Financial Services Consumer Panel
AN INDEPENDENT VOICE FOR CONSUMERS OF FINANCIAL SERVICES

THE TURNER REVIEW

A RESPONSE FROM THE FINANCIAL SERVICES CONSUMER PANEL

June 2009

The Turner Review

A response from the Financial Services Consumer Panel

Index

	Page
Introduction	**3**
Overview	**5**
The Turner Review: Responses to the recommendations	**8**
Deposit insurance	**8**
Remuneration	**9**
Macro-Prudential analysis	**10**
FSA supervisory approach	**11**
Firm risk management and governance	**15**
Cross–Border banks	**17**
Open questions for further debate	**18**
Conclusion	**19**

Introduction

1. We welcome Lord Turner's frank exposition of what went wrong in the financial markets to cause the financial crisis. As industry, governments and regulators work hard to get the financial system working effectively again, we want to ensure that the interests of consumers are protected. We therefore offer some reflections from a consumer perspective.

2. Ultimately the retail consumer is severely affected by what has happened. Not only are consumers, as taxpayers, shouldering the bill for the assistance, they are finding it more difficult to raise mortgage finance; they are facing lower rates of interest on their savings as Governments move to reflate economies; and they are facing higher rates of interest for credit. While focus is properly on ensuring that macro-prudential risk is appropriately managed and supervised going forwards, regulators and Governments should ensure that the interests of the consumer are fully considered as they take these reforms forward.

3. Against this background we offer some views on those aspects of the review and associated Discussion Paper which have most impact on consumers. In addressing the proposals we have taken a wider perspective on the effectiveness of the FSA from the consumer viewpoint. In our view this is an appropriate time to challenge whether the FSA's regulatory approach and powers are adequate and used effectively to deliver against the Consumer Protection objective. We would therefore like to highlight the following key points:

    a. **The FSA must not dilute its focus on conduct regulation.** Whilst additional focus on prudential regulation is crucial at this time, we anticipate that in the race to generate much needed revenue firms are likely to indulge in behaviours which will lead to consumer detriment. Therefore the need for good conduct of business supervision is crucial.

b. **The FSA should be a more transparent regulator.** FSA should name and shame firms who are in breach of regulatory obligations. Consumers have a right to know more about the shortcomings of the firms with whom they deal well before the ultimate sanction of enforcement action by the FSA. Enforcement is not the only regulatory tool used by the FSA to change firms' behaviour and we would like to see the full suite of tools deployed more transparently.

c. **The FSA should regulate all aspects of business of the firms it authorises, including provision of consumer credit at present regulated by the Office of Fair Trading**. We believe that this would encourage a more mature approach to responsible lending and would give clarity to consumers who expect there to be one regulator. We do not believe that this should be entirely on a principles basis and we believe that consumers should retain protection under the Consumer Credit Act. It remains our concern that some of the most detrimental practices occur in the provision of credit

d. **The FSA should take a tougher stance on Enforcement.** In particular we believe that the FSA should take a tougher stance on past business reviews so that consumers obtain redress when they should.

e. **The FSA must strengthen its interrogation of business models.** The FSA has signalled its intention to do so, however this should be not only to identify emerging and growing prudential risks, but also business models which have the potential to create significant consumer detriment.

f. **The FSA must consider the benefits of product regulation for certain sectors of the market.** We welcome the commitment by the FSA to produce a Discussion Paper on this topic later in the year. It is not clear that this is the best way to

reduce the risk of consumer detriment arising, but it is an issue which needs consideration in the light of recent events.

4. We would emphasise that it is crucial that the consumer interest is given due attention while the debate on regulatory reform moves forward. We will reflect more on this as the Government, the FSA and the industry take forward implementation of the reforms which fall out of the Turner review and the wider debate on financial regulation

Overview

5. As the Turner review illustrates, market discipline failed to restrain excessive risk-taking so clearly there is a need for enhanced regulation. However regulation can only get us so far. What is missing from the review is recognition of the role that the prevailing political consensus played in the crisis. Governments of all colours had placed emphasis on deregulated free markets and light touch regulation; the virtues of home ownership and an abundance of credit. The FSA's Financial Risk Outlook went a long way towards identifying the economic risks in the prevailing environment, but did not encourage the behavioural change on the part of firms, consumers and regulators which was required.

