



HM TREASURY

Reforming financial markets: summary of responses

November 2009



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Introduction

1.1 *Reforming financial markets*¹ was published on 8 July 2009. The paper outlined the Government's analysis of the causes of the financial crisis and set out a series of proposals for reforming and strengthening financial regulation, and protecting and supporting consumers.

1.2 The Government sought views from respondents on two broad types of questions – specific proposals for primary legislation, and more general areas for discussion. Comments were requested by 30 September 2009. During the consultation period, Treasury ministers and their officials met with a wide range of stakeholders to discuss the proposals. A number of stakeholder consultation workshops, bilateral meetings and discussions with international counterparts were also held.

1.3 Written responses, where confidentiality was not requested, can be found on the Treasury website at the following address: www.hm-treasury.gov.uk/fin_bill_index.htm. In total more than 100 responses were received.

1.4 The Government has considered all the responses to the consultation in developing the analysis set out in this document, including, where relevant, proposals for the Financial Services Bill, introduced into Parliament on 19 November 2009. The Government has also taken account of the recommendations made by the Treasury Select Committee (TSC) in their recent report, *Banking Crisis: regulation and supervision*. The Government also responded to the TSC's report separately on 19 November 2009.

1.5 Different groups and individuals took varying approaches to responding to the consultation. Some responses addressed in detail the specific questions set out in the document, whereas others made more general comments about the Government's approach to regulation of financial services. The Government is grateful that a large number of organisations and individuals took the time to respond to the consultation. All views have been taken into account and incorporated into the policy development process, in some cases leading to changes to the proposals suggested in *Reforming financial markets*. Examples of this include:

- changes to the wording of the Financial Services Authority's (FSA) new objective, to better reflect the balance between the costs of financial crises and the possible impact on UK economic growth of actions to maintain stability (see paragraph 2.18);
- minimising the financial risk to the Financial Services Compensation Scheme (FSCS) of the expansion of its remit, by giving it the ability to decline to act if it is not satisfied that funding is being or will be provided to meet the expenditure and expenses that it will incur (paragraph 2.43); and
- the decision not to provide the consumer financial education body (CFEB) with statutory immunity (see paragraph 2.62).

¹ *Reforming financial markets*, HM Treasury, 8 July 2009. http://www.hm-treasury.gov.uk/d/reforming_financial_markets080709.pdf

1.6 The vast majority agreed with the Government's view that reform of financial regulation is urgently needed. There was broad support for the majority of the Government's proposals, with comments chiefly focusing on the detail of the changes to financial regulation and their implementation.

1.7 There was broad support for the Government's proposals to drive greater focus on systemic risk, with the institutional framework updated to reflect greater emphasis on financial stability. The Government welcomes the emphasis placed by respondents on the need for cooperation between authorities involved in monitoring financial stability, with unambiguous separation of duties and responsibilities. Many responses also suggested that an improved focus on financial stability should not compromise economic growth and competitiveness, including lending levels in the short and medium-term. The Government agrees with this and is very conscious of the need to strike the balance between ensuring financial stability and allowing the financial sector to continue to provide vital services to society – including affordable lending. Many also indicated that international consensus and cross-border initiatives were vital in ensuring the success of improved and strengthened regulation.

1.8 There was broad support from across the stakeholder spectrum for the Government's proposals to support and protect consumers, including from the financial services industry itself. For example, one respondent stated that the firm "strongly supports any initiative that enhances the financial capability of consumers and we therefore welcome the Government's proposal to extend the Money Guidance scheme from spring 2010"². Another respondent stated that they "consider that the establishment of a separate authority, in itself, will develop the profile of consumer education/financial capability, which is arguably the greatest shortcoming of the present arrangements. Establishing a separate authority will concentrate attention on developing financial capability."³

1.9 There were however two small pools of respondents who respectively suggested that the Government's proposals should go further, and conversely that the Government should postpone focus on consumer-related measures and focus solely on financial regulation reform. While reform of financial services regulation is vital, the Government is also committed to making financial services work better for consumers, which is why *Reforming financial markets* set out measures to protect, inform and empower customers of financial services products.

1.10 Following consideration of stakeholder responses, many of the proposals in part A and some in Part B have been incorporated into the Financial Services Bill (the Bill). The Government's answer to each question sets out more detail and, where relevant, provides an update on these proposals.

² The full text of Aviva's response to *Reforming financial markets* can be found with the other consultation responses at www.hm-treasury.gov.uk/fin_bill_index.htm. See page 13 for the specified quote.

³ The full text of the British Bankers Association's response to *Reforming financial markets* can be found with the other consultation responses at www.hm-treasury.gov.uk/fin_bill_index.htm. This quote is featured on page 15.

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Summary of responses

Part A – Primary legislation proposals

Reforming regulatory institutions

Formalising and strengthening the arrangements for institutional cooperation

- 1 What are the benefits in creating a more formal and transparent body to coordinate the authorities' more systemic approach to financial regulation? Do you have any views on the role and remit of the CFS?

2.1 A significant majority of respondents who addressed this question welcomed the greater formalisation and transparency proposed for the new Council for Financial Stability. Among those that supported increased transparency, a large number flagged that any disclosure should take account of confidential or market sensitive data.

2.2 A great variety of views were expressed on the role and remit of the Council. Many replies stressed the need for good coordination between the authorities and that the remit, roles and responsibilities of the Council should be clear. Several respondents stressed the importance of the Council having an international outlook and effectively coordinating the authorities approach to international fora.

2.3 The Government welcomes the support for a more formal and transparent approach to coordination between the Bank of England, FSA and Treasury on financial stability. The Bill provides for the Council in primary legislation. The Council's arrangements will enable a suitable level of transparency by:

- quarterly meetings of the Council that discuss strategic issues being publicly minuted;
- the Treasury producing an annual report on the work of the Council; and
- the Council's Terms of Reference being prepared and laid before Parliament as a statement.

2.4 In line with respondents concerns about inappropriate disclosure, there will not be public disclosure of matters that are commercially confidential, may threaten effective action of the Council or threaten the stability of the United Kingdom.

2.5 The Government believes that it should move to arrangements for the Council as soon as possible. As such, the Council will meet as envisaged in the Bill in advance of its enactment.

- 2 To what extent would an annual report on key developments increase knowledge and awareness of significant regulatory actions taken under the Banking Act and FSMA? From your point of view, what areas would it be useful for this report to cover?

2.6 Of those that addressed this question, nearly all thought that an annual report was welcome. Many respondents commented that a report would help transparency and accountability. A number of other themes were identified by more than one respondent, these include: the importance that reports are not just reviewing events, but are also forward looking; the need for careful coordination of the interactions with the Bank of England's Financial Stability Review (FSR) and Financial Risk Outlook (FRO); and the benefit of more regular reporting.

2.7 The Government welcomes the emerging consensus in favour of an annual report for the Council. The annual report can increase transparency and accountability of discussions. The Council's Terms of Reference will set out that along with the FSR and FRO, the report will be considered by the Council at its quarterly minuted meetings. These quarterly meetings will also provide greater transparency on the thinking and action of the Council more regularly than once a year.

- 3 In addition to the input of non-executives from the governing bodies of the FSA and the Bank, what other ways could external advice and commentary be incorporated in this process?

2.8 Respondents mainly felt that external expertise would be beneficial to the operation of the Council. A theme of a number of respondents was that the authorities' assessment of risks in the run-up to the crisis and its handling had suffered from 'group think' and some cautioned that the Council needed to avoid being too insular.

2.9 The status of the involvement of external experts varied from those that felt that there should be permanent independent experts as standing members of the Council, akin to the Monetary Policy Committee model, and the more popular suggestion that the Council should consult with (panels of) external experts.

2.10 A number of participants, many from the relevant sectors, flagged the need for industry engagement; some respondents emphasised the need for input from academia and those thought to be clearly independent. A number of respondents flagged that in consulting experts due account should be taken of representatives from sectors beyond banking, notably insurance. In the extreme some thought that the Council itself should be independent of Government.

2.11 The Government believes that the Council's primary function is to provide for effective coordination of analysis and action between the authorities. It is right that the Council should compose of the Chancellor of the Exchequer, Governor of the Bank of England and the Chairman of the FSA. Many confidential matters of the Council can only be appropriately discussed between the competent authorities. However, the Government feels that it is important that the Council draws on external expertise. The Council's Terms of Reference will indicate that:

- the Council will draw on external expertise as necessary;
- members of the Court of the Bank or the FSA's board may be invited by the Chancellor to attend and participate in meetings of the Council; and

- other experts may also be invited to present evidence or expert analysis on particular issues.

2.12 It is worth noting that the institutions represented by the members of the Council already do this through their existing governance structures, for example the non-executives of the FSA and Bank, and as part of their day-to-day engagement with stakeholders, both informally and through formal consultation.

- 4 What mechanisms might be used for enhancing democratic accountability? Is this important? Are there any risks that need to be considered – for example, around market sensitivity, or threats to consumer confidence?

2.13 The majority of respondents recognised the existing effective scrutiny of the members of the Council provided by the Select Committee system and Parliament in general. In addressing this question, and earlier questions, a significant number of respondents flagged that confidential and market sensitive information should not be disclosed. An expressed concern was that transparency and accountability can build trust, but must not alarm.

2.14 The Government supports appropriate accountability of the Council. As a body rooted in statute, dealing with issues of clear public interest, there should be effective accountability mechanisms. The Government intends that the publication by the Treasury of an annual report on the Council, which will be laid before Parliament, should assist Parliament in scrutinising the work of the Council. The Government notes consultees' support for the existing scrutiny role of the Treasury Select Committee and looks forward to exploring with the Committee on how best to develop its scrutiny of the Council.

