

THE FINANCIAL SERVICES
PRACTITIONER PANEL
ANNUAL REPORT

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CHAIRMAN'S INTRODUCTION

The financial services sector and the world of regulation are complex and evolving. It is accepted that in the relationship between regulated and regulator there will, by its very nature, always be an element of creative tension. However, the Financial Services Practitioner Panel (the Panel) believes strongly that the best way to harness that energy and ensure that the whole system operates to the advantage of all concerned (including, of course, consumers) is to foster a suitably open, intelligent and constructive exchange of information, ideas and views between the Financial Services Authority (FSA) and the regulated community.

The Panel has a vital part to play in creating an all-important link between the FSA and practitioners, helping in particular to ensure that the FSA's policies and performance are objectively assessed and that the views and concerns of the industry are properly represented at the highest level.

I assumed the role of Panel Chairman in November 2003, succeeding Donald Brydon who had held that position for the previous two years. I would like to take this opportunity to pay tribute to Donald's efforts and commitment as Chairman. His strong and enthusiastic leadership of the Panel helped ensure that it remained the independent, authoritative and influential voice for the industry that is so crucial – his CBE awarded in the New Year honours was richly deserved recognition of this role. I am extremely grateful that the Panel will continue to benefit from Donald's expert and valued contribution for a further year, and that I personally will receive the benefit of his support and wisdom as my Deputy Chairman.

I intend to establish a good working relationship with the FSA's new Chairman and Chief Executive – the Panel is encouraged by many of the early messages conveyed by Callum McCarthy and John Tiner, but it is of course key that these positive statements are indeed delivered (for example, the undertaking to cut the number of consultations by half). It is clear to the Panel that the FSA is moving from a policy phase to an implementation phase and, in managing this change of emphasis, it will be essential for the regulator to prioritise areas for future development and focus resources on core issues for the market – we would welcome the opportunity to contribute to the success of this process.

2003 has been a busy and challenging year for the FSA and practitioners generally, creating a full and lively workload for the Panel. In this Annual Report, we have summarised some of the main issues and concerns that have arisen for us during that period. For example, we include our commentary on issues such as the basis of cost benefit analyses, the UK's international competitiveness and the application of the FSA's ARROW framework, along with our views on the proposed Sandler regime

for the sale of simplified products. We have also included our thoughts on the FSA's planned Product Risk Framework, the much-debated CPI176 softing and unbundling proposals and the use of past performance information.

Looking forward, 2004 promises to be another year where the Panel will have an important role. We have therefore also used this Annual Report to anticipate the key areas that will be of interest to us and, where appropriate, require our monitoring and engagement. There is already much business on our agenda for 2004 – for example, the process and outcome of the HM Treasury review of the Financial Services and Markets Act 2000: 2 years on (the N2+2 Review), the implementation and impact of the major FSA internal reorganisation, the impending statutory regulation of mortgage and general insurance intermediation, and our own extensive survey of regulated firms to take place in the summer. This, of course, is in addition to the ongoing stream of FSA, Government and EU proposals and initiatives that will undoubtedly continue to occupy our time.

The Panel also hopes to be closely involved in the FSA's work on financial education. We will help the FSA work towards its statutory goal of promoting public understanding of the financial system, with a specific focus on consumer education and transparency measures wherever possible. In this respect the Panel will continue to work with the FSA to help it build consumer trust and achieve its objective of maintaining confidence in the UK financial system. It should not be overlooked that there is significant common interest between practitioners and consumers – confident consumers help create and support a healthier marketplace.

Finally, I would like to thank my fellow Panel members for the significant contributions that they have made to our operation and achievements during 2003, in terms of the substantial time they have given to the Panel's work, their extensive expertise and always well-considered views. Whilst all Panel members are, in their own right, respected industry figures, I firmly believe that our real strength lies in our collective power and authority – as a group, we really are able to make a difference. I have enjoyed working with them all, and look forward to doing so again in the coming year. I would also like to thank our small team of support staff for their professionalism, skill and sheer hard work – we rely heavily on them for the smooth organisation and management of our affairs.



Jonathan Bloomer

March 2004

MAIN ISSUES ARISING IN 2003

This section of the Panel's Annual Report contains a summary of the items which we believe have been of the greatest interest to practitioners during 2003, and outlines the position or action the Panel has taken. Some of these also link with subjects covered in the following section, Looking Forward.

