Enforcement and Credible Deterrence in the FCA

Tracey McDermott, Director of Enforcement and Financial Crime, the FCA, at the Thompson Reuters Compliance & Risk Summit, London

18 June 2013

Introduction

Good morning. I am delighted to be here to speak to you this morning.

It has been 78 days since the creation of the Financial Conduct Authority (FCA). I want to talk today about what we have focused on in those 78 days, what we think is important in embedding long-lasting change in financial services, and about what you might expect to see from us over the next year and into the future.

What has changed? As many of you will be aware, the FCA is the same legal entity as the Financial Services Authority (FSA); we occupy the same buildings in Canary Wharf and Edinburgh; and we have many of the same staff – including myself. But, have no doubt about it, the FCA is a new regulator.

We have new objectives, new powers and key new partners (in the Prudential Regulation Authority (PRA) and the Financial Policy Committee (FPC)). More fundamentally, however, we have a new approach to regulation – we have sought to learn the lessons of the past and to build on the best of the FSA (including the strong reputation we have built in our enforcement function) to develop an approach that will be more effective in the future.

Some of the changes this leads to are structural – we have created a new Policy, Risk and Research Division which, among other things, is developing the 'radar' of the organisation – enabling us to get better at joining the dots and being more confident to intervene earlier. That Division also houses our competition specialists – and you will no doubt have seen that we will imminently be joined by two very experienced competition professionals, Mary Starks and Deborah Jones, who will share the post of Director of Competition. Our competition remit is new for us and requires a different way of thinking. We will be spending much more time looking at underlying problems and root causes, and at what is driving problems in the markets.

Some of the changes are to processes – we are rolling out an entirely new supervision model – changing the way we approach supervision of the 26,000 firms we regulate for conduct, and 23,000 firms for prudential matters.

We have published, jointly with the PRA, a paper on barriers to entry in the banking sector and have made changes to our regulatory requirements and authorisation processes, which will reduce some of the regulatory barriers to entry into the banking sector and, as a result, enable an increased competitive challenge to existing banks.

But ultimately, structures and processes are simply the machinery for executing a regulatory philosophy and approach. And we have set out clearly, for instance in the *Journey to the FCA* publication, just what that philosophy involves. An approach that is more forward-looking – seeking to anticipate problems before they arise or catch them earlier; a more innovative way of thinking about old problems – using tools that have not, historically, been used by regulators; an approach that is more confident – being willing to back ourselves and our judgement to make interventions to achieve our overall objective of ensuring markets work well.

All of this is of course, underpinned by the traditional regulatory tools of policy development, controlling the gateway through authorisations, monitoring on-going conduct through supervision and market surveillance, and enforcing when things go wrong. We aim to use those tools in a much more joined-up way across the FCA.

Obviously, our approach will continue to evolve – you would expect it to only three months in – our competition remit is, in particular, something that will develop, and which we will say more about over the coming months and years. We also have new challenges – the move of consumer credit regulation to the FCA, the implementation of AIFMD and CRD IV, the imminent report from the Parliamentary Commission on Banking Standards– which will all impact on how we do our job. So we will not be standing still – but what we have done so far should give you a flavour of things to come.

New approaches

I said I would talk about some of the things that you will already have seen that demonstrate a different approach. One example is our use of behavioural economics to help us understand how consumers make certain financial decisions, what really drives firms' behaviour, and how this affects competition.

We recently published our first two occasional papers that explore how people make financial decisions. One of these looked at how consumers responded to redress letters (these were letters from a firm offering their consumers an amount of redress because they had identified a problem with a financial product they had been sold). We know, from past experience, that redress programmes do not always have the level of take-up one would expect. Which seems counter-intuitive – surely if you receive a letter through the post that says you are entitled to some money back, you would immediately take up the offer?

But people don't. Instead of simply accepting that as the position, we sought to explore why that was and whether there were simple things that could be done to make a difference to the response rate.

