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Dear Ms Bantanidis

Consultation Paper CP 09/10*
Reforming remuneration practices in financial services**

This is the Financial Services Consumer Panel's response to CP 09/10*** Reforming remuneration practices in financial services.

Overview

The Panel supports the introduction of a mandatory Code of Practice on remuneration by way of a new rule in the FSA Handbook and we welcome too the debate on possibly extending the requirements to authorised firms other than those being covered in the current proposals.

We subscribe to the widely held view that remuneration practices have been a contributory factor in the current financial crisis. Remuneration is also an important factor in trying to rebuild consumer confidence during the aftermath of recent banking failures. Consumers have had enough of senior executives being paid high salaries and bonuses that exceed most consumers' annual income many times over, while at the same time running financial institutions into the ground, particularly when it is the taxpayer who then has to bail them out. The importance of a sea change in the approach to remuneration should not be underestimated if retail consumers are to engage in financial services with any degree of confidence and trust in future.

Q1: Do you agree with our analysis on the need for change and the gaps in the current regulatory approach?

There is a need for changes to remuneration practices arising from the analysis of the Turner Review. This drew attention to the harmful effect of economic rent extraction made possible by the opacity of margins, the asymmetry of information and knowledge between end users of financial services and producers, and the structure of principal/agent relationships. Although the Review focused on rent extraction in the context of complex securitised credit, recent research indicates that this practice is a general phenomenon in current financial markets.

Q2: Do you think that introducing this Code into the Handbook as proposed would have adverse implications for the UK as a financial centre? Or do you think its introduction might have neutral or positive implications?

This will depend to some extent on the steps taken internationally and we recognise the risk of regulatory arbitrage. We note from the Paper that the FSA will be taking into account how other countries will be implementing regulatory changes to improve remuneration policies when deciding how to proceed in the UK. Given the UK's leading role in worldwide financial markets we urge the FSA to take the initiative by putting in place a mandatory Code, ahead of approaches taken in other jurisdictions. There is little or no prospect of building UK consumer confidence in financial services without firm and transparent regulatory action on remuneration.

Q3: Do you agree with this analysis of market failure?

Paragraph 1.21 of the CP states: "we are not concerned with the levels of remuneration, which we regard as a matter for firms' boards and shareholders." Nevertheless, rent extraction acts to the detriment of consumers by raising transaction costs above the level which would arise in an efficient market. It should therefore be the objective of the regulatory regime to bear down on this by promoting efficient markets. This is a further argument for reforming remuneration practices.

Q4: Do you have comments on the content or the scope of the draft Code?

The proposed Rule (paragraph 5.8) should be extended '... and promote effective risk management and efficient markets.' It is to be hoped that the Code would improve market efficiency. The FSA should monitor its impact by, inter alia, estimating the scale of rent extraction by the sectors to which the Code applies.

Q5: Do you agree with our proposal to make the general requirement into a rule and the specific principles into evidential provisions, so that the Code becomes enforceable?

We agree. The conduct of the banking industry as a whole before and during the financial crisis has clearly shown that no reliance could be placed on any kind of voluntary code. There is no point in setting an enforceable rule if it is not enforced in practice, however. Swift and vigorous action by the FSA in cases of non-compliance will be a necessary part of delivering the right messages to firms.

Q7: Do you have any comments on the suggestion that firms publish an annual remuneration statement?

We support this suggestion which would bring a welcome level of transparency to firms' remuneration policies.

Q8: Do you think that the scope of the Code should be extended to cover the remuneration policies in firms which are undertaking outsourced or contracted activities on behalf of a firm subject to the provision of the Code. If so, what should the scope of such a requirement be (for example should it just be limited to firms carrying out FSA regulated activities)?

There must in our view be some form of extension of the Code to these firms in order to close a potential loophole in the application of the proposed Rule. Generally speaking, FSA authorised firms that outsource specific regulated activities are responsible for compliance by the outsourced firm. There could be practical difficulties in extending this practice to remuneration policies, but we do think that FSA authorised firms must take some responsibility for the outsource choices that they make in terms of remuneration policy and risk management overall.

Q9: Do you have any comments on our proposals for the implementation of the Code and transitional issues?

We support the FSA's proposals for implementation and transitional issues. The timetable, including the final transition date of 6 November 2010, seems practical.

Q12: Do you agree that remuneration risk is part of business risk? Should remuneration risk be specified in GENPRU 1.2.30R as a separate major source of risk that firms should, where relevant, identify and manage?

Yes, we agree that remuneration risk is part of business risk and that it should be identified and managed appropriately.

Q13: Do you think that there are concerns about inappropriate remuneration practices in financial firms besides those covered by our consultation proposals? If so, what in your view are the principal causes for concern?

We have a general concern that remuneration practices that are linked in any way to targets/sales volumes or reward based on short term performance can impact on firms' behaviour and, ultimately, the way in which they treat their customers.

Q14: Do you think that the scope of the Code should be extended to all FSA-authorised firms?

Given that the Code represents best practice we believe there is a strong argument for extending it to all authorised firms, on a basis that is proportionate and appropriate for the individual business. It would be sensible to establish a de minimus threshold to exclude businesses such as credit unions.

Q15: If so, do you think that it should be on the same basis as for banks, building societies and the larger broker dealers, ie with one Handbook rule and ten evidential provisions?

The FSA's approach – one Handbook rule, with evidential provisions – is entirely appropriate, but there would have to be flexibility within the evidential provisions for different types and scales of business.

Q16: In your view, what would be the benefits and costs of extending the Code to all FSA-authorised firms?

There are numerous benefits from this approach. Given the high levels of consumer distrust and lack of confidence in banks and other financial organisations, the application of the Code would bring a level of much-needed transparency and honesty to financial services markets. It would also be evident that the risk of

remuneration practices skewing the business to the detriment of consumers had been recognised and was being managed. We would not have expected the cost of applying the Code across the board to be significant.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Adam Phillips', with a long horizontal flourish extending to the right.

Adam Phillips
Acting Chairman
Financial Services Consumer Panel