6. It should be noted that underlying the crisis were poor lending practices towards consumers. Lenders, encouraged by the prevailing economic mood were encouraged to lend money for widespread investment in home ownership. This led to the extension of loans to consumers who would not normally have been able to raise suitable credit. The De Larosière report highlights the role played by sub-prime lending in the US. This was replicated in the UK as the Turner review documents. In the decade to 2007 there was strong demand for housing relative to supply. This fuelled house price inflation and an escalation in borrowing. Mortgage debt rose from 50% to over 80% of GDP and many loans were offered at high initial loan to value ratios as consumers and firms gambled that house prices would rise continuously. Lending took place to those who would normally have

been considered too risky to acquire a loan and buy to let loans also rose significantly

7. In this climate, with cheap credit plentiful, demand for housing boomed, fuelling house price escalation. Faced with rising house prices, consumers were encouraged to use equity in their homes to raise credit. Ultimately houses are homes, but too many people saw them as a source of wealth. The notion that bricks and mortar was a sure investment encouraged consumer indebtedness with the result that now, with prices falling, some consumers will be exposed to negative equity.

8. Clearly, it is not the role of the FSA to shape society's attitude to property ownership. However it is within the FSA's rule book to ensure that firms engage in responsible lending practices and do not engage in business practices which will bring undue risk. The FSA has been frank about its failings in this regard although it is not the only organisation which is culpable. Notwithstanding the extensive rule book, we believe that the prevailing consensus on the role of regulation in recent years meant that in practice the FSA was unable to make the regulatory intervention required to tackle these risks. As Lord Turner has explained, all this took place against a background whereby regulation was encouraged by Governments and political parties of all colours, to be light in touch. We would concur with the summary in para 11.13 of the accompanying Discussion Paper DP 09/02, that

> "In the period from the FSA's creation through to 2007, the prevailing view of industry, society as a whole and government was that market disciplines would in general prevent the development of systemically damaging excesses in the economy and the risk of proactive regulatory intervention far outweighed the benefits particularly in terms of inhibiting innovation, competition and growth in the financial sector."

9. We believe that this lighter touch regime encouraged by the political consensus left open a regulatory gap. Now, in the light of the crisis, society expects a much more robust system of regulation if consumer confidence is to be restored. This will require a change in the culture of regulation. The change required is as much about stronger enforcement of rules and better trained staff as about the structure of regulation. We welcome the FSA's commitment to investing in staff development and a tougher approach to enforcement and we will watch how this evolves in practice. We also welcome the recent remarks by Hector Sants which signal that the FSA will take tougher action against firms that are not meeting their regulatory obligations. We believe that prior to the crisis the relationship between the regulator and the regulated was not sufficiently challenging and we believe that the relationship should be based on policing rather than partnership. As this change in regulatory culture develops, there will need to be a review of the FSA's regulatory tools.

10. In our response, we do not seek to address the recommendations of the review in detail, but we do offer some observations on the issues where change will have a clear impact to the benefit of consumers. Each issue is introduced by an extract from the recommendations in Lord Turner's report.

The Turner Review: responses to the recommendations

Deposit insurance

Retail deposit insurance should be sufficiently generous to ensure that the vast majority of retail depositors are protected against the impact of bank failure

Clear communication should be put in place to ensure that retail depositors understand the extent of deposit insurance cover.

11. We have engaged with the FSA on the extent and limits of cover. Our arguments have been well rehearsed and the FSA have implemented improvements. We remain concerned about the lack of protection afforded to temporary high balances and will continue to make representations to the FSA on this issue.