FOS/FSA RELATIONSHIP

The role of the Financial Ombudsman Service (FOS) and its relationship with the FSA has caused unease among practitioners for some time. The Panel has repeatedly pointed out the concern over the FOS's quasi rule-making abilities and the often blurred line of demarcation between the FOS and the FSA. In particular, the scope of the FOS to define such concepts as risk without a full public consultation of the sort undertaken as a statutory obligation by the FSA, as well as the absence of a practical appeal mechanism against FOS decisions, have been the source of much anxiety. The resulting uncertainty, in the Panel's view, further undermines market confidence, as well as firms' ability to manage their business risks effectively. In addition, the Panel would like greater assurance that practitioners do not face double jeopardy – specifically, where a firm may have complied with FSA rules but despite that is subsequently found 'guilty' by the FOS.

The Panel intends to continue holding regular discussions with the relevant senior officials at the FOS and the FSA, with whom we enjoy an open and productive relationship, to consider how our concerns might be addressed. In the meantime, we welcome the news that HM Treasury's N2+2 Review will explore in detail how the FOS and the FSA work together. This will include the circumstances in which the FSA may itself take wider regulatory action rather than rely on individual determinations by the FOS, possibly by building further on the existing Memorandum of Understanding between the two organisations. However, we are conscious of the limitations of what can be done without primary legislation.

INTERNATIONAL COMPETITIVENESS

Rising compliance costs and the increasing burden of regulation in the UK generated by domestic regulation and governmental initiatives, as well as EU financial services legislation, are perceived by many practitioners to pose a serious threat to the international competitive standing of the UK financial services market. There are also concerns in the industry over the FSA front-running EU regulation and gold-plating

EU directives in the transposition process. Together, this could create an unnecessarily onerous regime that could damage UK markets relative to their European neighbours.

Maintaining the competitive position of the UK is one of the principles of good regulation outlined in the Financial Services and Markets Act 2000 (FSMA). The Panel has urged the FSA to uphold this principle by keeping this point at the very forefront of its policy-making decisions. The FSA must have proper regard for the UK's international competitiveness and include this consideration in all regulatory initiatives.

With political and regulatory initiatives toward a common European financial services market gathering pace, the threat of financial services companies moving their core operations elsewhere should not be underestimated. We hope that the FSA's new Regulatory Policy Committee is alive to this issue, and the Panel shall itself continue to keep the point under review.

COST OF REGULATION

In last year's Annual Report, the Panel highlighted strong practitioner concerns over the cumulative cost of regulation and its impact on regulated firms – an issue that also featured prominently in the findings of the Panel's 2002 survey of regulated firms. The past year has shown that industry anxieties over this problem have not lessened. In fact, they may have grown stronger, due to the deluge of regulation ahead of the 2005 target completion date of the EU's Financial Services Action Plan (FSAP).

In a closely related matter, the Panel has repeatedly voiced its concerns over the operational complexity and associated cost of the entire regime – another issue that featured in our Annual Report last year but continues to be relevant. The annual incremental rise in the overall cost of compliance to financial firms operating in the UK is widely regarded as a serious threat to their ability to compete.

The Panel has made a number of suggestions to the FSA to address these matters. For example, it is necessary to prioritise the international and EU agenda so that both the FSA and market participants are able to devote sufficient resources to the implementation of the EU's FSAP. Also, the interfaces between the UK regime, the EU and the US should be addressed to minimise political and commercial obstacles that might prevent a cost-effective common financial services market. We would support any initiative to conduct an in-depth survey to better understand the source and size of compliance costs and to evaluate the effect of regulation on the competitiveness of UK firms. In addition, the Panel would like to see the FSA explore the merits and logistics of applying a tangible 'regulatory dividend' – for example, as an incentive for firms fostering an inherently sound compliance culture and infrastructure, a suitably lighter-touch supervisory approach could be applied. The ARROW process should, over time, yield this result.

By the FSA's own admission, the costs of the regulatory regime to the industry have risen since it assumed its full powers, and the absolute quantity of regulation has also increased. The FSA must look at these facts and compare them with the benefits to be gained by allowing market forces to prevail. The Panel welcomes the news that such an analysis will be conducted as part of HM Treasury's N2 + 2 Review.