So we embarked on a real life experiment with a regulated firm, which had had a problem in the way it sold a product to customers. We conducted a field study that adapted certain aspects of the firm's redress letters, such as using bullet points, shortening the text, and sending a reminder. We had 128 different consumer experiences (64 different versions of the letter and some of these people then received a reminder) and the difference between the response rate to the best and worst was from 1.5 % to 11.9 % (a seven-fold increase and an extra 20,000 people). We found some things that surprised us – the introduction of the FSA logo made no difference to response rates and the CEO's signature actually reduced response rates – and others that didn't – simple, clear, easy to understand letters got a better response rate. We have taken forward these lessons in how we approach these issues in the future.

I highlight this as it is a public example of how we are thinking differently about the way in which we identify risks and solve problems. Using behavioural economics is only one part of the FCA's new approach, but it illustrates our increased focus on looking to understand better how consumer choices are made and influenced. We will also think about whether we can use this type of thinking to inform how we look at the way senior managers and firms make their own choices.

The difference in approach and way of thinking, however, goes far wider than this. We are particularly focused internally on how we ensure that we get maximum bang for our buck. This means bringing together, much earlier and more overtly, people from around the organisation, to challenge traditional approaches to doing things and bring relevant skills together. So we won't always see a linear progression from policy to authorisation to supervision to enforcement – we will consider what tools are likely to be most effective at what time.

In practice, this means you may well see my enforcement teams engaged much earlier with issues – whether through formal action or through working directly with supervisors as we seek to understand issues and formulate our response. And this sometimes makes firms uncomfortable – but it is something you will have to get used to. Enforcement is part of the FCA's overall regulatory approach – it's not just what happens if supervision fails.

We have also said we will look to engage differently with the industry through earlier engagement and a more interactive approach. This was illustrated by our work as we developed the FCA, where we conducted roadshows across the country with a wide variety of firms of all shapes and sizes.

But here I should sound one note of caution – engagement will only work if the process is two-way. We often hear that firms want us to be more predictable or they want a better understanding of the FCA approach – and, unsurprisingly, this was reflected in the Practitioner Panel Survey published earlier this year. But despite that apparent desire to understand us, the same survey said that only 23% of non-relationship managed firms had used the *Journey to the FCA* documents to find out about the FCA and fewer than half visited the FCA website. This contrasts with 57% getting information about us from the media. The figures from relationship-managed firms were better but the media was still a significant source of information.

We recognise we need to make ourselves easier to do business with but we cannot do it alone. If firms do not try and understand what we are about, they are much more likely to fall foul of our expectations or find us unpredictable.

Culture in financial services

I have talked a lot about changes at the regulator. But the regulator is not alone in needing to change. A vibrant, successful and sustainable financial services industry will only be possible if firms, and the individuals within them, also change. The loss of trust in financial services is an entirely rational reaction to the events of the past few years – rebuilding that trust will require a concerted effort from all concerned.

There has been much discussion of how that will happen. A core theme is recognition that culture in financial services needs to change – and there are a great many initiatives and programmes under way across the sector to make that happen. I said last June that perhaps the Barclays LIBOR fine would be a watershed moment – and it has been – the repercussions have been wide-ranging. And this is very welcome – after all, the first step in achieving a change is recognising the need to do things differently. But changing culture is not easy – and it's not quick –the industry will not be judged by what it says, but by what it does and the outcomes of that result.

And much of this is down to firms and their senior management – what will they do differently to make this change happen? But the regulator also has a role here – so I would like to spend a little time exploring what I think that role is and where enforcement fits in it.

To start off with, it's important to say what I mean when I talk about 'culture' – to me, it's about what we do and the way we do it. It is the underpinning that drives the decisions we make and the actions we take. So when we talk about good or bad cultures – we are using it as shorthand to describe a set of norms, beliefs, and practices that drive the wrong decisions and the wrong outcomes. Critically, we are not suggesting there is a single regulator-approved identikit culture that will suit every organisation. It's just not that easy.