12. We have consistently maintained that clear communications need to be put in place so that consumers understand the degree of cover. We continue to believe that there should be protection by brand, indeed the recent wave of mergers and acquisitions as a result of the crisis means that it is more difficult for consumers to spread their risk across a number of institutions and this underlines the case for protection by brand. We note the House of Commons Treasury committee recommendation that "We think that financial institutions must make clear to their customers where they are subsidiaries of other institutions where this is relevant in terms of deposit protection. Ideally we would like to see each brand holding a separate licence"[1]

13. We believe that the FSA should look again at the funding mechanism for the FSCS so that it is fair and attempts to deal with the issues of moral hazard. In particular we would like to highlight the issues faced by mutually owned institutions.

---

[1] Para 91, 7th Report: Banking Crisis: dealing with the failure of the UK Banks, Treasury Committee HC Session 2008/2009

14. Building societies are prevented from obtaining more than 50% of their funding from wholesale markets so they have been generally less exposed than banks to the problems in those markets. However payments to the FSCS levy are based on deposits. Consequently building societies face paying higher fees relative to those institutions with riskier business models. For example, Yorkshire Building Society paid twice as much as HBOS into the scheme in 2008. The Building Societies association told the Treasury committee that contributions to FSCS in 2008 have amounted to 15% of Building society profits as compared to 2% of those of the Banks. Furthermore, it is claimed that the levy could be the difference between profit and loss for a number of societies this year*.* We believe that the building societies are shouldering an undue burden in meeting the bill imposed by those institutions that failed.

Remuneration

Remuneration policies should be designed to avoid incentives for undue risk taking; risk management considerations should be closely integrated into remuneration decisions. This should be achieved through the development and enforcement of UK and global codes.

15. We welcome the recognition that remuneration strategies can incentivise undue risk-taking. Remuneration structures needs to encourage more long term behaviour. We welcome also recognition of the harmful effects of rent extraction arising from activity that does not deliver intermediation efficiently, but inflates remuneration and adds to transaction costs to the detriment of consumers. Where the FSA sees questionable remuneration practices, it should be able to take action, for example by varying prudential limits and requirements. There is a need to realign compensation incentives with long term firm wide profitability. We encourage the FSA to look at the remuneration structure for senior executives. We also recommend that reward structures at all levels are examined so that there is no incentive for poor behaviour of customer facing staff.

Macro-prudential analysis

Both the Bank of England and the FSA should be extensively and collaboratively involved in macro-prudential analysis and the identification of policy measures. Measures such as countercyclical capital and liquidity requirements should be used to offset these risks.

Institutions such as the IMF must have the resources and robust independence to do high quality macro-prudential analysis and if necessary to challenge conventional intellectual wisdoms and national policies.

16. The explosion in credit in the UK meant that the UK was particularly badly placed to deal with the impact of the crisis. In 1997 when the Tripartite structure was created, the Bank of England's responsibility for regulating the overall level of credit was removed. However, regulation needs to deal with how markets and firms actually behave. Notwithstanding a desire for a regulatory system which enables innovation, the light touch approach to regulation failed to stop the irrational exuberance of individual market participants and created systemic risk.

17. Therefore we welcome the proposal for stronger collaboration between the FSA and the Bank of England to scrutinise macro-prudential analysis. We are surprised that existing methods of dialogue and collaboration have been so inadequate. As Turner sets out, the Bank of England tended to focus on monetary policy analysis to fulfil its responsibilities controlling inflation while the FSA focused on individual institutions and failed to adequately deal with sectoral risks. *'The vital activity of macro-prudential analysis, and the definition and use of macro-prudential tools fell between two stools'.*[2]

18. There is clearly a role for countercyclical capital and liquidity requirements to dampen the effects of the boom and bust periods of

[2] Turner review p84

the economic cycle. As the Bank of England manages monetary policy in line with broader macro-economic objectives the FSA should take action to support the delivery of those macro-economic objectives. Strengthened tripartite arrangements will provide a vehicle for co-ordination.