Strengthening the governance arrangements and statutory framework of the Financial Services Authority

- 5 What are the benefits of giving the FSA an explicit objective for financial stability?

2.15 Approximately a third of respondents commented on questions relating to the FSA's stability objective. In general, these respondents were positive about the proposal to give the FSA an explicit objective for financial stability. However, a widely raised concern was the potential for overlap and confusion between the Bank of England's and the FSA's responsibilities in this area; the importance of clarifying the roles of both bodies was stressed.

2.16 The Bill amends FSMA so as to give the FSA a new statutory objective to "contribute to the protection and enhancement of the stability of the UK financial system". In addition to other requirements touched on below, the Bill requires the FSA to produce a strategy, and to consult the Treasury on, how it will pursue financial stability. The objective is similar to the one given to the Bank of England by the Banking Act 2009, which also requires the Bank to produce a strategy, in consultation with the Treasury. The Bank of England and the FSA – as central bank and independent single regulator respectively – both have important, but clearly distinct, roles in protecting and maintaining financial stability. The Terms of Reference of the Council for Financial Stability will stipulate that it will consider the financial stability strategies of both the FSA and the Bank; this will clarify roles and avoid confusion between the FSA and the Bank.

- 6 What are the advantages and disadvantages of amending FSMA to make clear that the FSA must take into account any possible wider economic and fiscal costs in its decision-making?

2.17 Most stakeholders supported this proposal. However, a small number expressed concern that a requirement to take account of wider costs could result in an over-regulated 'zero failure' regime.

2.18 The Government recognises the validity of this point and is mindful that there is a balance to be struck between the costs of financial crises and the possible impact on UK economic growth of regulatory stability-related actions. It seems worthwhile to cover these considerations in the Bill. Therefore, as a result of these stakeholder comments, the Bill stipulates that the FSA must have regard to both these factors (see proposed section 3A(2)(a) and (b)).

- 7 What are the advantages and disadvantages of amending FSMA to place a duty on the FSA to promote sound international regulation and supervision?

2.19 Respondents generally welcomed the Government's proposals to create an explicit duty on the FSA to promote international regulation and supervision, as it would formalise the FSA's role in this work. Many felt that an explicit duty would ensure that the UK's interests were well represented internationally and that European and international aspects of financial stability would continue to be given sufficient attention.

2.20 Some respondents noted that the FSA should have already been engaging internationally. However most respondents felt that the duty would clarify and enhance the FSA's role on the European and international scene. Some also pointed out that the duty would enable the FSA to be adequately resourced to carry out this important work. Respondents did not foresee any particular disadvantages arising from the creation of a specific international duty on the FSA.

2.21 The Government intends to legislate to provide the FSA with an explicit financial stability objective, part of which is to establish the importance of taking into account the impact of wider European and international financial stability issues on the FSA's regulatory and supervisory decisions. To achieve this, the Bill will impose a specific duty on the FSA to work internationally to promote international regulation and supervision.

- 8 To what extent would these proposals improve the FSA's ability to have a more systemic or macro-prudential approach to prudential regulation?

2.22 The Government welcomes the broad consensus that these proposals would improve the FSA's ability to have a more systemic and macro-prudential approach to regulation.

Enhancing the FSA's powers

- 9 Do you agree that the FSA's rule-making power and powers of intervention should be explicitly deployable in pursuit of any of its regulatory objectives and not just that of consumer protection?

2.23 The majority of stakeholders were in favour of this proposal; indeed some believed that the FSA already had these powers.

2.24 The Government welcomes respondents' support for these proposals, which will be brought forward as part of the Bill.

10 To what extent will the FSA's enforcement capability be enhanced by a power to suspend individuals or firms for misconduct?

2.25 The Government received 20 direct responses to this question. The majority of respondents supported the proposal to provide the FSA with a power to suspend firms or individuals for misconduct. There were however some concerns relating to the FSA's use of such power, with a number of respondents noting the importance of checks and balances and appropriate right of redress. A small number of respondents indicated that they believed the FSA already possessed these powers, and questioned whether this proposal was in fact a clarification of existing powers.

2.26 In light of these responses, the Government proposes to legislate in the Bill to provide the FSA with a power to suspend or limit an authorised person's permission for up to 12 months, and suspend or restrict an approved person from undertaking certain 'controlled' functions for a maximum period of 2 years, for breaching requirements imposed by or under FSMA. Currently, the FSA can only impose a financial penalty or public censure on a firm for misconduct, and can only impose a penalty or public censure on an approved individual, or withdraw approval completely (rather than suspend). The Government believes that these proposals enable more nuanced and appropriate enforcement procedures to tackle offences. The FSA has a duty to act reasonably and proportionately, and all of the FSA's activities are subject to appropriate checks and balances, including the right of appeal, as set out in FSMA.

11 To what extent will the FSA's enforcement capability be enhanced by a power to penalise persons who perform a controlled function without the necessary FSA approval?

2.27 The Government received 20 direct responses to this question. The vast majority of respondents agreed that such a penalty would enhance the FSA's enforcement capability, and encouraged the Government to take this proposal forward.

2.28 The Government proposes to legislate in the Bill to provide the FSA with a power to penalise persons who perform a controlled function without the necessary FSA approval.

12 Are the Government's proposed amendments to FSMA the best way of ensuring that the FSA can continue to take effective action to tackle abusive short-selling practices?

2.29 The Government received 25 direct responses to this question. The majority of respondents agreed with the approach proposed. Firstly, there was overwhelming support for the FSA to be able to place restrictions on short selling and to require disclosure of short selling. The Financial Inclusion Centre responded that they "support the proposals on short selling. The FSA must have powers to implement emergency measures quickly and a duty to operate a permanent disclosure regime on short selling"⁴. In addition, respondents generally recognised that this ability would be

⁴ The full text of the Financial Inclusion Centre's response to *Reforming financial markets* can be found with the other consultation responses at www.hm-treasury.gov.uk/fin_bill_index.htm. This quote can be found on page nine.

better kept independent of the FSA's market abuse powers. Deloitte's response stated "we support the proposed amendments, not least because it separates actions taken for reasons of financial stability from those that constitute market abuse"⁵.

On the use of the emergency powers

2.30 Although the majority of respondents agreed with our proposals, three respondents asked for standards and a statutory threshold to be set for the exercise of urgent restrictions on short selling without consultation. It was suggested that the FSA publish findings that extreme conditions were found to be prevalent in the markets and that these powers were required, before imposing the measures to deal with the emergency.

2.31 The FSA can only exercise the powers to make urgent short selling rules without consultation if it considers this is necessary to protect the stability of or maintain confidence in the financial system. Specifying a statutory threshold and standards for doing so would risk the FSA's ability to take action when it is impossible to specify precisely in what circumstances emergency action might be required. The FSA will explain why it is taking emergency action but requiring it to publish findings before it does so is unrealistic. It is essential that the FSA is able to act quickly in emergencies and publicising that it is intending to or may take action before it actually does so may be counterproductive.

2.32 Other respondents wanted clarity over how long the FSA could extend these powers for. The Bill specifies that initially these emergency short selling rules may last for no more than three months. The FSA may extend such rules once, for a maximum of a further three months without consultation, but it needs to make and publish a direction to do so and again it can be expected to explain why the rules need to be continued. If unstable market conditions were deemed to be longer term, then the FSA has to then consult in the usual manner if it wishes to extend any restrictions beyond this initial six-month period.

2.33 *Reforming financial markets* referred to 'abusive' short selling practices and a small number of respondents pointed out that this terminology could be confined to relating to occurrences of market abuse in short selling strategies. The Government has not used this language in the Bill, preferring to grant the FSA the power to impose urgent short selling measures where it considers that it is necessary to do so to protect the stability of the financial system or to maintain confidence in the financial system.

On the disclosure requirements

2.34 The majority of respondents agreed that the FSA should have the power to make rules requiring a permanent disclosure regime for short positions in UK stocks. However, a few respondents were concerned about the UK making changes to the disclosure regime out of step with Europe so that the industry would be subject to unnecessary changes and transition costs.

2.35 These concerns are unfounded as the FSA will work to develop an agreed European disclosure policy for short selling and the power the Government would be granting the FSA is very much a 'enabling power'. The FSA will be able to ensure that rules made under this provision are consistent with a disclosure regime which is harmonised across Europe. The details of the disclosure regime, such as the disclosure threshold and to whom the disclosure are made, are still then working policy matters and the FSA have not proposed any rule changes at this stage. An agreed disclosure policy across Europe will make better sense for the firms who operate in several countries and who need to comply with these requirements.

⁵ Deloitte's full response to *Reforming financial markets* can be found with the other consultation responses at www.hm-treasury.gov.uk/fin_bill_index.htm. This quote is on page five.

2.36 A small number of respondents also urged the FSA to carry out a full cost benefit analysis over the proposed new disclosure regime. The FSA carried out a consultation exercise on the outline of a short selling disclosure regime, including cost benefit analysis, in its Discussion Paper on Short Selling published in February 2009⁶. The FSA will conduct a fuller cost benefit exercise when proposals for a detailed regime have been worked up and finalised. Disclosure rules made by the FSA would be in line with any harmonised European regime. In addition, any European short selling disclosure regime will also need to go through the usual legislative procedures.