The FSA is required by the FSMA to conduct cost benefit analyses (CBA) ahead of its policy initiatives, to demonstrate that new provisions are necessary and proportionate. Generally speaking, the Panel welcomes this; CBA can be a valuable tool in determining the likely effectiveness, impact and necessity of a regulatory initiative.

However, the Panel has some concerns over quality and process. For example, CBA are often produced relatively late in the process, at which point there may be pressure to prove that benefits exceed costs. The Panel would prefer to see CBA conducted early to help form the policy, not after to justify the decision made. We also believe that certain costs are often unrepresentative or not included at all, and that there is a disregard for the total cost of regulation and the industry's ability to absorb the incremental price of rule changes. It is also important that potential areas of consumer disadvantage, such as a reduction in choice, and the possibility of unintended consequences are properly and fully taken into account.

Following our representations, the Panel has been delighted to learn that the FSA has recently launched a concerted attempt, under the aegis of the Regulatory Policy Committee, to conduct CBA earlier in the policy development process. We were also pleased to hear that, as part of the N2 + 2 Review, the regulator will seek to design a means of analysing costs and benefits retrospectively, to assess whether the actual effects of regulation turned out as expected. The FSA is also committed to exploring a means of examining the cumulative impact of regulation.

THE ARROW PROCESS

In principle, the industry is very supportive of the ARROW process and believes it is the appropriate approach for a fair and effective risk-based regulatory framework in the UK. Since it is a highly complex and relatively untested process, being implemented for the first time, the Panel has monitored informally firms' reaction to ARROW and fed some of the key issues back to the FSA.

In particular, we consider that there should be an improved mechanism for delivering the FSA's ARROW conclusions to firms before being finalised – at the very least, to allow a review for factual accuracy. Moreover, there should be more clarity on what needs to be achieved by firms to lower their risk rating. This is especially relevant to address firms' concerns that the ratings are based principally on size, irrespective of the quality of their control systems and infrastructure. According to practitioners, the process would also benefit from a clearer prioritisation of actions in the risk mitigation plan to help firms decide how best to allocate their resources. To add further value, benchmark feedback on other firms' ratings would be welcome to provide context to the FSA risk ratings in relation to actual risk exposures.

The FSA must appreciate that the ARROW process is based on its own assessment of the risks firms present to its statutory objectives. This may cause disagreements between practitioners, who face real commercial pressures, and the FSA, over the relative importance of concerns raised by ARROW and over the proposed risk mitigation tools.

We welcome the fact that the FSA has been very open to the Panel's views on ARROW and has stated publicly that it intends to address a number of these points to improve this evolving process. This includes the issue of size-based bias, the benchmarking of risk ratings and the prioritisation of actions in the risk mitigation plan.

CONSUMER EDUCATION AND RESPONSIBILITY

The FSA is obliged by statute to protect consumers. However, the FSMA also states that consumers must take some responsibility for their own actions. Practitioners accept that the latter will only be possible if at least a basic level of financial literacy and awareness among consumers can be assumed. Hence, the Panel strongly supports the FSA's efforts to boost consumer education with appropriate initiatives. At the same time, we would also urge the FSA to better articulate what it believes the principle of consumer responsibility should mean in practice.

Generally, the Panel prefers for the focus to be on consumer education and transparency measures wherever possible, rather than more costly direct regulation. Better-educated consumers would require less protection and assist in the promotion of more effective competition between financial services providers. However, we do recognise that consumer education initiatives will not change public awareness overnight and will take significant time and effort to produce the expected results.

Too much emphasis on over-regulation, consumer protection, reviews of disclosure and selling practices, and Government-imposed product designs pose a serious threat to the competitiveness of UK firms. It is worth considering at what point the regulator, in seeking to protect consumers, actually starts to damage competition and innovation, so disadvantaging the very people whose interests it is seeking to safeguard.

Amongst other things, the FSA may wish to consider engaging more with practitioners in partnership initiatives for the education of consumers, and routinely including a suitable consumer education budget in relevant individual policy proposals.

Recent FSA announcements of stepping up its activity in the area of consumer education and, in particular, the creation of the Financial Capability Steering Group (FCSG) in late 2003 are steps in the right direction. The Panel would be happy to provide the FCSG with whatever support and input might be appropriate.