FSA supervisory approach

The FSA should complete the implementation of its Supervisory Enhancement Program (SEP) which entails a major shift in its supervisory approach with:

- *Increase in resources devoted to high impact firms and in particular to large complex banks.*
- *Focus on business models, strategies, risks and outcomes, rather than primarily on systems and processes.*
- *Focus on technical skills as well as probity of approved persons.*
- *Increased analysis of sectors and comparative analysis of firm performance.*
- *Investment in specialist prudential skills.*
- *More intensive information requirements on key risks (e.g. liquidity)*
- *A focus on remuneration policies*

The SEP changes should be further reinforced by

- *Development of capabilities in macro-prudential analysis*
- *A major intensification of the role the FSA plays in bank balance sheet analysis and in the oversight of accounting judgements.*

19. We note that the FSA is recruiting more supervisors and encouraging a more intrusive supervisory strategy through SEP. SEP will deliver an increase in resources devoted to high impact firms. At para 11.14 of the DP it is said,

> *'in the future the FSA's supervisors will seek to make judgments on the judgments of senior management and take action if in their view those actions will lead to risks to the FSA's statutory objectives'*

20. Supervision will shift from focusing on systems and processes to proper scrutiny of business models. We believe this is long overdue. Supervisors need to be brave and decisive. We remain concerned about the ability of supervisors to really deliver effective challenge. We note that the FSA has introduced maximum and minimum time of tenure for supervisors. There is an inherent tension between securing continuity and regulatory capture. We will be interested to see how the intensive supervision works in practice and wish to be assured that an appropriate degree of challenge is being given and that supervisors are up to the job.

21. We have seen that widespread practices which cause consumer detriment have been too difficult for the FSA to solve because of the impact on business profitability. Bank charges and PPI are clear examples. We believe that proper interrogation of business models will prevent such activity. As we have said a cultural shift is required which will engender a change in regulatory behaviour

22. There is a suggestion in the Turner Review and elsewhere that the FSA has been focused on Conduct more than Prudential regulation. We would be very concerned if this meant that less scrutiny was placed on the Conduct of Business in future as there remain significant areas of detriment. We suspect that where there are prudential issues with a firm, there are also likely to be conduct concerns. We would encourage the FSA to be vigilant in holding senior management to account for the entirety of their business performance. We welcome recent statements by the Director of Enforcement that action against senior management can be a more powerful enforcement tool than action against the firm and we look forward to this being taken forward in practice.

23. We note the discussion regarding the bank examiner model and observe that those countries with a bank examiner model did not fare any better as a result of the crisis. However, we remain concerned that

there is insufficient resource to deliver effective regulation. We believe that supervisory performance and the level of resource must be kept under review, although we do recognise that the industry has already weathered a significant fee increase at a difficult time.

24. The FSA must ensure that it has teams of supervisors who are sufficiently qualified and experienced to tackle the senior management of all firms whenever the need arises and to do so with the full support of the FSA Board. The FSA claims to operate a non-zero failure regime, but this is clearly not the case when there are some institutions which are too systemically important to fail. Clearly no Government would ever allow firms the size of HBOS or RBS to collapse. This brings significant moral hazard at many levels.

25. From a regulatory standpoint Lloyds Banking Group will present significant challenges. Given its dominance in the UK retail market place the Group will require particularly close supervision. State ownership means that Government is well placed to influence behaviour of some institutions. We believe that this offers an opportunity for Government and regulator to encourage good practice towards customers which might then be shared across the financial system. We believe this opportunity should be grasped.

26. We have yet to be convinced that the regulator has sufficiently effective powers in practice. The revelations of the discussions between the FSA and HBOS illustrate that even where the regulator has identified and pointed out issues surrounding the risks inherent in a firm's business model, it made no difference to the firm's behaviour. We will be looking for reassurance that firms and Government will consent to a philosophy of regulation which encourages effective regulatory intervention and puts the interest of the individual, taxpayer and consumer at its heart.

27. More thought needs to be given to the suite of regulatory tools at the FSA's disposal. 'Variation of permission' is a fairly blunt instrument and it is questionable whether this can really be an effective tool when dealing with firms of systemic importance when this would clearly have an impact on market confidence. We encourage, for example, public exchanges of letters. We believe that if firms were conscious that things may come out in the public domain they would be more inclined to act. What is clear when looking at the HBOS files is that HBOS senior management wilfully disregarded what the FSA was saying to them about their business. This may not have been the case if HBOS had been aware that such exchanges might be taken into the public arena. Such public exchanges would also direct non-executive directors (NEDs) and auditors to areas of regulatory concern.