Conclusion

2.37 The Government has therefore included the power for the FSA to prohibit, or require disclosure of, short selling in the Bill. This will give the FSA full powers to require the production of information or documents in order to ascertain whether there has been a breach of any short selling rules, and to enforce against a breach of those rules either with an unlimited fine or by publication of a censure.

13 Can you identify areas where the FSA does not currently have sufficient power to request information that it requires in order to carry-out more system-wide analysis of the financial sector?

2.38 20 consultation respondents directly addressed this question. Three respondents felt the FSA already had sufficient powers. One respondent felt that the FSA had insufficient powers to request information relating to hedge funds and private equity. A further four respondents supported the proposals without identifying particular areas where the FSA had insufficient powers. One respondent also stressed the importance of being able to share information across national boundaries.

2.39 A number of other respondents supported the proposals but stressed that the additional powers should not add to the burden on regulated bodies. Respondents also opined that the additional powers should be used proportionately and should not be overly costly to administer, particularly in relation to smaller bodies. One respondent pointed out that the FSA can already get information on non-regulated institutions forming parts of groups containing an authorised firm. Another suggested that where possible, information requests from the different authorities should be co-ordinated to minimise disruption and duplication.

2.40 Following discussions with the FSA, the Government is satisfied that there is a need to provide the FSA with greater powers to seek information from entities which are not regulated under FSMA, where the information concerned is relevant to the financial stability either of individual financial institutions or of one or more aspects of the stability of the financial system of the United Kingdom. This will include the power to collect information from non-regulated financial services firms, providers of critical services to such firms (e.g. IT suppliers), and the power for Treasury to extend the scope of info-gathering powers in future. The FSA will be able to exercise these powers at the request of an overseas regulator.

2.41 These powers will be subject to a number of safeguards, including the requirement for the Treasury to approve the FSA's policy statement on use of the power and the obligation on the FSA to consider the burden of the information requirement on firms.

⁶ DP09/1 Short Selling, Financial Services Authority, February 2009

Expanding the role of the Financial Services Compensation Scheme (FSCS)

14 What are your views on this proposal to expand the role of the FSCS?

2.42 On balance, interested stakeholders were in favour of this proposal. 22 respondents commented specifically on the proposal to expand remit of the FSCS to act as paying agent for a foreign deposit guarantee scheme, of whom all but one were explicitly in favour of the proposal. The BBA stated that “this will clearly be of real, practical assistance to depositors in relevant circumstances.”⁷ The Financial Services Consumer Panel said that “it is important that consumers find it easy to be compensated and this will be expedited most effectively through dealing with the compensation scheme in the country in which they live. Expanding the role of the FSCS to act as the agent for compensation schemes in other countries when they have to pay compensation to UK consumers is therefore useful”⁸. Respondents were keen to stress however that the authorities must ensure that there is no additional cost to UK levy-payers.

2.43 The Government has therefore included in the Bill a measure to improve depositor protection by expanding the remit of the FSCS to allow it to act as agent to deliver compensation on behalf of other compensation schemes or authorities. The measures will ensure that compensation can be paid quickly and effectively, reducing costs and minimising disruption to customers of financial services firms. In response to concerns about avoiding additional costs for the scheme, the measure will ensure that in carrying out this function the FSCS will take on minimal financial risk. The FSCS will be able to decline to act, for example, if it is not satisfied that funding is being or will be provided to meet the expenditure and expenses that it will incur.

Competitive markets that work for consumers

Financial Capability and Money Guidance

15 What are the advantages and disadvantages of the relevant consumer credit firms contributing to the costs of Money Guidance?

2.44 There was widespread agreement among respondents that consumer credit firms should contribute to the costs of Money Guidance. In their response, the consumer organisation Which? said: “We see the benefits in contributions by consumer credit firms. The purpose of education and advice is to improve the position of the consumer in their decision-making on financial matters”⁹.

2.45 Given that Money Guidance covers a wide range of personal finance issues including consumer credit, it is logical that the whole of industry, including consumer credit firms, should contribute. Consumer credit firms will benefit from better-informed and more capable customers.

⁷ As stated above, the full text of British Bankers Association’s response to *Reforming financial markets* can be found with the other consultation responses at www.hm-treasury.gov.uk/fin_bill_index.htm. See page seven for the specified quote.

⁸ The full text of The Financial Services Consumer Panel’s response to *Reforming financial markets* can be found with the other consultation responses at www.hm-treasury.gov.uk/fin_bill_index.htm. See pages 22-23 for the specified quote.

⁹ The full text of Which?’s response to *Reforming financial markets* can be found with the other consultation responses at www.hm-treasury.gov.uk/fin_bill_index.htm. This quote is from page three of the document.

2.46 A small number of respondents suggested that industry contributions should be broadened to organisations such as utility companies or mobile phone providers, as the benefits of more financially capable consumers would have positive impacts across many different sectors.

2.47 The Government also consulted through bilateral meetings and workshops with a range of stakeholders on the question of whether the principle that consumer credit firms should contribute to funding of Money Guidance, should apply also to funding for the range of financial education initiatives undertaken by the new consumer financial education body (CFEB). This was met with general agreement.

2.48 The Government will legislate in the Bill to give the Office of Fair Trading (OFT) the power to collect contributions from consumer credit firms. In the Impact Assessment that accompanies the Bill (published on 19 November 2009 and available on the Treasury's website), the Government has set out the benefits for the financial services industry of better informed and educated consumers; it is clear that these far outweigh the costs. The Government will consider further whether it would be appropriate to broaden the industry funding base of Money Guidance in the future to other sectors.

16 The Government believes that some organisations, such as free and impartial debt advice providers, should be exempt from the levy on consumer credit licence holders – do you agree? Are there other cases where an exemption is appropriate?

2.49 While there is widespread acceptance that free and impartial debt advice providers should be exempt, there are concerns that this might create a loophole for commercial organisations. A few respondents specifically mentioned that they would like to see transparency and a firm set of criteria for exemptions from funding.

2.50 Other candidates for exemption included credit unions and Community Development Finance Institutions.

2.51 The Bill provides for the OFT to make exemptions for certain classes of consumer credit licensees/applicants. It is expected that any exemptions will be based a set of criteria which will be tested with stakeholders and set by the Treasury and the Department for Business, Innovation and Skills (BIS).

17 What factors should be considered in designing an appropriate levy scheme for consumer credit firms?

2.52 While most respondents believed that consumer credit firms should contribute to the funding of Money Guidance, a range of issues were raised which should be considered in designing a levy scheme, including which organisation should collect the levy and where the costs of collection should fall. It was noted that many consumer credit firms are also licensed by the Financial Services Authority (FSA); it would be important to ensure that these firms did not pay twice.

2.53 The Government intends to minimise additional administrative burdens on firms by collecting the levy from consumer credit firms via the OFT license fee; this is the same mechanism used for collection of the Financial Ombudsman Service (FOS) levy. The Bill will also allow the OFT to recover the costs of collection from the sums collected.

Strengthening the FSA's consumer capability

18 What issues need to be resolved to establish a successful consumer education authority set up by the FSA?

2.54 There was broad support from the respondents for the Government's proposals to set up a separate consumer education body. In Nationwide's response the building society stated that "in principle a single authority should help to raise financial capability higher up the agenda of both the Government and industry"¹⁰.

2.55 There were a number of issues that respondents felt needed to be resolved to establish a successful consumer education authority, beyond the questions on scope, independence, and governance and funding below.

2.56 Many consultation responses were concerned about the new body's scope and how it would interact with other organisations. It was felt that a wealth of expertise on financial capability already existed and that the new authority might duplicate current work. Many emphasised the importance of a clear remit and strategic fit with other organisations.

2.57 A number of responses suggested that the new body should be high profile and provide strategic leadership in this field, with a brand that is easily understood and recognised by the public.

2.58 A small number of industry respondents expressed concern that funding for the consumer financial education body (CFEB) would come principally from the industry, yet it appeared unclear how their views would be represented. A few industry responses suggested that the structure of the fees should incentivise firms to maintain and develop their own education initiatives through for example, 'positive naming' or accreditation of firms running effective financial capability programmes.

2.59 Several respondents queried how the new body's activity would be evaluated. It was felt that current evaluation of financial capability did not fully capture its impact.

2.60 Many respondents felt strongly that the body should not have statutory immunity.

2.61 The Bill gives CFEB the power to deliver its functions through other organisations, meaning that the new authority will be able to call upon the considerable skills and expertise of other individuals and organisations. It is envisaged that the new body will work via memoranda of understanding with other organisations concerned with providing consumer information and education; this will be part of its strategic role in promoting and coordinating financial education.

2.62 The new body will also work closely with the devolved administrations to ensure a joined-up approach across the UK.

2.63 CFEB will be required to demonstrate in a published annual report how it has achieved its objectives; this includes evaluation and measurement of the impact of its initiatives.

2.64 The Government has decided that, on balance, there is no clear justification for statutory immunity for CFEB.

¹⁰ The full text of Nationwide's response to *Reforming financial markets* can be found with the other consultation responses at www.hm-treasury.gov.uk/fin_bill_index.htm. See page nine for the specified quote.

19 What are your views on the scope of the new authority? Should it also, for example, champion consumer interests and act as a consumer voice in financial services?

2.65 The Government has already made clear that the scope of the authority must be set out clearly, with clearly defined boundaries, to ensure that it is not replicating existing activity.