SANDLER PRODUCTS

The Panel last year warned of the problems embedded in the current approach to the proposed stakeholder investment products, or Sandler products. Donald Brydon, then-Chairman of the Panel, took the opportunity at the FSA's Annual Meeting in July 2003 to highlight practitioners' potential vulnerability to mis-selling complaints, even if they were compliant with the Sandler provisions and the FSA conduct of business regime. As a consequence, distributors might have to retain pre-Sandler suitability and fact-finding processes – with the associated costs, but without the prospect of economic benefit.

Moreover, the creation by HM Treasury of the Sandler suite of products did not follow the route usually taken by commercial organisations, of defining demand and the appropriate customer-base ahead of product design and pricing. This back-to-front process of designing stakeholder products ultimately put the FSA into an unenviable and difficult middle ground. In addition, providers, especially smaller firms, may well be reluctant to develop and manufacture such products given the inevitably tight margins imposed by the proposed charging restrictions.

Echoing the Panel's concerns, the Financial Services Consumer Panel and the Chairman of the FSA, Callum McCarthy, both voiced their reservations over Sandler products; in particular, over the inherent dangers in selling equity-based products without full (or any) advice. In an interview in November 2003, Mr McCarthy questioned whether a simplified purchase system for products with a heavy equity component would provide appropriate consumer protection – one of the FSA's four statutory objectives. The FSA are currently carrying out further consumer research and the Panel keenly awaits the outcome of this work.

PROHIBITION ON INSURANCE AGAINST REGULATORY FINES

In July 2003, the FSA published a consultation paper of miscellaneous amendments, CP191. Included in this document were details of a proposal to prohibit authorised persons from entering into, arranging, claiming or making a payment under a contract of insurance that would pay all or part of a financial penalty imposed by the regulator.

The Panel expressed strongly its view that the nature of this proposal reflected an inappropriate and disproportionate response from the FSA. We are not persuaded that the scale of the perceived problem warrants such a prescriptive approach.

The FSA's decision-making arrangements, through the Regulatory Decisions Committee, are relatively untested and there remains a lack of full confidence in this system amongst practitioners. It should also be recognised that evaluating the degree of respective culpability between individuals and their firm – for the purposes of determining the ultimate target of enforcement action – is often a difficult task, with much scope for argument. Moreover, we reject outright the suggestion that an individual or firm might deliberately misbehave (or perform to a lower standard) in the knowledge that insurance was in place to cover any subsequent fine. Irrespective of the size of any financial penalty, the Panel would suggest that it is the threat of adverse publicity, professional and reputational damage that serves as the greatest deterrent.

One of the points that we have continually stressed is for the FSA to better harness market forces and have greater faith in the industry's willingness and ability to regulate itself and develop sensible and suitable solutions. This is an example where the overall circumstances of the perceived problem would have benefited from the FSA taking a more risk-based approach.

We were disappointed to learn that, following the formal consultation process, the FSA decided to press ahead with the proposals broadly along the lines previously set out. The Panel remains unconvinced that there was sufficient support (less than a third of respondents were in favour) to justify the FSA's decision to do so, or that it represented a true reflection of industry opinion on this matter.

PAST PERFORMANCE

The FSA had proposed in its Consultation Paper 183 a regime (building on an earlier consultation, CP132) for the standardisation of the use of past performance information. In most respects, the Panel broadly welcomed the proposals – believing them to be generally reasonable and workable for the industry. We considered that the FSA had responded positively to the concerns we had raised previously about the implementation of an overly-prescriptive series of provisions.

That said, the Panel remained opposed to the intention to restrict the use of monetary values, feeling that these were in fact helpful to consumers, particularly given the concerns about their understanding of percentages. Although clearly framed as guidance, the Panel saw this particular proposal as a de facto rule and, in effect, a complete prohibition – firms being unlikely to risk exercising the relatively limited discretion that existed.

However, at the end of 2003, following a decision by the FSA Board to support the Panel's position, the FSA announced that the policy in this regard had been amended accordingly. The Panel welcomes this development.

SOFT COMMISSION AND UNBUNDLING

With regard to the proposals in the FSA's CP176 on Soft Commission Arrangements and Bundled Brokerage Services, which was driven in part by the recommendations on transparency in the Myners Report, the Panel expressed to the FSA some concerns over the draft CBA. The Panel did not take a strong position on the broad desirability or undesirability of softing or bundling, but recognised that softing is the more controversial issue.

