Q7&8). 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 FSA, or that the FSA itself be required to have regard to the need to engage with consumers as per our suggestions in response to Q7&8.

We would also suggest that, given the government's objective to make the CPMA "a strong consumer champion in pursuit of a single objective", it might be appropriate to offer a justification for retaining a practitioner panel. This would help to allay any concerns about regulatory capture and improve consumer confidence in the new regulatory system.

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

We welcome in principle the idea of bringing together corporate information, corporate governance and investor stewardship in a single, powerful new companies regulator, and hope to contribute to BIS' consultation in due course.

We are aware that some concerns have been raised about the proposed transfer of the UKLA into the FRC. We remain to be convinced of these objections. In particular, we would comment that the concerns raised about whether the FRC is equipped to undertake forward-looking, proactive market supervision open up wider questions about the FRC's role and regulatory approach, which we believe merit further consideration. A strengthened, more proactive FRC would seem to be implicit in the government's proposals. Perceived inadequacies in the FRC's *present* focus and capabilities therefore would not seem to be a strong reason for rejecting reform in this area.

Our main concern, however, is that the fate of company regulation in general should not rest on the decision whether to proceed with the merger of UKLA and FRC. In our view, the proposal to create a new companies regulator is not contingent on this move, and there remains a strong case for it regardless. Moreover, the need for strengthened supervision of companies and their investors would remain even if regulatory responsibilities continued to be divided along present lines. One widespread concern that has emerged during BIS' consultation on narrative reporting is the inadequacy of enforcement of the current reporting framework. The creation of a new companies regulator would present an opportunity to enhance or replace the Financial Reporting Review Panel (FRRP), and we very much hope that the government's proposals will reflect this.

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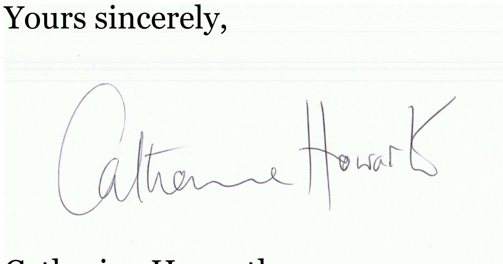
We are also hopeful that the creation of a new body could bring renewed focus and impetus to the stewardship agenda. Our one concern is that this should not accentuate the tendency for this agenda to be subsumed into corporate governance. This tendency is reflected in the FRC's Stewardship Code, which treats stewardship activities largely as a means of enforcing the Corporate Governance Code, and implies that they arise from an obligation to investee *companies*, rather than an obligation to ultimate asset *owners* to protect and enhance the value of their pension savings or investments.

The recent failure of institutional investors to challenge poor corporate governance in financial institutions, which has prompted the current focus on investor stewardship, had devastating effects on ultimate asset owners such as pension savers. In our view, promoting greater accountability to those whose assets are at stake, and a culture of long-termism that protects their interests, must be central to the regulatory agenda. It would therefore be unfortunate if oversight of stewardship was entirely divorced from that of consumer protection in the retail investment market. Indeed, the present review provides a good opportunity to draw these connections more explicitly, and we hope this opportunity will be grasped.

We remain at your disposal and would welcome the opportunity to meet with you to discuss any or all of the above.

Yours sincerely,



Catherine Howarth
Chief Executive, FairPensions

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