2.66 Most respondents indicated that, while they wanted the body to have consumers' interests at its heart, they did not want the new authority to become a consumer voice; firstly because there are many existing organisations already play this role (such as Consumer Focus) or will play this role in the future (the proposed Consumer Advocate) and secondly because it would dilute the consumer financial education agenda. However, a minority of respondents felt very strongly that the new body should pursue consumer advocacy.

2.67 Several respondents felt that CFEB could take the lead for the financial inclusion or debt advice agendas in addition to financial education.

2.68 The Government has decided, in line with the majority view, to focus CFEB's remit on financial education but intends to consider further whether the scope of the body could benefit from being expanded.

2.69 The Government expects that CFEB will work with consumer advocacy organisations where appropriate.

20 What are your views on the governance and funding proposals for the authority?

2.70 There was strong feeling that there should be both industry and consumer representation on the CFEB board.

2.71 Views were split as to who should fund the new authority with some suggesting that it should be purely the responsibility of the industry (including consumer credit firms), while others believed that it should be the responsibility of Government.

2.72 . Respondents felt it would be helpful for the Government to provide greater detail on the level and sources of funding as well as on the practical running arrangements of the new body than was set out in *Reforming financial markets*.

2.73 Some respondents felt that there might be benefits in different funding sources for CFEB itself and for specific projects that CFEB may deliver to limit the funding burden on the industry. Respondents agreed with the Government that the use of funding from dormant accounts would be appropriate.

2.74 The Bill sets out further detail on the governance and funding arrangements for the new body. The Government remains of the view that Board members will be appointed by the FSA (with the approval of the Treasury for the Chair and Chief Executive) but that the terms of appointment will be such as to ensure their independence from the FSA.

2.75 CFEB itself will be funded principally by the financial services industry which will allow CFEB to continue delivery of the National Strategy for Financial Capability although, for specific projects, CFEB will be able to accept funds from a variety of sources. The Government estimates that implementation of the national Money Guidance service will form the largest part of the expenditure of the new body; further detail is set out in the Impact Assessment. In addition to

industry funding, the Government intends to direct dormant accounts funds and public funds to support implementation of Money Guidance.

21 To what extent should the authority be independent of the FSA?

2.76 There was overwhelming support for operational independence for CFEB, although a number of respondents felt that CFEB should be entirely independent of the FSA. It was generally felt that CFEB should be sufficiently independent of the FSA to command respect from both industry and consumers and therefore achieve greatest impact on consumer education.

2.77 Most felt that there should be close working relationship between CFEB and the FSA, so that for example the FSA could consult CFEB on regulatory disclosures to consumers. However some believed there was a risk of tension between FSA and the new body.

2.78 A small number of respondents had concerns over the removal of the FSA's public awareness responsibility, indicating that this might cause it to neglect its focus on consumers.

2.79 A few respondents stressed that the CFEB's actions should not undermine financial stability.

2.80 The Government agrees that operational independence for CFEB is of paramount importance and proposes that the new body should be set up along the same lines as Financial Ombudsman Service (FOS) and the Financial Services Compensation Scheme (FSCS). CFEB will retain some lines of accountability to the FSA, e.g. the FSA will approve its budgets and plans. It is also expected that CFEB and the FSA will work closely on consumer issues: the Bill gives CFEB a role to advise the FSA and other regulators on issues affecting consumers.

2.81 The Government believes that, as the FSA retains its objective on consumer protection and will take on a remit to ensure that CFEB can carry out its functions effectively, the FSA's role to protect and empower consumers will not be impaired by the removal of its objective to promote public understanding of the financial system.

2.82 The Bill proposes that the new body have regard to financial stability when making policy.

Swift and effective redress

22 How can better routes to collective address be achieved, which deal with claims more efficiently, reduce the time that claimants may have to wait, and reduce the volume of individual cases dealt with by the courts or FOS?

2.83 There were 26 direct responses to this question. Opinion was divided over the desirability of a new mechanism to enable groups of consumers to seek collective redress. There was both support for alternative dispute resolution mechanisms and recognition that the Financial Ombudsman Service is not a suitable vehicle for settling mass claims, as it must deal with each case on its individual merits. There was also broad support for some form of collective action process through the courts, although several respondents expressed reservations. They questioned the need for a new mechanism, and stressed that better access to justice should not generate more claims or promote a litigation culture.

2.84 The overall message was that early action to minimise complaints, coupled with better consumer education, and action by firms themselves to resolve complaints is preferable to regulatory action or litigation. If new mechanisms are to be developed, they should be carefully

designed to dovetail with existing mechanisms, reduce costs and be compatible with other redress proposals at national or European level.

2.85 The Government is seeking better ways of dealing with instances of mass claims more quickly and at lower cost. It should be possible to design industry-wide solutions to provide redress more effectively in these rare cases. Costs can be reduced if those solutions are proportionate and can be implemented soon after a problem has begun to manifest itself. It is not intended to generate more claims, or to promote a claims culture, so it would be important to apply the loser pays principle, and ensure that claims without merit can be dismissed quickly. The potential solutions are discussed in the following paragraphs.

23 What are the pros and cons of updating FSMA section 404 through expanded new powers for the FSA to which different procedures will apply as proposed?

2.86 Opinion on streamlining the FSA's current powers in FSMA section 404 was polarised. The consumer groups and other bodies were in favour. They highlighted that the power has never been used and suggested that the current threshold conditions, such as Treasury and Parliamentary approval, were set too high for it ever to be usable in practice. Industry respondents said that the FSA's existing powers were adequate. They were concerned that firms should not routinely be obliged to review all their business over a lengthy period of time due to costs. There were two principal concerns: (i) that the power would not be used sparingly, in a proportionate way, and (ii) that the existing checks and balances on the FSA's use of the power would not be replaced with adequate oversight or appeals procedures, leaving firms with no ability to challenge FSA decisions through the courts.

2.87 While taking into account industry concerns about the importance of checks on the FSA's use of its powers, the Government maintains that it is appropriate for the FSA to be able to secure redress for consumers in cases of sector-wide consumer detriment, as it can currently do on a firm-by-firm basis under existing powers. The Bill therefore streamlines FSMA section 404 to provide that the FSA may make rules ("s404 rules") requiring firms to establish a consumer redress scheme if (a) it appears to the FSA that there may have been a widespread or regular failure; (b) as a result, consumers have suffered or may suffer loss that would entitle them to redress; and (c) it is desirable to establish a scheme to secure redress for consumers.

2.88 The Government expects this power to be used only in the most grievous cases where there is reason to believe that there has been widespread consumer detriment. A decision by the FSA to proceed would be subject to public consultation, a cost benefit analysis, and a requirement for the FSA to be satisfied that it is the most appropriate way of meeting its objectives, having regard to proportionality. It will be for firms themselves to carry out an investigation and decide whether there has been a breach, in accordance with the s404 rules. Firms may apply for judicial review to challenge the FSA on any point of law.

2.89 Some firms would like to go further, and subject s404 rules to automatic review by a court, or have a full right of appeal on the merits of the case. FSMA does not provide for a right of appeal against the FSA's other rule-making powers other than through judicial review. That is because judicial review is the appropriate mechanism for challenging rules that apply on a general rather than individual basis and do not involve consideration of the facts of individual cases. It would be highly unusual to have a requirement of court approval for the making of regulatory rules. Such decisions are properly a matter for the regulator, and it would in practice undermine the role and operational effectiveness of the regulator.

2.90 The Government has taken into account industry concerns by drawing the scope of a streamlined section 404 narrowly and introducing additional protection for firms. It will be

confined to failures by authorised firms and payment services providers to comply with legal requirements for carrying on a regulated activity. The standards to be applied will be the standards in force at the time of the breach, not current or later standards. Firms will be able to challenge the FSA on any point of law through the courts. Any complaint by consumers to the Financial Ombudsman Service in respect of acts covered by s404 rules will be dismissed while the firm concerned is carrying out the consumer redress scheme and will thereafter be considered in accordance with the s404 rules and not the Ombudsman's "fair and reasonable" jurisdiction under FSMA.

24 What are the pros and cons of introducing a new representative action process where there is evidence of a breach of FSMA or FSA rules, and should this extend to breaches of other requirements in the area of FSA supervision?

25 How should such a representative action process be structured?

2.91 There was cautious support for a representative action process as a more effective way of handling large numbers of claims, depending on how it was structured. Consumer groups said it was desirable to have a mechanism to secure redress for all consumers affected by a breach, for the courts to be able to actively manage a representative action, and for a representative to be able to negotiate an overall settlement. Industry respondents suggested that current processes were adequate, and that much would depend on the detail. They were concerned not to open the door to high value class action lawsuits with little merit, and the balance of opinion was against the creation of an opt-out process in which all eligible consumers are included in the case unless they choose not to participate. The Government agrees with respondents that a representative action should be a last resort, and the incentives should favour alternative dispute resolution. Some respondents stressed that the FSA should not itself be able to bring an action as a representative, nor be able to prevent an action.

2.92 The Government will legislate in the Bill to enable collective proceedings to be brought by a representative on behalf of a group of consumers who have claims that raise the same, similar or related issues and who would otherwise be entitled to pursue their own case individually. Eligible claims will arise from the use of financial services in the course of regulated activities falling within FSMA, consumer credit activities falling within the Consumer Credit Act 1974, and payment services. Potential defendants are authorised persons, approved representatives, payment service providers and those carrying on consumer credit activities. The causes of action can range from claims for breaches of regulatory rules, breaches of legislation transposing European Directives and any breach of the general law.