28. Transparency is a powerful tool. This could include 'naming and faming' as well as 'naming and shaming'. There is a case for highlighting the businesses that did not pursue a reckless dash for growth. When we talk about the banking crisis, the debate fails to acknowledge that some institutions appear to be weathering the storm better than others.

29. We welcome the FSA's assurance that it will pay more attention to assessing technical skills as well as the probity of the person in senior roles in banks. We place considerable importance on this as those working in the financial industry need to be appropriately skilled. At a time when the FSA is looking at requiring higher professional qualifications for advisers, it is inconsistent that the qualifications of those running our main institutions are questionable in some cases. We welcome the FSA's change in policy which we believe is long overdue.

30. Although the FSA has taken the stance that it is not an economic regulator, in the sense that it does not see a role in setting prices, more penetrating economic analysis is required to examine and understand

whether the market is working in all areas of financial services. Within individual firms, a full interrogation of the business model is required to identify how profits are generated in the business. This would enable the FSA to identify prudential risks affecting the firm, as well as potential risks of consumer detriment. For example, such analysis of the business models of our High Street Banks would have identified where firms were over-reliant on PPI sales to boost profits. The fact that firms would be subjected to detailed interrogation of their business models ought to encourage more appropriate behaviour by firms, to the benefit of both consumers and the long term sustainability of the firm.

31. At para 11.18 of the DP it is said that '*the focus on ensuring that supervision has an integrated view of a firm's risk also means that the supervisory process for its risk identification needs to draw not just on firm specific data but also on market information, sector and general economic analysis*". We welcome that the FSA has recognised the need to undertake a more rigorous approach to assessing risk. We wait to see whether the introduction of conduct risk supervision and the expanded role of sector analysis will deliver more effective regulation. For example, linking up conduct with macro-economic analysis will inform judgments as to whether firms are treating customers fairly as it will enable the FSA to interrogate business models and identify unfairness.

Firm risk management and governance

The Walker Review should consider in particular:

• *Whether changes in governance structure are required to increase the independence of risk management functions.*

• *The skill level and time commitment required for non-executive directors of large complex banks to perform effective oversight of risks and provide challenge to executive strategies.*

32. The De Larosière report highlighted corporate governance failings as one of the most important ingredients of the current crisis. Many would say that RBS should not have bought ABN AMRO at that time or at that

price. There is a need to introduce governance structures which will prevent reckless decisions.

33. It needs to be abundantly clear to senior management that they are accountable for the performance of the firm on all levels. It would be desirable for the Chief Executive of each regulated firm to sign an annual statement of compliance with the regulatory regime, to be published with the Annual Report and Accounts. This would include any shortfalls in compliance and the management actions put in hand to remedy these.

34. We look forward to the outcome of the Walker review into Corporate Governance and the skills that NEDs need to discharge their responsibilities adequately. In conducting the review however, it should be recognised that however much it is desirable for NEDs and shareholders to be more active in holding senior management to account, in practice it my not be possible to rely on NEDs to provide appropriate challenge in all circumstances and the regulator will need to provide that challenge.

35. It is arguable whether senior management in some firms was complying with its existing obligations under the FSA's rules, which are set out clearly in the Statements of Principle and Code of Practice for Approved Persons, (APER). In the Turner review it is said that 'light touch' regulation is not an accurate description of the FSA's approach. Our observation is that too often it was. The FSA has plenty of rules but it could be perceived that there was inadequate enforcement as ongoing issues with PPI attest. The FSA should demand high levels of compliance and take tough action where rules are broken. It should also take action where they detect undue risk.

36. As we have already mentioned, against the backdrop of the prevailing consensus about the role of regulators at the time it is difficult to see what the FSA could have done, although we have consistently

maintained that the FSA should have done more. We repeat that there needs to be some consideration given to the FSA's regulatory toolkit so that the regulator is empowered to take action where significant risk is emerging.