But we can identify some common drivers of the problems that have come to light over the last few years. Here and overseas a culture had developed in many areas of financial services where the pursuit of revenue – often short-term revenue – was the primary focus of people's activities and energies. Whether that revenue was derived from selling the wrong products to the wrong people; seeking to manipulate an industry-wide benchmark to suit your own book; or, from using inside information to benefit yourself or your firm is, to a large degree, irrelevant. People within the industry had forgotten why financial services firms existed in the first place. Rewards flowed to those who were seen to make money not to those who built long-lasting client relationships, so people, naturally, thought that was what institutions valued.

And this is important in understanding how things could be different. Ultimately, the events of the past few years – from the crisis itself, to PPI, to LIBOR, can be laid at the feet of individuals (sometimes, on the face of it, large numbers but still small in the context of the industry as a whole). Does that mean financial services professionals are particularly bad people – has it attracted the worst of our society? I don't think that is true – I believe that in financial services – as in any other walk of life, the people range from the good to the bad with everything in between.

But individual wrongdoing – sometimes deliberate, sometimes misguided – has still flourished. Why is that? Why did their own moral compass not make them stop and why did the many others who must have been aware of misconduct not stop and say "Isn't this wrong?" Why did those who were obeying the rules not speak up? Was this due to a lack of understanding? A lack of confidence? A lack of interest?

It's probably a combination of all of them. If what is valued and rewarded is 'bad' behaviour, then it may be difficult to fight against that tide. So firms in the future have to ensure that they are positively rewarding those who do the right thing. They also have to recognise that where there are challenging decisions about the balance between ethics and profits to be made, they need to be very visibly championing the former over the latter.

And what is the regulator's role here? The regulator is not there to define an ideal culture – the imposition of the views of a small number of people on a global industry is as likely to cause problems as it is to solve them. But what regulators can do – and what the FCA is doing – is to test and to challenge assertions about what the culture of an institution is. How? Not by looking at the set of corporate values and mission statements – those will rarely say we are setting out to rip off our customers – but by looking at outcomes, by looking at how things actually work, and reflecting those back in an uncompromising way. So if you say that you want consumers to be at the heart of your business, how can you be happy with your complaints levels? If you want to promote a long-term view – how does your incentive structure promote that? If you want people to speak up – how do you make it easy for them to do that and how do you deal with it in real terms when someone does?

But, you might say, what has all that to do with enforcement? Isn't that all about rules and regulations? Not about the spirit or the feel of it? I would accept that to some extent – but the role of the regulator is wider. We are here to influence, persuade and – where necessary – enforce. We set rules, regulations, and laws to identify lines that cannot be crossed – steps that cannot be taken.

In society generally, laws may reflect social norms, for example: we do not kill people or steal other people's possessions; or, they may reset social norms – you must wear a seatbelt, you must not drink and drive; or, they pursue the common good – you must not speed, you must pay your taxes. The 'morality' of some of these is obvious – others less so.

The same applies in financial services – there are some things that are obviously wrong and accepted as wrong – such as boiler room scams for instance; there are other things that are obviously wrong but which people rationalise – perhaps because of the lack of a visible victim or something visible – for example, insider dealing. Other things are, within a certain subculture, perhaps perceived as OK – for example, LIBOR – even though objectively it's clear they are not. Sometimes there will also be grey areas.

The role of the regulator and of regulation is therefore a necessary but not sufficient condition. We – by influencing and persuading – can help people shift their perception of what is acceptable. Through enforcement of the rules however, we make clear that there are consequences when the lines are crossed, we demonstrate societal disapproval and we send a message to others who may be tempted.

So while enforcement is a fairly blunt tool it's an important one. And the best way to avoid falling foul of enforcement is to ensure that your decisions are driven by the right values.

What we are looking for is an industry where people challenge themselves on whether their actions are consistent, not just with the letter, but also the spirit of the rules. A good starting point is our Principles – there are 11 for firms – they are simple, easily understood and I think relatively uncontroversial in scope. They cover the entire range of behaviour and it is no surprise that almost all of our enforcement cases are based on the Principles.

If firms really embed those in their approach, they will not go far wrong. In contrast, a firm that runs itself based on trying to ensure that they comply, and comply only, with the letter of detailed rules will lend itself to attempts to game the system, will lead its people to think they are absolved of the responsibility to think more widely about what is right and what is wrong, and will, ultimately, not achieve the right outcomes.