2.93 The courts will be able to authorise collective proceedings in respect of a group of financial services claims containing the same, similar or related issues of fact or law. The effect will be that each person whose claim is represented will be bound by the court's rulings in the case. Any person may apply to the court to bring an action, and the court will need to satisfy itself as to a variety of matters including the nature of the case whether there is adequate funding for the proceedings, whether the representative is a suitable litigant, and whether the claims can be dealt with by means other than litigation. The FSA and OFT will have a right to be heard by the court and it is expected that the court will have regard to their advice about the alternatives to collective proceedings.

2.94 The Government has decided not to rule out actions on an opt-out basis. This is consistent with the treatment of consumer redress in FSMA, which gives the FSA wide powers to obtain redress for consumers, without requiring consumers to opt-in. Much depends on the circumstances of each case, and the number and size of claims. The Government considers that

a decision on whether an action should therefore be opt-in or opt-out should be for the court to determine with regard to the particular features of the case before it.

2.95 It is expected that the Treasury will have a power to make regulations to set out prescribed matters for the court to consider. Regulations may, among other things, exclude or include specified persons and claims; make provision about damages (for example for the court to award aggregate damages rather than individually assessed damages); provide for the apportionment of damages among the class, for example by reference to a formula; and how the payee may hold and distribute payments to claimants; and the suspension of any limitation period for those whose claims are comprised in the collective proceedings.

26 The Government invites views on the potential costs and benefits of its collective redress proposals.

2.96 Only one response was received. This suggested that the non-monetary benefits in the provisional impact assessment appeared reasonable, and that the monetary benefits depend on both consumer bodies and firms having confidence in the process.

Part B – Areas for discussion

Managing systemically significant firms

- 1 Do you agree that the systemic significance of a financial institution should be explicitly linked to regulatory capital requirements?

2.97 Almost all respondents agreed with the Government that the authorities should take the nature of the institution into consideration in setting regulatory capital requirements. They felt that the impact as well as the probability of failure should be factored into regulatory strategies. However, many respondents argued in favour of a single policy framework, proposing for example a sliding scale approach rather than a separate regulatory framework for systemic institutions. Many respondents argued that other methods should also be used to regulate systemically important institutions, rather than just capital requirements, e.g. liquidity requirements and enhanced supervision.

2.98 Some respondents also expressed the view that “systemic significance” should not merely be a function of size. For example, the business model and risk appetite of the institution should also be considered.

2.99 Many respondents also drew attention to the importance of reaching an agreement internationally on regulating systemic institutions to prevent UK firms being disadvantaged when competing with non-UK institutions.

2.100 Some respondents commented on the importance of a realistic time period for implementing any enhanced regulatory requirements in order to give firms enough time to adapt to the changes.

2.101 The Government welcomes the broad consensus from respondents that the Authorities should take into account the systemic significance of a financial institution in setting regulatory capital requirements. The Government has also taken note of the importance many respondents placed on having a single policy framework in place, and the value of considering other regulatory and supervisory tools in addition to capital requirements to address the risks posed by systemically important firms.

2.102 Domestically, the Government welcomes the FSA’s Discussion Paper on the treatment of systemically important financial institutions and its conclusions that there is a strong case for applying some form of capital surcharge to systemically important banks to reduce the probability of failure and to internalise the external costs that their systemic importance produces. The Government will continue to work with the FSA as they continue to develop the design of the domestic policy framework.

2.103 Internationally, the Government welcomes the agreement by G20 Leaders in Pittsburgh that prudential standards for systemically important institutions should be commensurate with the costs of their failure. The Government believes that action should reflect international agreement and discussion on these issues and will work closely with international partners to achieve this. The Government fully supports the work programme by the Financial Stability Board (FSB) on possible measures to reduce the moral hazard posed by systemically important institutions, which includes consideration of the merits of more intensive supervision and specific additional capital, liquidity, and other prudential requirements. The Government looks forward to the FSB’s proposals, which they will set out to G20 Leaders by October 2010.

- 2 How should systemically significant institutions be categorised? For example, should there be a fixed list or a sliding scale of importance, how often should such a list be updated, and should any list of systemic significance be made public?

2.104 Many respondents felt that defining the concept of “systemic” and categorising systemic institutions is very challenging. Many respondents also felt that a fixed list of systemic firms would cause problems for institutions on the boundary and consequently, most respondents agreed that it would be better for the Authorities to use a sliding scale approach for categorising systemic firms. However, many respondents noted that the sliding scale should be based on complexity and interconnectedness, as well as size.

2.105 However, if the Authorities were to create a fixed list, respondents were keen that it should be updated regularly, given the relevance of context on whether or not an institution is considered to be systemic and the high pace of change in financial markets. Some respondents also requested that the Authorities make their criteria for assessing the institution clear and transparent to allow institutions to plan ahead.

2.106 Many respondents also requested that any such list be kept private as a public list may cause those firms labelled as systemic to be treated differently by stakeholders. On the other hand, some stakeholders felt that a fixed list, were it to exist, should be made publicly available to give consumers the greatest amount of information possible and to eliminate uncertainty in markets.

2.107 The Government agrees that there are challenges in the categorisation of systemic institutions. To that end, the Government welcomes the new IMF/BIS/FSB guidelines to identify systemically important financial institutions, markets and instruments, which represent an important contribution to the development of internationally consistent policies to address the risks they pose. The Government will continue to work with the FSA and the Bank and with international partners on these issues.

- 3 Can you identify any other important challenges to implementing stricter regulation on systemically significant institutions?

2.108 As already raised in the previous questions, the majority of respondents highlighted the potential for regulatory arbitrage and possible detrimental effects on UK competitiveness if regulatory proposals were implemented too quickly or without international consensus. The importance of responding collectively on cross-border firms was also highlighted.

2.109 Respondents drew attention to the importance of flexibility in drawing up the framework and consideration of future shocks, as well as a proportionate approach that does not aim for a zero-failure regime.

2.110 Respondents stressed that the benefits brought about by large and complex firms should be recognised, and the importance of maintaining these was emphasised.

2.111 In this context, respondents highlighted the importance of aggregate impact assessments and cost benefit analysis, considering the cumulative effect of policies being proposed.

2.112 It was also emphasised that detrimental effects on maintaining effective competition may result domestically, if stricter regulation of systemically significant institutions disadvantages these firms relative to their competitors. A further challenge identified by a number of

respondents related to the possibility that firms may restructure such that they avoid stricter regulations imposed on systemically significant institutions.

2.113 One respondent raised concerns over firms or activities that, whilst not systemically significant individually, may be in aggregate.

2.114 Several respondents called for greater clarity regarding the extent to which firms outside the banking sector would be categorised as systemically significant.

2.115 The Government recognises the benefits often associated with large and complex firms alongside the necessity of ensuring that they are sufficiently regulated. As set out previously, the Government acknowledges the importance of, and is working towards ensuring, international agreement in this area.

2.116 The Government welcomes findings in the FSA's Discussion Paper on the treatment of systemically important financial institutions that address many of the concerns raised by respondents, notably including cumulative impact assessment of proposed reforms, the potential for groups of firms to be systemically significant and the extent to which firms other than banks may be systemic.

2.117 The Government is not proposing to pursue a zero-failure regime, which would be neither realistic nor desirable, and is therefore legislating for recovery and resolution plans to contribute to the reduction of both the probability and impact of failure.

2.118 The Government's response to concerns regarding domestic competition are addressed in more detail under questions 5-11 on competition.

4 Do you agree that banks should be required to establish more detailed contingency plans in times of failure?

2.119 A significant majority of respondents were broadly supportive of the proposition that banks should be required to establish more detailed contingency plans in times of failure. For example, the response from Royal Sun Alliance opined "all firms should ensure that they have appropriately robust contingency plans in times of failure"¹¹. It was suggested by a number of respondents, however, that further research should be conducted in this area before implementation, incorporating an impact assessment and cost-benefit analysis. Respondents requested clarification of the objectives and intended practical operation and assessment of such plans, and a number emphasised the importance of the appropriate timing of implementation.

2.120 Several respondents advised that regulators should be involved in the development of contingency plans, for example by instructing firms on their required content, inspecting and approving plans. It was emphasised that contingency plans must be proportionate and reviewed continually. PricewaterhouseCoopers said "We see great merit in the proposal that all banks should establish more detailed contingency plans for action in times of failure, provided the requirement is to prepare plans that are proportionate to the size and complexity of the bank concerned"¹². Some respondents highlighted that contingency plans should be subject to review as part of the FSA's wider supervisory framework. One respondent suggested that public disclosure of plans should not be required.

¹¹ The full text of the Royal Sun Alliance (RSA)'s response to *Reforming financial markets* can be found with the other consultation responses at www.hm-treasury.gov.uk/fin_bill_index.htm. See page seven for the specific quote.

¹² The full text of PricewaterhouseCoopers' response can be found with the other consultation responses at www.hm-treasury.gov.uk/fin_bill_index.htm. Please see page nine for the specific quote.

2.121 A number of respondents cautioned against forcing banks to adopt particular structures, especially without international consensus.

2.122 Some respondents requested clarification as to which firms would be covered by requirements to establish more detailed contingency plans in times of failure.

2.123 The Government is legislating for recovery and resolution plans (RRPs) in the Bill. By requiring firms to produce plans that set out the range of actions the firm might take to deal with a stress situation (recovery), or how the Authorities' menu of resolution options might be applied to the firm in question (resolution), and by identifying potential obstacles to action and suggesting possible solutions, RRP's aim to:

- Reduce the probability of firm failure;
- Reduce the impact of firm failure when it does occur on the wider financial system, economy and public finances;
- Reduce the moral hazard problem of systemically significant firms;
- Contribute to better management of firms by creating regulatory incentives for firms to avoid being systemically risky.