Generally there has been agreement with the FSA's stance on the softing of non-research services, however, the Panel believes that on the question of the bundling of research a market-driven approach may be the best solution. An overly prescriptive, rules-based regime, in the Panel's view, would not correspond with the FSA's principles-based regulation.

Panel members also felt that there was insufficient recognition of the risks from possible unintended consequences and their impact on UK firms' international competitiveness. This could include wide-ranging structural change within the investment industry, and the likely increase in the cost of research (which would impact small firms in particular).

An announcement is expected from the FSA shortly on the outcome of the consultation exercise. The Panel awaits this development with interest to see the extent to which its own views, and the views of many others from within the industry, have been taken on board.

LOOKING FORWARD

This section summarises the main areas of likely interest to the Panel during the year ahead.

THE NEW FSA STRUCTURE

In November 2003, John Tiner announced a major reorganisation of the management and operational structure at the FSA. This is designed to better align its organisation with its strategic priorities in the coming years and to facilitate the shift in emphasis from policy development to implementation. At the same time, the reorganisation is hoped to maximise the FSA's ability to meet its statutory objectives, to comply with the principles of good regulation, and to achieve its vision of maintaining efficient, orderly and clean markets while helping retail consumers to get a fair deal.

One of the key drivers behind the change is to make the FSA an easier and better organisation, with which practitioners and consumers can do business.

The Panel wholeheartedly supports these initiatives which, in principle, should operate to the benefit of the industry and consumers alike. For example, the split between wholesale and retail markets should create a more appropriate distinction and facilitate a more proportionate regime for the regulation of these two fundamentally different sectors – something for which the Panel has been pressing for some time. However, such ambition does not itself come without certain risks. Making the new structure work for both the industry and its own staff – including the transition to the new structure – will require strong and careful leadership and communication from the top. In the meantime, it will of course be vitally important that the FSA maintains “business as usual” and continues to recognise the importance of attracting, developing and retaining a capable and suitably experienced body of staff.

The new FSA structure will also have knock-on effects for the operation and working practices of the Panel itself. Firstly, in line with the new arrangements for the FSA Board, the Panel is likely in future to be asked to devote proportionately more time and resources to dealing with higher-impact policy issues, and do so at an earlier stage in the thinking process. This should allow us to focus on key issues, at a point in the process where our experience and expertise can have the most influence.

THE HM TREASURY REVIEW OF FSMA, TWO YEARS ON

The launch of the review of the Financial Services and Markets Act 2000 (the N2+2 Review) was announced by HM Treasury in November 2003. There will be three

main strands – the impact of FSMA on competition, FSA practices and operational aspects of the FOS, and the boundary of regulation.

Before that announcement, the Panel had put on record its views on the proposed nature and scope of the Review. Most of our key suggestions have been included in the terms of the Review. These include the procedures and operation of the FOS and its relationship with the FSA, the complexity and cumulative costs of regulation, the process and scope of cost benefit analyses, the ability of the FSA to provide informal guidance, and the usability of the FSA Handbook. Some of these issues are explored in greater detail elsewhere in this Annual Report.

We also argued against undertaking a ‘value-for-money’ review of the regulatory regime, on the basis that it was too early to do such a review and that the difficult market conditions since N2 might distort the outcome. The Panel therefore welcomes the decision not to undertake such an assessment at this stage.

We shall follow with interest the course of the N2 + 2 Review, the outcome of which is expected in about a year’s time. The Panel will also seek to contribute its views and expertise to the process where appropriate.

We should also at this point mention that the Panel made a written submission and Jonathan Bloomer gave oral evidence to the House of Lords Constitution Committee’s enquiry into the accountability of regulators. Whilst we are generally satisfied with the existing tiers of accountability, and with the FSA’s responsiveness and willingness to engage with practitioners, we look forward to reviewing the conclusions reached when the final report is available.

2004 SURVEY OF REGULATED FIRMS

The Panel has recently started work on its next biennial survey of regulated firms, to take place during 2004. This is an important piece of work that will give the industry a valuable and timely opportunity to have its say about the way in which the FSA has performed during a particularly eventful period. It will also provide a basis against which to measure how the industry perceives the FSA’s response to the main issues arising from the survey undertaken by the Panel in 2002. These include the usability of the FSA Handbook of rules and guidance, the provision by the FSA of accurate and prompt guidance to individual firms, and the overall costs of compliance.