Senior management

The responsibility for the overall culture of firms and its overall compliance of course sits at the top. The regulators need to be able to rely on leaders and senior managers within the financial services industry to recognise and place emphasis on their regulatory responsibilities – both personally and at a corporate level, to set the right tone, and to lead by example.

Again, we have a fairly simple set of standards or principles that we require approved persons to comply with – set out in APER. I wonder if I did a quick straw poll among the approved persons in the room, how many could identify all seven? But if you did run through them, you would see nothing surprising – and nothing particularly controversial. But I fear they have not had enough prominence in the way people have run their businesses to date.

Something has to change here. There is a public clamour for action against individuals – but that is not the driver. The issue is that repeated fines for conduct failures here and overseas demonstrates that fining firms alone is not enough – we must do something different. In order to achieve credible deterrence, senior managers must be held to account.

This is not easy – the complexities of large organisations mean that it is often evidentially difficult to bring action against senior management. So our record is limited so far, but it should not be thought that we have made no progress in this area. The FSA took some significant action last year. In September 2012, the FSA imposed the highest fine on a senior executive for management failings on Peter Cummings, former Executive Director of HBOS plc. and Chief Executive of its Corporate Division. It imposed a penalty of £500,000 and banned him from holding any senior position in a UK bank, building society, investment or insurance firm.

The FSA also fined Mitsui Sumitomo Insurance Company, and fined and banned its former executive chairman, Yohichi Kumagai, for serious corporate governance failings.

We also publicly censured Tidjane Thiam for being knowingly concerned in a failure by the Prudential to inform the regulator of the upcoming AIG bid early enough.

Indeed, a little known fact is that the FSA took more actions against individuals over the 2012/13 year than we did against firms. We took action against 55 individuals, which included over £5m in fines, 43 prohibitions, and 13 criminal convictions. In comparison, we took action against 38 firms (fining them £418m).

Investigations into individuals are not easy. They are evidentially complex and hard fought. And that should be no surprise. There are potentially serious consequences for those individuals found to have breached our principles. A very important part of our job is to ensure fair, objective, and dispassionate assessment of their conduct.

We often come under a lot of public scrutiny in relation to our sanctions on individuals – whether it is we that are being too harsh, or whether it is we are being too lenient. We often hear the same arguments being played out in the press at the same time about the same case. This reflects the difficulty of this area. Either way, we can expect that many of our published sanctions will be unpopular – however, this does not affect the way we run and make decisions on our cases.

Our role is to hold the line and take forward action against individuals where we see evidence that they are at fault. We recognise these cases will take us much more time, and resource to see through. We will not always win but this will not deter us from demonstrating that we are serious about holding individuals to account where they have failed to uphold the standards expected of them.

Many have questioned whether we have the ability to see this through. If you doubt our resolve and capability, then look at what we have done with insider dealing over the last few years. Many thought these cases would be too difficult to prove and we would not have much success in getting criminal convictions. However, we have had 23 convictions since 2009, and we have just had a particularly successful year that saw the culmination of many years' work in several criminal investigations.

The success of our insider dealing strategy is not driven by the results of one or two high profile cases. It did not just depend on the work of the Enforcement Division. It has been built on a methodical and patient approach working across the organisation – with our Markets experts, Financial Crime and Intelligence experts, and Enforcement teams all playing their roles. What we had was a clear mandate as to what we were trying to achieve, a joint sense of purpose, and the resources to deliver what was required. And in our first few insider dealing cases we faced a whole slew of legal and procedural challenges with interlocutory decisions going up to the Court of Appeal and the Supreme Court. But we learned from those cases and they have provided a solid foundation to take forward ever more complex cases

And where that has taken us is from our first convictions in 2009 of a son and father-in-law who netted profits of £50,000 in relation to one deal – to last year where we saw 12 convictions for insider dealing – five of which were of City professionals (or former City professionals) with profits in the millions.