2.124 The Bill makes a number of provisions around RRP's, including the following:

- A duty will be placed on the FSA to make rules requiring firms, or authorised persons of a specified description, to produce RRP's. The content of RRP's will not be defined in legislation, but the Bill does provide for RRP's to include the preparation and maintenance of key sets of data or information. The FSA will consult on the detailed rules on RRP's in the normal manner, and this will include a full cost-benefit analysis.
- The Bill specifies that the FSA must make rules for those authorised firms subject to Part 1 of the Banking Act 2009;
- The Bill provides an order-making power for the Treasury to stipulate to the FSA the dates by which RRP rules must be in place for categories of firms other than those covered by Part 1 of the Banking Act 2009 (authorised firms 'of a specified description');
- The FSA is required to consult the Bank of England and the Treasury before preparing draft rules for both recovery and resolution plans;
- The FSA will be required, in drafting rules on RRP's, to have regard to any relevant international standards on RRP's. By requiring the FSA to take in to account international standards as they develop, opportunities for regulatory arbitrage and detrimental effects for the UK's competitiveness will be minimised;
- The Bill requires the FSA to consider whether all recovery and resolution plans are satisfactory. In assessing the resolution plans required from firms subject to Part 1 of the Banking Act 2009, the FSA must consult the Bank of England and the Treasury. The Bank of England and the Treasury may notify the FSA of any inadequacies of such a resolution plan and can suggest remedial actions which the FSA must have regard to; and
- The Bill gives the FSA additional enforcement powers related to the collection of information in relation to RRP's.

2.125 Detailed rules on RRP's for firms subject to the Banking Act 2009 will be prepared by the FSA in 2010 and will be based on substantial evidence gathered from the FSA's ongoing pilot

project of a small number of large UK banks. The Bill allows the FSA to introduce RRP gradually and in a proportionate and risk-based manner. In the first instance, RRP will be required from firms covered by Part 1 of the Banking Act 2009, expanding to other firms to timetables set out by the Government by order. All such rules will be subject to full consultation.

2.126 RRP will become an integral part of the FSA's risk assessment toolkit and broader supervisory approach.

Competitive markets that work for consumers

Barriers to entry and encouraging new entrants to the retail banking market

- 5 What steps could the Government take to increase competitive pressures in the market, to the benefit of consumers?

2.127 Some respondents felt that there were no problems with competition in the financial services market, but the majority of those who commented believed improvements are necessary. Many suggested that a restructuring of state-supported banks could increase competition. It was also felt that competition would be enhanced if consumers were better able to compare financial products.

2.128 Since the publication of *Reforming financial markets* the Government has taken steps to strengthen competition in financial services, most notably in respect of restructuring and divestments of the two banks that have received substantial capital injections from the Government and the state-owned Northern Rock. The Government believes it is right that the Royal Bank of Scotland (RBS) and Lloyds Banking Group (LBG) restructure their organisations and undertake compensatory measures to reduce any competition distortions in the market resulting from government support; and the announcements of 3 November 2009 provide more detail on these developments. In addition, the OFT is putting in place measures to increase transparency in the banking sector as a whole, including more clarity on the full costs of personal current accounts. This will drive competition by helping customers to understand the true cost of banking services, enabling them to shop around for alternatives.

- 6 In addition to the barriers to entry identified by the OFT and the Competition Commission, are there further barriers faced by potential retail-banking providers?

2.129 Most stakeholders considered that the OFT and Competition Commission had identified the main issues, although a small number questioned whether these factors did actually restrict new market entrants. Some respondents noted that provision of state support may be a barrier to entry because customers may only wish to deposit their money with those banks that benefit from Government guarantees or are deemed 'too big to fail'.

2.130 The Government is pleased that respondents considered that the list of barriers to entry was correct. The Government has acted to protect competition by placing restrictions on those banks which have received support. For example, since March 2008 Northern Rock has operated under a competitive framework that restricted its commercial activities in specific areas, in order to prevent Northern Rock gaining unfair advantage as a result of government support.

7 How can the Government and industry facilitate easier account switching in the retail banking sector?

2.131 Numerous stakeholders argued that the level of account switching in the UK has been underestimated. Nevertheless, it was frequently suggested that action to improve the transfer of direct debits would do most to facilitate account switching.

2.132 The OFT announced on 7 October 2009 that it has reached an agreement with the main retail banks to reduce the risks and make the process of switching accounts easier. This follows the OFT's 2008 market study which highlighted the difficulty of switching accounts. A number of measures have been or are being introduced to improve the switching process, including steps to reduce problems that arise from transferring direct debits, and other efforts to increase consumer awareness of the automatic switching process.

8 What additional work would be needed to ensure that the infrastructure to support faster payouts in the event of bank failure could also support account portability?

2.133 The majority of respondents argued that account number portability is unworkable in practice.

2.134 In the light of responses the Government will keep the matter under consideration, but has no immediate plans to take forward specific work in this area.

9 With the development of new technologies, where might new entrants to the retail banking market come from and how can consumers be encouraged to take advantage of it?

2.135 Respondents felt that new technologies are most likely to be exploited by larger, established banks because reputation and trustworthiness are important where use of new technologies is concerned.

2.136 The Government will continue to consider the impact of new technologies on competition among banks.

10 Do you support the Government's proposals to embed facilitating market entry into medium-term financial sector policy making by requiring the FSA and OFT to specifically address the issue in: Cost Benefit Analysis on new regulatory proposals; and the OFT's annual updates to its financial services strategy?

2.137 The large majority of respondents were in favour of these proposals. The Government welcomes respondents' general support for these proposals and is working with the OFT and FSA to take this and related issues forward.

11 Would you support requiring the OFT to consider enforcing the adoption of industry-wide disclosure standards to ensure consumers are well-equipped to make decisions about their financial affairs and to switch suppliers?

2.138 The majority of stakeholders supported this requirement, although some have argued that any disclosure standards that are introduced should be voluntary.

2.139 In addition to the action set out under question 7 above, the Government is working to increase consumers' capability to equip them with the skills and understanding to choose and manage products effectively. In the Financial Services Bill, the Government is introducing provisions to require the FSA to establish an independent consumer financial education body (CFEB). CFEB will lead the national rollout of the Money Guidance service and take forward the National Strategy for Financial Capability.

Access to simple, transparent products

- 12 Would simplified labelling help consumer understanding of financial products? What lessons can be learned from the traffic light system of food labelling and how can these be applied to financial products? Should such labelling be compulsory?

2.140 There was a fairly polarised set of responses to the question of whether labelling would assist consumer understanding. Whilst a majority of respondents believed that consumers would benefit from simplified labelling there were a significant number, mainly those representing the financial services industry, who were opposed to the concept, commenting that it would be unlikely to benefit consumers. Those responses from organisations representing consumers were, in general, the most strongly in favour, however even among those who were strongly, or generally, in favour of the concept there were a number of concerns. Age Concern and Help the Aged said "we would welcome a system of labelling that encouraged the development of simple, accessible products, and made product disclosure more effective"¹³ and Citizens Advice were "supportive of efforts to provide clear information to consumers which seek to streamline the decision-making process and highlight simple and good value for money products"¹⁴. Several respondents felt that simplified labelling could lead to consumer detriment rather than benefit as it could discourage them from investigating products fully or from seeking financial advice and that consumer education should be a higher priority. A few respondents also noted the growing prevalence of internet comparison sites which allow consumers to compare products – suggesting that these negate the need for product labelling comparisons. However, it was also acknowledged that in the main such sites were sponsored by, or linked to, the financial services industry and may not be fully impartial.

2.141 When considering, in more detail, the traffic light labelling approach a few respondents were strongly in favour of the system – feeling that consumers were familiar with it and that it represented an extremely simple method of presentation. However, most respondents felt that a simple traffic light labelling system would be unsuitable for financial products. Some felt that it could not cope with the inherent complexities of the products and was too simple in its approach, others felt that it would need to focus on only a few relevant criteria and would therefore not provide enough information. Some respondents went on to suggest alternative approaches to labelling for financial services products, which included a format similar to the efficiency ratings given on domestic appliances and a consumer checklist approach.

2.142 Of those who felt that product labelling would offer some benefit, there was a split on the question of compulsion. Some felt that such a system could not work if it were not

¹³ The full text of Age Concern and Help the Aged's response to *Reforming financial markets* can be found with the other consultation responses at www.hm-treasury.gov.uk/fin_bill_index.htm. See page 13 for the specified quote.

¹⁴ Please see link above for full text of Citizens Advice's response. The quote can be found on page 16.

compulsory – because providers offering less appropriate products would not use it – whilst others felt that it should be up to providers whether they used the system or not. Some suggested that some providers might feel that simplified labelling may be detrimental to consumers and would therefore not wish to participate.

2.143 The Government is grateful for all the views expressed. It was clear that most respondents, representing a wide range of views, were in favour of some form of simplified labelling and felt that this would help consumers to make choices. However there were also a number of concerns about the risks of oversimplification and unintended consequences. In the light of responses, the Government will examine various methods of labelling in more detail. On the question of compulsion the Government is minded to wait until the alternative methods of labelling have been examined in more detail before making a decision on this.

13 Which products would – and would not – be suitable for simplified labelling? Is it possible to establish a single system of disclosure for a diverse range of products?