The survey will include a qualitative element – to help identify ‘hot topics’ and provide depth generally – followed by a quantitative phase. During the quantitative phase a detailed questionnaire will be sent to large firms and to a sample of smaller firms. In previous years, separate questionnaires had been issued to Chief Executives and to Heads of Compliance – however, it is understood that this created a degree of confusion and resulted in a lower overall response rate than would otherwise have been expected. So, this year, we intend to issue a single questionnaire that covers all relevant aspects. Any new or emerging subject matters will be considered for inclusion in the questionnaire. However, we also intend to retain a degree of consistency and continuity with our previous surveys which – in addition

to being best practice in such exercises – will allow us to evaluate responses on certain specific issues over a period of time.

We are pleased to confirm that we have appointed NOP Financial to undertake the key day-to-day aspects of the research work. The main questionnaire element of the survey is likely to be undertaken during June and July 2004. In due course we will be in touch with those firms from whom we are seeking input – whether qualitative or quantitative.

It is hoped that the Panel will be in a position to publish and share the outcomes of the survey with interested parties, in particular the FSA and the industry, in late 2004. The Panel will then open discussions with the regulator about how any key points arising from the survey might best be taken forward.

We hope that firms will provide the Panel with their views in this extensive and authoritative undertaking. This will give a tangible and reliable basis on which to provide constructive feedback to the FSA.

EXTENSION OF THE FSA SCOPE AND ITS OPERATIONAL EFFICIENCY

The FSA will shortly face the significant challenge of extending its regulatory scope to mortgages and general insurance intermediation. Clearly, the character of the FSA will change as a result, both for those firms already falling under the FSA's auspices and for those becoming subject to statutory regulation for the first time. This is evidenced by some of the organisational realignment that was announced by John Tiner in autumn 2003. The volume of authorised firms will grow substantially, and as the FSA has rightly recognised, this will require the application of significantly greater 'industrial' process in its business.

With regard to the detailed provisions of the mortgage and general insurance regimes, we know that, in particular, the FSA Small Business Practitioner Panel – the co-chairmen of which are members of this Panel – has for its part scrutinised the proposals during the various consultation stages both carefully and critically. Whilst the final arrangements appear to be broadly workable for the sectors in question, time will tell whether the sometimes prescriptive and – for many – daunting requirements prove to be the proportionate and necessary basis of regulation that the FSA hopes.

The Panel will monitor over the coming year how the FSA is coping and whether the extension of its remit is being well managed and governed. Issues of operational efficiency are crucial in this context, especially after the Panel's survey of practitioners in 2002 revealed particular anxieties around such matters.

Creating plans to improve and measure FSA efficiency have become important strategic imperatives for the FSA; it must find ways of streamlining, as John Tiner has acknowledged. The published goal of cutting consultation papers by half in 2004 and on focusing on the 'must dos' rather than the 'nice to dos' is an encouraging development. Such tighter control over the FSA's output should have a positive impact on the overall quality of its work, would require a more critical assessment of whether or not to proceed with a particular initiative, and would naturally force the regulator to prioritise more critically.

IMPLEMENTATION OF EU DIRECTIVES

Callum McCarthy, in his inaugural speech as new FSA Chairman in October 2003 at the European Policy Forum, elaborated on the great challenges that lie ahead for the UK regulator and practitioners with regard to the implementation of the EU's Financial Services Action Plan (FSAP). The financial services industry faces the task of implementing more than 14 major EU legislative measures. The most immediate of these concern, among others, the Distance Marketing, Insurance Mediation, Financial Conglomerates and Prospectuses directives. Other significant initiatives in the pipeline include the Transparency, Investment Services, Reinsurance, Unfair Commercial Practices, Risk Based Capital and Insurance Solvency II directives.

Even though the timetable is driven by the FSAP implementation deadline, it will be important over the coming years to ensure that market participants are given adequate time to adapt to the new rules.

Of great concern to the Panel is super-equivalent implementation, or gold-plating, which poses a great threat to UK firms' competitiveness in Europe. The Panel has in the past urged the FSA to avoid any instances of super-equivalence, unless it is able to provide a clear and indisputable explanation of the reasoning behind the decision. We shall continue to press this point.