37. In considering the corporate governance of firms, it is also worth raising questions about the corporate governance of the FSA. Sassoon has suggested that the FSA Board does not need to have the same corporate governance structure as the banks it supervises and specifically he questions whether the FSA needs NEDs. Our view is that the NEDS clearly have a role to play, but that they may well need more support in order to be able to play their role more effectively. We also note that traditionally there has been strong practitioner knowledge and experience on the Board. We believe the ability of the Board to provide challenge to the FSA might be better encouraged by more diverse membership. We have made representations to the FSA that we would like to see consumer representation on the Board.

Global cross-border banks

International coordination of bank supervision should be enhanced by

- *The establishment and effective operation of colleges of supervisors for the largest complex and cross-border financial institutions.*
- *The pre-emptive development of crisis coordination mechanisms and contingency plans between supervisors, central banks and finance ministries.*

The FSA should be prepared more actively to use its powers to require strongly capitalised local subsidiaries, local liquidity and limits to firm activity, if needed to complement improved international coordination.

European cross-border banks

A new European institution should be created which will be an independent authority with regulatory powers, a standard setter and overseer in the area of supervision, and will be significantly involved in macro-prudential analysis. This body should replace the Lamfalussy

Committees. Supervision of individual firms should continue to be performed at national level.

The untenable present arrangements in relation to cross-border branch pass-porting rights should be changed through some combination of:

- *Increased national powers to require subsidiarisation or to limit retail deposit taking*
- *Reforms to European deposit insurance rules which ensure the existence of pre-funded resources to support deposits in the event of a bank failure.*

38. There is a clear consensus emerging on the need for international co-ordination of banking regulation with which we concur.

39. The Panel has long been concerned regarding the supervisory regime for banks which have cross-border operations and whether branch passporting rights, home country supervision, and national deposit insurance provided consumers with adequate protection. We note that the review proposes that this should be dealt with either by stronger host state regulation or stronger EU wide regulation. We do not believe that the two concepts are mutually exclusive and both can play a role in improving regulatory protection. We believe that stronger host state regulation would bring clarity and certainty to consumers that the firms with which they deal will be treated consistently by regulators.

Open questions for further debate

Should the UK introduce product regulation of mortgage market Loan-to-Value (LTV) or Loan-to-Income (LTI)?

Does effective macro-prudential policy require the use of tools other than the variation of countercyclical capital and liquidity requirements e.g.

- *Through the cycle variation of LTV or LTI ratios.*

40. We welcome the debate on product regulation and the acknowledgement that even well managed firms have been involved in the development of risky products. We also believe that too much reliance has been placed on the principle that well informed customers will only choose products which suit their needs. We look forward to participating in the debate when the FSA brings forward its Discussion

Paper about product regulation later this year. At this stage we would however like to offer some observations.

41. It is argued that Product vetting would restrict innovation, however as Turner concludes not all financial innovation has been for the social good and there needs to be protection from toxic products. We also think that effective self-regulation can play its part with trade bodies agreeing common standards of good practice as in the case of SHIP with Home Equity plans

42. We would argue however that in general consumer detriment is caused less by the actual product and more with the fact that products are sold to the wrong customers. There will be occasions where high loan to value mortgages might be appropriate. It will depend entirely on the circumstances of the consumers to whom they are offered and the prevailing market conditions. This might be an area where more guidance can be offered by the regulator, rather than an outright ban on these types of products. In any case these are covered by responsible lending rules. A more assertive stance by the regulator to ensure that these rules are followed ought to achieve the same outcome as introducing new powers to regulate products.

43. We also encourage the FSA to do more to warn consumers on product issues so that consumers can do more to protect themselves. Whilst the ‘Money made Clear’ material is good quality information for those who can find it, we believe that the FSA could do more to communicate to consumers the things to look out for in order to protect themselves. However we believe that better consumer information can be no substitute for effective regulation.

Conclusion

44. We welcome the publication of the Turner Review and the opportunity to participate in the debate on the future of financial services regulation. We reiterate our key message that in taking forward the

reforms to strengthen macroprudential stability, the FSA must not lose sight of the issues facing consumers. We believe that the economic climate brings new risks to consumers which require the regulator to remain vigilant when looking at how firms conduct their business.