2.144 The responses to this question were wide ranging. Whilst some felt that simplified labelling would be best suited for products that carry investment risk (as risk is a feature not widely understood by consumers) others felt that it would best suit simpler – more widely understood – products. At the extreme ends of the responses, roughly the same number of respondents felt that it would suit all financial products, as those that argued it would be appropriate for no financial products. The originators of these responses varied: in general consumer groups were most in favour of simplified labelling applying to all products whilst industry respondents were more selective as to their approach.

2.145 A few respondents felt that it would be possible to establish a single system for all relevant products – if the parameters were chosen well. However most felt that the diversity in the products meant that a single system would be likely to lose the amount of detail that would be needed to make it worthwhile.

2.146 The Government intends to continue to focus on those products which are purchased by a wide range of consumers. There is scope to expand the work to include other products as developments continue. As part of the next steps in this work the Government will be looking to assess, with consumers, which products they deem appropriate to the criteria. The Government agrees that a single system may reduce its effectiveness however it is felt that, even if the detail changes, there should be a single recognisable approach to product labelling in financial services.

14 Should price be benchmarked? Should there be disclosure to help people identify products which are relatively expensive?

2.147 A few respondents felt that benchmarking of prices would be beneficial for consumers. However, most respondents felt that it would focus consumers too much on price at the cost of other factors, and that it could be extremely detrimental for consumers to make their choice based on price alone. Of those in favour of benchmarking of prices, mixed between consumer groups and industry, it was felt that price was an important consideration for some people, especially where products were very similar. Many respondents pointed out that price comparison websites already provided consumers with an option of comparing prices, although again their lack of impartiality was mentioned. Some respondents felt that a consistent (and meaningful) method of showing price was important in allowing consumers to compare

products. It was also commented that some products (for example protection products) are individually priced and it would therefore be difficult to provide comparative information.

2.148 The Government agrees that price is only one factor in choosing the most suitable product from a range of similar offerings. However for many people price is one of the most important factors. The Government agrees with the view that allowing people to compare price by ensuring consistency of price presentation is extremely important.

15 Why do some existing simple products not sell well?

2.149 Several respondents, mainly representing the financial services industry, pointed out that some existing “simple products” do sell relatively well. However most respondents accepted that simple products, especially those where there had been regulatory intervention, often did not sell well. Many respondents felt that this was because regulatory restrictions meant that the products did not always accurately meet consumer needs whilst others felt that price caps, and therefore low returns for providers, meant they were not marketed to consumers or that there was a lack of competition due to fewer providers wanting to sell them (increased competition leading to increased marketing and thus increased awareness). Some also felt that the products did not sell well because advice had become too expensive and that this, combined with a lack of consumer awareness of their financial needs (a lack of consumer education), meant that individuals were not buying products to meet those unknown needs.

2.150 These responses suggest that the proposed approach of labelling, rather than additional regulation, may be more beneficial to consumers.

16 Should the Government extend the concept underlying RU64 to other products – i.e. require firms to demonstrate why a complex or expensive product is better than a simpler or cheaper alternative?

2.151 Whilst a few respondents, representing consumer groups, were in favour of such an extension believing that by ensuring providers informed consumers of cheaper options it would lead to consumers getting better value most, particularly those from the financial services industry, were opposed to the extension. Some respondents pointed out that RU64 was only relevant where advice was being given and whole of market advisors were already obliged to consider all their customers needs before making a recommendation. Other respondents felt that this would again suggest to consumers that price was the most important factor to consider (as other direct comparisons would be unlikely except where stakeholder versions of the product existed). It was also suggested that an extension of the RU64 rule could lead to consumers choosing less suitable products and may lead to undersaving.

2.152 The Government is inclined to agree with the view that an extension of the RU64 rule may be inappropriate for the range of products under consideration but continues to believe that consumers should be able to readily compare prices of the products (whilst also understanding that price is not the only product differential).

17 Who should set benchmark standards for products?

2.153 The responses to this question were varied. Some respondents felt that no benchmarks should be set. Those who responded with suggestions varied from the industry, to regulators or the Government, there was no clear distinction between industry responses and consumer

group responses as to who should set benchmarks although consumer groups were slightly more in favour of a regulatory or legislative approach to benchmarking. Others suggested that any benchmarking should be based on consumer behaviour. Several respondents also suggested a committee approach.

2.154 The Government will consider this in more detail as this work progresses. The Government intends to consult further on simple transparent products by engaging consumer focus groups, the Retail Financial Services Forum and holding further talks with stakeholders. The intention is that this additional consultation work will allow the Government to put forward more detailed implementation proposals for public consultation early in 2010.

Mortgage insurance

18 Are there barriers to the provision of mortgage insurance in the UK?

2.155 As set out in *Reforming financial markets*, mortgage insurance for lenders may encourage lenders to manage risk and open up lending to borrowers. The Government received fifteen responses to the questions on mortgage insurance, a number of which combined responses to this question with responses to question 19, below. Responses were received from a wide range of stakeholders, including consumer groups, academics, insurance providers, mortgage lenders and their representative bodies. The majority of respondents argued that there were no significant barriers to the provision of mortgage insurance for lenders, citing a range of mortgage insurance products as supporting evidence. Other respondents suggested that there were barriers, including poor understanding of products by mortgage lenders, and a lack of capacity and appetite on the part of insurance providers.

19 What are the advantages and disadvantages of the Canadian model of mortgage insurance?

2.156 As noted above, a number of responses to this question were combined with responses to the previous question. The Canadian model of insurance includes compulsory mortgage insurance for mortgages above a certain loan-to-value ratio and the provision of mortgage insurance through a state-owned agency, the Canada Mortgage and Housing Corporation. The majority of respondents did not support the introduction of elements of the Canadian model at this time – which they argued could increase the cost of mortgages to borrowers and require permanent Government intervention in mortgage and insurance markets. A number of insurance providers argued in favour of a system of compulsory mortgage insurance, arguing that the system of compulsory mortgage insurance in Canada has resulted in low level of mortgage arrears and increased availability of mortgage credit for first-time buyers, and that the private sector does not have capacity to support the UK mortgage market in full.

2.157 The Government is grateful for respondents' views. The Government considers that the case is not yet made for moving towards a Canadian model of mortgage insurance in the UK, but the Government will keep this proposal under review and take stakeholders' views into account as part of its ongoing work.

Financial Services Compensation Scheme (FSCS) governance and accountability

20 Do you have any views on how the governance and accountability of the FSCS can be strengthened to help it successfully deal with these new challenges?

2.158 Eight respondents commented specifically on the structure of the FSCS, its arrangements for governance and accountability and its performance during the recent period of financial instability. A number of respondents made specific comments on governance and accountability, including suggestions that FSCS should have a “duty of care” to achieve the best result for levy payers, a proposal that the FSCS should be subject to audit by the National Audit Office, and recommendations that the Government should look at the make-up of the board to ensure that it is independent and representative. The Investment Management Association (IMA) suggested that “in light of the significant sums owed to it from defaulted firms [...] the FSCS may need to be re-configured as an entity reporting to HMT”¹⁵.

2.159 A significant number of respondents focused on concerns around the funding of the scheme. 11 respondents commented on cross-subsidy between FSCS levy classes, all of whom oppose cross-subsidy on principle. 11 respondents commented on FSCS pre-funding, of whom 10 opposed the proposal. Some respondents linked these issues to the fundamental structure of the FSCS, for example Prudential stated that the “time is right for a fundamental review of the FSCS now that it is clear it cannot finance bailouts of the major banks.”¹⁶

2.160 Having considered the consultation responses, the Government continues to believe that the existing arrangements for FSCS governance and accountability have worked well. Nevertheless, respondents have indicated that it would be worthwhile to look at the existing arrangements to ensure that the FSCS is well equipped to respond to the challenges that its new roles and responsibilities, and the changed environment for financial stability. As part of this review the Government will consider what changes may be appropriate, including around the make up of the FSCS board, and whether it would be appropriate for the FSCS to be subject to audit by the National Audit Office.

2.161 The Government believes that it is important that the FSCS should retain its operational independence, particularly in light of the proposal in *Reforming financial markets* that the Treasury will be able to require the FSCS to act as a paying agent for a foreign deposit guarantee scheme or government as set out the section above on expanding the role of the FSCS. The Government does not propose that the review of governance and accountability will look at the fundamental structure of the scheme established by FSMA.

2.162 The Government does not propose that the review of FSCS governance and accountability will focus on funding of the FSCS. The Government believes that it is right that the scheme should be funded by levies on the financial services industry, however the structure of FSCS levy classes is a matter for the FSA. The FSA will be undertaking a funding model review with a consultation paper planned for 2010-11, which will invite views on this issue. The Government notes that changes to the allocation of levies within classes or changes to the way in which levies are apportioned between classes will always be difficult.

2.163 The Government remains of the view that pre-funding is an appropriate approach in the long-term to the funding of the FSCS. However, it would be inappropriate to begin a transition

¹⁵ The full text of The Investment Management Association’s response to *Reforming financial markets* can be found with the other consultation responses at www.hm-treasury.gov.uk/fin_bill_index.htm. See page five for the specified quote.

¹⁶ The full text of Prudential’s response to *Reforming financial Markets* can be found with the other consultation responses at www.hm-treasury.gov.uk/fin_bill_index.htm. See page ten for the specified quote.

to such a scheme given the current situation, so the Government has decided that pre-funding will not be introduced before 2012, and when pre-funding is introduced, the initial levy will not be set at a level that would compromise financial stability or undermine efforts to strengthen the banking system. In line with the commitments the Government has given, there will be full consultation before the introduction of pre-funding including on the timing, coverage and levies for a pre-funded scheme, and the specific concerns raised by respondents about the detail of the pre-funding arrangements will be addressed as part of that consultation.