As Mr McCarthy said in his October speech, "at the FSA, we must ensure that we do not over-engineer implementation and careful consideration will be given before adding further regulatory burdens to the already heavy burdens derived from the EU directives." The Panel will monitor the transposition of EU directives into the UK regime closely, to ensure that these words will be applied in practice.

To achieve smooth and proportionate implementation of EU measures, the FSA has committed to working with its fellow EU regulators in regulatory networks such as CESR, the Committee of European Securities Regulators. Several Panel members are also involved in this process. Donald Brydon, our Deputy Chairman, represents UK market participants on CESR's Market Participants Consultative Panel, Alan Ainsworth is a member of the working group advising the European Commission on asset management issues, and Roger Sanders has joined the CESR consultative working group advising on implementation measures for the Investment Services Directive.

PRODUCT RISK FRAMEWORK

The Panel is cautiously supportive of the FSA's thinking behind the introduction of this framework but warns that proper implementation and application will be crucial to ensure that it achieves its aims without damaging the financial services industry. The desire to take a more proactive approach to identifying products of potential concern or risk to consumers has a number of benefits. However, an improper, invasive or overly-prescriptive use of the framework could seriously undermine innovation, risk-taking and competition – the key features of a healthy financial sector in the UK. Also, it is important that the FSA considers carefully the potential competitive advantages of EU passported firms selling their products into the UK.

It is unclear at this stage how the Product Risk Framework will fit within the ARROW framework, and how the FSA will manage the risk of it becoming a product regulation and approval regime by the back door. The Panel also feels that the FSA will need to work closely with practitioners to ensure that it properly understands the products and their target audience, and assesses them objectively. For that purpose, it is crucial that FSA staff are adequately trained so that firms can be confident the tool will be used intelligently. Finally, we should add that the Panel would not support the publication of individual assessments – to that end, we have noted John Tiner’s comments before the Treasury Select Committee in October 2003 that no such publication would take place.

If there is to be a Product Risk Framework, it would seem sensible that the same framework was adopted by both the FSA and the FOS. Further, an undertaking not to reassess the framework with the benefit of hindsight would be welcome.

The Panel intends to monitor developments in this area closely to make certain that the aforementioned concerns will be addressed. In particular, we note the FSA’s current research with a sample of firms and look forward to discussing the results and implications in due course.

A N N E X 1

Panel Members

Membership of the Panel is constructed to represent the various key sectors within which regulated financial businesses operate, based principally on nominations made by trade associations. Members are drawn from the most senior levels of the industry, and are formally appointed by the FSA Board. The Chairman's appointment must also have the formal approval of HM Treasury.

The Panel aims to rotate its membership to ensure a balance between consistency and new input. A list of current Panel members, along with their contact details, is below. We would like to extend our thanks to David Grigson, Finance Director of Reuters, who stood down as a Panel member during the course of 2003, and to James Crosby, Chief Executive of HBOS, who has stood down to take up a position as a non-executive director of the FSA. We wish him well in that important appointment and hope that this will help make the FSA Board even more aware and appreciative of the Panel's role and work, as well as reinforcing the need for the FSA to be suitably responsive to the views of practitioners generally.

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ANNEX 2

Background

INTRODUCTION

The Financial Services and Markets Act 2000 (FSMA) establishes the Panel as a statutory body, alongside the Consumer Panel – the latter representing the interests of consumers. This was in recognition of the important role of both Panels in the accountability and regulatory framework established under FSMA.

Both the Practitioner and Consumer Panels became statutory on 18 June 2001. From then on the Panel adopted the name of Practitioner Panel, as it is called in FSMA, rather than its previous name of Practitioner Forum.

MEMBERSHIP

Membership of the Panel is constructed to represent the various regulated financial sectors, based mainly on nominations by trade associations. Members are drawn from the most senior levels of the industry.

FSMA only specifies two sectors that must be represented; recognised clearing houses and recognised stock exchanges. Members are formally appointed by the FSA, with the Chairman receiving the formal approval of HM Treasury.

The Panel aims to rotate its membership to ensure a balance between consistency and new input.

