

THE FINANCIAL SERVICES PRACTITIONER PANEL

John Tiner
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Financial Services Authority
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10th March 2006

Dear John,

I am writing to you as Chairman of the Financial Services Practitioner Panel to convey some comments from industry representatives about principles-based regulation and the FSA's thematic work; we have already touched on several of these issues in our recent bilateral meeting. I would like to emphasise that what follows is the result of informal conversations with a number of practitioners and industry representatives, and not the result of a far-reaching investigation. It is nevertheless indicative of industry views and, therefore, should be taken seriously by the FSA. Our survey – being conducted over Q2 and Q3 2006 – will provide a more comprehensive insight in due course.

To begin, I would like to stress that the Panel and the industry remain very supportive of principles-based regulation and believe it is the appropriate approach towards a modern proportionate and effective risk-based regulatory framework in the UK. Moreover, we recognise that principles-based regulation is still a new and largely untested concept, and that a clear-cut, definitive outcome might be an unrealistic expectation at this point.

In light of this, however, we felt that some informal feedback might help the FSA to fine-tune its processes, procedures and thinking going forward. These are, of course, suggestions only, intended to foster a frank, open and constructive exchange of ideas on this important subject.

The following concerns have been raised by practitioners in various fora and conversations, including at my recent briefing of senior trade association representatives. I had previously assumed that the most significant concerns regarding principles-based regulation were held primarily by smaller firms, and was surprised to note at the briefing quite how strongly the industry at large felt on this issue; hence my desire to write to you directly.

- As experience evolves there is a need for the FSA to continuously articulate what it means in today's market by principles-based regulation, not only to smaller firms, but to the industry as a whole. Some firms perceive a lack of clarity, making firms unsure of the FSA's expectations. This also creates the fear that an arbitrary framework might be applied in practice.
- Broad consistency of implementation across the organisation will be crucial to ensure the success of principles-based regulation. That said, it is vital for the FSA to acknowledge that no two firms are the same, and supervisors must be able to apply risk based concepts with appropriate understanding, flexibility and pragmatism.

CC: Andrew Whittaker
Kelley Titcomb

- Practitioners continue to voice their anxieties over the role of enforcement, fearing that it will be used to set precedents and help interpret untested principles. Similarly, it is feared – wrongly or rightly - that firms will be singled-out for enforcement action to serve the FSA's public-relations imperatives, or to lay down an industry marker.
- There are similar concerns over the Financial Ombudsman Service and its role in interpreting principles rather than rules. While most FOS cases may hinge on case-specific factual elements rather than direct consideration of FSA rules, it is important to accept that FOS decisions are widely seen to set precedents for best practice. It will be important that the "wider implications" process is sufficiently robust to identify and address such instances.
- While principles-based regulation is welcomed, the industry is concerned that there is a danger of creating a second tier of regulation through the back door, via press releases, Dear CEO letters, "good practice" guides and enforcement precedents, without being subject to the normal, statutory consultation processes.
- There appears to be a disconnect between the FSA's commitment to principles-based regulation generally, and its highly prescriptive approach in some specific areas (e.g. financial promotions). It is important that FSA senior management and middle management policy makers and supervisors are "as one", thus ensuring that the high-level messages are indeed understood and delivered throughout the organisation.

The following items could contribute to successful principles-based regulation. We realise that most of these are familiar to you and some are already being taken forward.

- Industry guidance should help bridge some of the gaps between some practitioners' preference for rules, and principles-based regulation, however, the FSA should be prepared to review and endorse such initiatives where found appropriate. While we accept that the FSA would stop short of giving such guidance "safe harbour" status, the industry would nevertheless welcome a "sturdy breakwaters"-type assurance that such industry guidance could provide. We hope that the FSA is prepared to work collaboratively with the trade associations on this.
- The quality of FSA supervisory staff is crucial in ensuring that principles-based regulation will work, and will be implemented pragmatically and consistently – training to raise the quality of supervisors is thus essential in the context of principles-based regulation. In this regard, the Panel supports the Regulatory Curriculum and the residential Arrow course. We also intend to keep engaged with Kathleen Reeves on the wider issue of FSA staff competency and retention.
- Publications, like the TCF Aide Memoire, are helpful tools, especially for smaller firms, in the interpretation of principles. However, it must be ensured that such documents are accessible and jargon-free. The FSA also needs to recognise and balance the differing views of firms' senior managers against those with day-to-day compliance responsibilities, who typically favour greater certainty and prescription.
- The FSA might consider communicating more clearly its approach to enforcement action in the context of principles-based regulation, to allay any of the aforementioned concerns.

On a related issue, practitioners have expressed to me some of their concerns regarding the FSA's thematic work, in particular mystery shopping exercises and Dear CEO letters. The latter have evolved as an FSA tool with the move to principles-based regulation and there is

some anxiety that Dear CEO letters risk supplanting the consultation process. Thus, a checks and balances mechanism should be in place to ensure that some final input can be provided by stakeholders prior to their distribution. Anecdotal evidence also suggests that FSA supervisors sometimes apply the content of Dear CEO letters as quasi rules during ARROW visits, shortly after they have been issued, rather than monitoring firms' compliance on a more discretionary and pragmatic basis.

With mystery shopping exercises, there are anxieties over general conclusions being drawn from often small sample sizes that have little statistical relevance; over the lack of feed-back to firms and industry representatives; and over potential enforcement action on the basis of mystery shopping. It has been suggested that the FSA should raise the result of contentious mystery shopping exercises with the relevant trade association prior to publication to fact-check their broad findings. Also, the FSA should help firms by providing them with specific feedback on mystery shopping results through supervisors and relationship managers. We understand that efforts are underway within the FSA to address some of these issues and welcome this development.

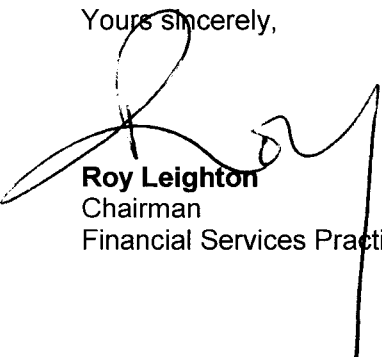
With regard to both, Dear CEO letters and mystery shopping results, the FSA's approach to their publication is thought to be key by industry representatives. The FSA should consider carefully how it publicly communicates the results of mystery shopping exercises, given their limitations; what it intends to achieve with publication; and what impact publication might have on consumer confidence. Similarly, given the absence of a consultation process prior to the issuance of Dear CEO letters, there are concerns over "regulation through press release".

Now that the FSA is placing greater emphasis on thematic work – a development which the Panel strongly supports in principle - the Panel is keen to get closer to its work in this regard at the strategic level and, where appropriate, in respect of particular issues.

I hope the above is viewed as constructive and helpful to the FSA in taking forward its approach to principles-based regulation. As ever, I will be happy to discuss the aforementioned issues further with you. In the meantime, I and fellow Panel members would appreciate your observations in response to the points raised herein.

With best wishes,

Yours sincerely,



Roy Leighton
Chairman
Financial Services Practitioner Panel