Strengthening crisis management and depositor protection across the EU: single point of contact

- 21 Do you agree that a single point of contact would be a suitable way of handling cross-border compensation issues in the EU? If not, why not and what alternative would you suggest?

2.164 21 respondents referred or alluded to the proposals for a single point of contact, the majority tending towards the view expressed by the BBA that “recent experience has demonstrated the benefits to consumers of a single point of contact in relation to cross-border compensation.”¹⁷

2.165 The measures outlined above around expanding the role of the FSCS improve depositor protection by expanding the remit of the FSCS to allow it to act as agent to deliver compensation on behalf of other compensation schemes or authorities, and the Government continues to believe that the EU should move towards a system in which host schemes would always act as the single point of contact for depositors in their country, irrespective of which scheme has the ultimate liability to pay for the compensation given to depositors.

- 22 How should a single point of contact operate?

2.166 There were no detailed suggestions for how a single point of contact would operate, but some respondents suggested that greater European cooperation and coordination would be necessary, including some who suggested that there should be harmonisation across the EU on compensation arrangements. Most respondents did not go further than this in making specific recommendations, however Zurich stated that a single point of contact should operate within the institutional structure of the EU’s Level Three Committees¹⁸.

- 23 Should there be more or less harmonisation of EU deposit-guarantee schemes?
- 24 What are your views on the possible introduction of a pan-EU deposit-guarantee scheme?

2.167 14 direct responses were received for these two questions. There was general support for some level of minimum harmonisation, particularly on the deposit guarantee limit and timescale for payout. There was substantial support for further harmonisation, although not exceeding the proposals that have already been published. The general consensus was that detailed provisions

¹⁷ The full text of BBA’s response to *Reforming financial markets* can be found with the other consultation responses at www.hm-treasury.gov.uk/fin_bill_index.htm. See page 14 for the specified quote.

¹⁸ The full text of Zurich’s response to *Reforming financial markets* can be found with the other consultation responses at www.hm-treasury.gov.uk/fin_bill_index.htm. See page eleven for the specified quote.

setting out whether there should be ex-ante and ex-post funding, and how levies should be collected should be left to national discretion. Only one respondent favoured maximum harmonisation.

2.168 A substantial majority of respondents opposed a pan-EU deposit guarantee scheme. It was thought that little value would be added by a European scheme and that any benefits would be outweighed by increased inflexibility, uncertain taxpayer liabilities, and differences in national insolvency regimes. It was suggested that depositors might have less confidence in a European scheme than a national scheme. Two respondents thought that a pan-EU scheme had some merit by providing more clarity for consumers and reducing competitive distortions. One respondent advocated a complementary European scheme supporting national schemes or covering compensation payments for cross-border firms.

2.169 The Government has set out its views in a response to the European Commission's consultation on deposit guarantee schemes¹⁹ and will take account of the views that have been expressed in further discussions with our European partners. A single European scheme may provide consistent deposit compensation arrangements and a deeper pool of resources than any single national scheme. It implies that Member States would be exposed to the risk of a failure in another Member State, of a firm over which they had no powers of supervision, and they would commit their national resource to compensate depositors in that institution.

2.170 The Government believes that, in the first instance, the focus should be on securing changes to address the technical deficiencies that have been identified in the Directive, and to raise the operational effectiveness of national schemes. Only if these are found wanting, should consideration be given to a pan-EU scheme. If consideration were given to a community scheme, a complementary scheme in addition to national schemes might be one way to provide a source of additional liquidity to national schemes, if an effective burden sharing mechanism could be found. This might cover only cross-border branches, although it should then cover all such branches and not solely those of large groups. It would be important not to duplicate national schemes, but provide an additional layer of support. Such a scheme might, for example, provide access to borrowing from a pre-funded pool or reinsurance of cross border liabilities. The costs and benefits would need to be assessed carefully, and the framework carefully aligned with evolving Community arrangements for bank supervision and resolution. It should not interfere with the effective operation of national or cross-border arrangements for crisis management.

Strengthening mutuals

Improving building society governance

25 What features of shared operating models could be applied to the UK building society sector?

2.171 A few respondents addressed the questions relating to shared operating models and the UK building society sector. These included building societies, sector representatives, and existing shared service providers. Responses were largely more positive about the potential for 'sharing services' in the UK building society sector, as opposed to implementing a more universal 'shared operating model' across the sector. Responses from the sector suggested that continental-style federated networks should not be implemented in the UK, given the need to maintain diversity

¹⁹ Review of Directive 94/19/EC on Deposit Guarantee Schemes, European Commission, 2009

and competition. A couple of respondents noted existing examples of shared services in the sector, including in areas such as IT systems, internal audit, compliance support, own insurances, and training & development. One respondent noted that creating an industry-wide processing utility could achieve significant savings, whilst others noted the opportunities for shared fundraising to give small societies access to wholesale funds. Generally, respondents recognised the potential for achieving operational efficiencies and cost savings through shared services, and identified back office functions and shared funding as two of the main areas where this could best be achieved. Most respondents noted the diversity of the sector, the differing needs of societies, and the need to avoid compulsion in implementing a shared operating model.

26 What are the barriers to shared operating models?

2.172 Most respondents noted a perceived loss of control and independence as a barrier to moving towards a shared operating model. One service provider proposed that setting up partnerships between societies and service providers could mitigate this. Other concerns included the timing, costs, operational risks, and logistics of transitioning to shared operating models, plus the number of societies that would need to take part to achieve economies of scale. On funding, cross-guarantees and cross-collateralisation were identified as draw-backs for well-run societies. Challenges were also identified for pooled funding, including who would own a pooled funding entity were one created, and what would happen if it got into difficulties. A couple of respondents also raised potential issues with VAT. Generally the barriers identified were operational rather than legislative.

27 What legislative or other changes would be needed to make such models effective in the UK?

2.173 The main issue highlighted in responses was tax, specifically a request for a change in tax treatment to ensure that shared service vehicles do not incur irrecoverable VAT costs. One respondent also noted that some changes may be needed to Sections 9A and 9B of the Building Societies Act to enable pooled funding proposals to be taken forward by the sector. Other than these issue, there were no suggestions for broad legislative changes needed to make such models effective in the UK.

28 Are there other measures the sector or Government should consider to achieve the long-term aim of a robust, thriving building societies sector?

2.174 The majority of responses highlighted capital as the key challenge to achieving a robust, thriving building society sector in the long term. Particular concerns included whether PIBS should be treated as Core Tier One capital and the viability of PPDS beyond their current use. The view of respondents was that PIBS should qualify as Core Tier One capital and that it was unlikely PPDS could have a long-term role in providing capital to the sector, due partly to a lack of investor interest in the consultation. Respondents welcomed the ongoing engagement on this issue at the experts group established by the Treasury this summer. One respondent also called for a re-assessment and levelling of the playing field between building societies and competitors, with reference made to issues including capital, funding, FSCS levies, and Government guarantees.

2.175 The Government welcomes the engagement of the sector on these issues. As noted in *Reforming financial markets*, the Government has convened a group of expert stakeholders to advise on the strategic issues affecting building societies, including shared operating models and

capital raising. The Government will report on the work of the experts group at the 2009 Pre-Budget Report.

Financial compensation and Industrial and Provident Societies

29 What is the best way of ensuring that IPSs convey to their members the nature of their investment?

2.176 A small number of respondents addressed this question and the related questions below. Concern was expressed that many members could believe they were savers rather than investors with risk capital.

2.177 It is important that societies make it clear that any investment by members is a risk and that they may not get their money back. IPSs that do not undertake regulated financial services cannot be regulated by the FSA and are, therefore, not eligible for participation in the FSCS.

30 Should a Code of Practice on withdrawable share capital be made statutory?

2.178 The responses were in favour of self-regulation combined with the voluntary code of practice currently issued by Co-operatives UK. However, respondents did not want to see a knee-jerk reaction to the events surrounding the problems with Presbyterian Mutual Society (PMS) that would result in a tougher regime and inappropriate burdens on the sector.

2.179 The Government intends to consult on measures applying across the UK in the New Year.

31 Are there specific measures the Government might take to help transparency and disclosure?

2.180 One suggestion was made that a Summary Financial Statement should be issued similar to that required by section 76 of the Building Societies Act. Some respondents did not find the FSA website easily navigable and respondents asked for it to include more information on its website regarding IPSs.

2.181 Giving greater force to the existing code of corporate governance for co-operatives may be effective, bearing in mind the diverse range of business across the sector. Consideration of other possible measures will be included in the Government's forthcoming IPS consultation.

32 Are there other measures that the Government should consider to enable credit unions, IPSs and friendly societies to thrive?

2.182 Respondents suggested that Government should ensure there is a robust regulatory and legislative framework for the mutuals sector, kept up to date and relevant with proactive engagement by Government. It was suggested that responsibility for IPSs be taken away from the Treasury and the FSA and given to another Department.

2.183 The measures currently under Parliamentary scrutiny should meet many of the needs of the sector over the next few years and represent a considerable step forward. It will take time for these to be integrated into working practices, and where appropriate, regulation. The legal framework could be significantly simplified by consolidating the existing legislation into one Act for credit unions, other co-operatives and benefit of the community societies.

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