David Challen retired from the Panel during 2002. He was the Panel's inaugural Chairman when it was set up in 1998, and remained as Deputy Chairman after handing over the chairmanship to Donald Brydon in 2001. Jonathan Bloomer was appointed as the Panel's Deputy Chairman in October 2002, before assuming the role of Chairman in November 2003.

ROLE OF THE PRACTITIONER PANEL

The Panel's main remit is to represent the interests of practitioners, and to provide input to the FSA from the industry to help it meet its four statutory objectives and seven principles of good regulation.

The Panel takes care to ensure it does not duplicate the important work of the trade associations in representing the views of their members. The associations have the staff and resources to promote the interests of their respective members in response to the impact of FSA policies on the sector they represent.

The Practitioner Panel aims instead to speak across all sectors in offering input at a strategic level.

The Panel has no directly employed staff and has requested no specific budget from the FSA. Ad hoc expenditure, such as the cost of the Annual Report and of its survey of regulated firms, is agreed with and paid for by the FSA.

The Panel keeps under review whether this is the most effective way of operating, but for the present considers it the right approach since regulated businesses ultimately pay for the costs of the FSA. This approach does require the generous support of members of the Panel and the administrative support of the FSA.

STATUTORY STATUS

On 18 June 2001, the commencement order giving statutory status to both the Practitioner and Consumer Panels under FSMA came into force.

Section 11 of FSMA brought an important part of the formal accountability of the FSA to the Panel into effect. This provides that, should the FSA ever reject formal representations offered by the Panel, it should have to explain its reasons in writing. The same also applies to the FSA's relationship with the Consumer Panel.

Both Panels have therefore agreed a common process for managing these "section 11 representations." It is important to strike a balance between ensuring that section 11 can be applied effectively, whilst at the same time avoiding unnecessary formality or bureaucracy that could weigh down frank and productive debate.

The Panel does not expect that formal representations under section 11 of FSMA will be made often, and it has not exercised its right to do so to date. This is nonetheless an important facility; whilst the Panel has no fear that the FSA administration would seek to sideline it or its views, the existence of section 11 is an important protection against such a possibility.

ACCESS TO THE FSA

The Panel Chairman meets regularly with the Chief Executive and Chairman of the FSA, through whom he and the Panel have access to the FSA Board. These meetings provide the opportunity to communicate issues of particular import and emerging concern.

The Panel's Annual Report is the subject of a formal presentation to the FSA Board. There are also frequent informal and ad hoc contacts between Panel members and directors and senior executives of the FSA.

FSA Managing Directors regularly attend Panel meetings to provide an update on current issues within their area of responsibility. Senior FSA executives also attend our meetings to present on policy developments, seeking the Panel's views before going out to wider formal and public consultation.

A N N E X 3

Panel objectives

The Panel measures its own performance and effectiveness on the basis of six objectives. They are not statutory but are agreed by the Panel's members to enable it to better perform its statutory role.

The six objectives must be seen in the context of two core principles that are vital to the proper functioning of the financial markets and to effective regulation:

1. **Practitioners' interests are best served by ensuring clients' prosperity and financial awareness.**
2. **A clear distinction must be drawn between wholesale and retail markets.**

Six Panel objectives:

- **Monitor overall effect of the FSA's activities on the industry**

To gauge the cumulative burden of incremental regulatory initiatives and regulation as a whole.

- **Assess the FSA's effectiveness, as seen by practitioners, against its objectives**

To evaluate the FSA's compliance with its statutory objectives and the principles of good regulation, including the desirability of facilitating innovation and of maintaining the UK's competitive position.

- **Actively communicate industry concerns to the FSA**

To voice to the FSA issues of general concern to the regulated community over developments that could impact the UK financial services industry.

- **Actively promote broad industry views and interests**

To play an active role in formulating and communicating to the FSA a broad practitioner view on the requirements for fair, efficient, and innovative markets.

- **Provide practitioner views to the FSA's on specific regulation**

To respond when requested to by the FSA with a practitioner view on early drafts of regulatory initiatives and discussion papers.

- **Promote international competitiveness of the UK markets**

To safeguard the competitive standing of the UK financial markets in the context of developments in the European Union and internationally, and to encourage innovation.

The Panel does not carry out activities on behalf of the FSA, nor does it seek to duplicate the work of trade associations.

There is further information on the way the Panel applies these objectives in practice on its website – www.fs-pp.org.uk