The cases are also much more complex. So last year we saw the prosecution of the Saturn case where we secured the convictions of six individuals who operated an insider dealing ring. Notably, we also saw an increase in the number of defendants charged with insider dealing who pled guilty, with five individuals pleading guilty last year. A clear sign that people recognise we mean business and we are able to follow through.

In relation to approved persons we are adopting the same approach. We are recognising that quick wins will be few and far between, that it will be necessary to adopt a 'cradle to grave' approach – addressing this issue from the way we authorise through the way we supervise, to the way we enforce, and that our first cases will be hotly contested – both evidentially and procedurally (the recent Court of Appeal decision in the Wilford Judicial Review is a good example of that) so we will need to stick to our guns if we are to make a difference. And this is in many ways more difficult than insider dealing – as we are talking about flawed judgements rather than deliberate dishonesty – but our insider dealing experience gives us the confidence that with resolve and time we can deliver this.

You will probably already have seen an increasing emphasis from our supervisors on getting senior management to attest where remedial action is being taken, and asking questions about exactly who is responsible for what. This is all part of focusing our attention – and yours – on the responsibility and accountability of senior management. And this is an area where you can expect to see more in the coming months and years.

Credible deterrence and building on the FSA's successes

So I have talked a lot about my thoughts on culture in the City and about how the leaders of the industry are key to helping us make real change and get it right this time. But what about other enforcement priorities? Will there be a wholesale change in the sort of enforcement cases you will see from the FCA? Are we still pursuing the same credible deterrence agenda?

Let me reassure you that the FCA is just as committed to achieving credible deterrence as the FSA was. We will continue to build on the enforcement successes we have achieved to date, and will use our expertise to support the FCA in achieving its overall objective of ensuring markets work well.

I am particularly proud of the FSA's achievements in its last year, and while it was not necessarily planned this way, Enforcement certainly went out with a bang. We published a total of 76 Final Notices imposing a record £423.2m in financial penalties during the year, including the highest fines we have ever levied.

These cases included the LIBOR penalties, which we have said reflected some of the most serious misconduct we have seen. Those cases, of course, concern conduct in the wholesale markets but you don't need me to tell you that their impact has been felt much more widely.

And we have made it clear that the FCA will be focused on wholesale conduct – so it is worth pausing on LIBOR because those cases they do have wider messages that firms should be considering.

- Conflicts of interest: Firms must have an in-depth understanding of how and why conflicts can arise so that proper measures can be implemented to address them, e.g. remuneration structures. (a common feature in the LIBOR investigations was the existence of long-standing, serious and inherent conflicts of interest).

- Culture: I talked about the importance of responsibility and action from the top in-depth earlier. The FSA's LIBOR investigations revealed a disturbing level of complacency and wholesale disregard for proper standards of conduct among firms with respect to their role and responsibilities in the LIBOR-setting process.

- Governance and risk management: I feel like I am stating the obvious here, but firms must ensure they have robust internal governance procedures, and proper risk assessment and monitoring in place. In the LIBOR cases, we saw many examples where firms failed to do the basics such as failing to apportion responsibility and failing to perform competent audits and reviews.

UK markets must be seen as an orderly and safe place to do business. The LIBOR fines demonstrate our commitment to ensure those operating in wholesale markets do not put their own interests above those of the markets as a whole.

FCA enforcement priorities

You should expect to see a continuing focus on LIBOR next year as well as a continuation of our work on market abuse and insider dealing. We will also see further cases relating to failings in controls over financial crime and we maintain our focus on protection of client money and assets.

As well as these cases which link to our integrity objective, we will also continue to take cases to support our consumer protection objective. So a few words on this.

Our consumer protection cases will continue to focus on mis-selling. But in addition to this we will be looking, in line with the FCA approach, at the drivers of behaviour – at culture within firms, remuneration structures and so on. And we have a number of cases where these issues are live.

We will also continue to place emphasis on what happens when things go wrong – how do firms treat their customers when there are failures? Do they have adequate complaints handling procedures in place? We have already seen a number of cases on this issue this year and there are more in the pipeline.

You will also see us taking more cases concerning different product types. We have, for instance, had a particular concern about the sale of low value insurance – does it really give customers the benefits they are told it will? We took action against Card Protection Plan Limited last year and again we have more cases in the pipeline. These cases are often characterised by low individual losses but very high customer numbers.

At the other end of the spectrum we also see cases with smaller numbers of individuals affected but large losses. Two examples are UCIS and pension liberation.

First on UCIS.

Our work in UCIS has been on-going since 2010. Since then we have issued 26 Final Notices in relation to poor UCIS practice, prohibiting 16 individuals and imposing fines of over £500,000. We found that many firms either did not understand or chose not to follow the existing rules around UCIS. They failed to understand the complicated structures and risk profiles of these products, undermining the consumer safeguards the existing rules were intended to provide. In the cases where we have taken action, the consumers involved are typically ordinary retail investors whose main source of funds for investments are their existing pension savings.

We saw some very poor practice. One example was an 88 year old widow who wished to fund her lifestyle while preserving the value of her estate. Previously, she had invested in with-profit bonds, and cautious/balanced ISAs or guaranteed funds. She was advised to surrender several bonds comprising over 70% of her assets to reinvest in two UCIS that offered no capital guarantee.

But, notwithstanding these cases, our on-going supervision of the UCIS market, which looked at individual financial advisers of all sizes as well as wealth managers, found that standards were not improving. We have therefore introduced new rules to strengthen the regime and reduce the scope for poor practice. However, recognising that the same investment strategies as are seen in UCIS often use a variety of other legal structures, our new rules create a uniform marketing restriction for a wider group of products.

Pension liberation is another worrying emerging trend.

During the last year, we've seen an in increase in the number of firms involved in this activity. What is it and why do we care?

Pension liberation schemes claim to be able to give people access to their pension funds before the age of 55. The people running the schemes target consumers in a bid to encourage them to unlock or liberate their pension funds, pre-retirement, to take equity out of an under-performing pension and invest it in a supposedly more profitable, usually unregulated, investment instead (indeed it is often a UCIS). They sometimes offer an immediate cash advance or loan to pension-holders for transferring their pension.

We have also seen examples of pension transfer activity where those selling unregulated investments are encouraging individual investors to transfer their pensions from more traditional schemes into SIPP products. Those are then be used to make investments in what are usually high risk unregulated schemes. This is often a cynical attempt by those selling the underlying investment scheme to access individual consumers' pensions savings in addition to other savings. We see this as a particularly damaging trend because it often involves the flight of pension savings from lower risk underlying investments to higher risk, unprotected schemes with uncertain investment yields.

Aside from the obvious risks involved in transferring pension funds into unregulated, highly speculative products, pension-holders who access money from their pension, either via a loan or other ways outside the normal allowed methods, run the risk of having to pay unauthorised payment charges to HMRC (up to 70% of the value of the entire pension).

We are working closely with other agencies such as The Pensions Regulator, HMRC and the police to understand more about pension liberation fraud and have contributed to a recent multi-agency initiative, led by The Pensions Regulator, aimed at publicising the risks and taking action against perpetrators. One of the key things we are doing here, again, reflecting the new FCA approach,, is looking at the whole value chain – not just those promoting unauthorised business but also at the roles of authorised advisers, pension companies and SIPP providers.

The involvement of authorised firms and individuals in a pensions transfer can cloak a scheme with an unwarranted air of legitimacy. We are therefore very concerned to ensure those advising or involved in this market really understand what they are getting into and are ensuring they give proper advice to their customers. We will be looking very carefully and very hard at their conduct.

I should, however, also note that we are heartened to see the number of reports coming into us from authorised firms that are declining to get involved in this activity and are giving us very valuable intelligence to help tackle this issue. I would like to thank those firms for this. As my Chairman said the other day, regulation will be more effective if we can work with the industry to root out bad practice and promote best practice. I would urge you to continue to do that.

In conclusion, I hope this whistlestop tour has given you an idea of the key things on the FCA's radar and a flavour for both what is changing and what remains the same. Change will not happen overnight but both the regulator and the industry owe it to the UK to ensure that we build on the foundations in place to restore the standing and reputation of financial services.