

The Financial Conduct Authority should be strangled at birth

Tim Ambler and Steve Farrall

Adam Smith Institute

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Executive Summary

The Financial Services Authority will shortly be broken into three parts of which the most important, and expensive, two will be the Prudential Regulation Authority and the Financial Conduct Authority (FCA), responsible in future for consumer protection. However we already have a specialist financial services consumer protection organisation in the Financial Ombudsman Service: we do not need two. Indeed the consumer will be ill-served by having to pay for both of them as the current plan indicates they will.

The nascent FCA shows no sign of understanding markets or brands and plans to busy itself interfering in City businesses and, if its predecessor is anything to go by, doing so late and at a vast cost to both the financial services sector and its customers. The PPI scandal can in fact be attributed to the FSA: in 2003 it pressured Independent Financial Advisers to insist on PPI being taken out with every new mortgage. Then it failed to monitor implementation. Furthermore the roles for the two FSA progeny overlap and businesses will face huge confusion between the two.

This paper shows that it would be better to terminate the FCA before it gets going and turn over the supply, as distinct from consumer, issues to the new Prudential Regulation Authority, i.e. the Bank of England. The remit of the Ombudsman should be expanded from consumers and micro-businesses to include all SMEs. The FCA's other main role, namely the regulation of independent financial advisers, would be better left to a professional institute in the same way as other professionals such as accountants and solicitors are governed by their own institutes. This can be backed up for unresolved complaints by the Financial Ombudsman Service.

Introduction

The Financial Services Authority will shortly be broken into three parts of which the two most important, and expensive, are the supply-side Prudential Regulation Authority (PRA) which will regulate the banks and the demand-side Financial Conduct Authority (FCA) for consumer protection. The main thrust of this paper is that we already have a consumer protection organisation in the Financial Ombudsman Service (FOS) and we do not need two. Indeed the consumer will be ill-served by having to pay for both of them as the current plan indicates they will.

The PRA will become part of the Bank of England and the division between the PRA and FCA is nowhere near as tidy as the paragraph about implies.

Transferring the relatively small supply-side roles of the FCA to the PRA will also clarify responsibilities.

FOS works reasonably well but to become the one stop shop, it needs a little tidying up to become the primary agency where consumer can take unresolved grievances for financial matters. It would still not be the sole financial protection agency as the Financial Services Compensation Scheme, the Office for Fair Trading, the Bank of England and the PRA will also be watching the market and ensuring fair dealing.

The FOS was created at the same time as the Financial Services Authority (FSA) in 2000. Unfortunately, despite the memorandum of understanding between them,¹ the separation between them was, and remains despite, or perhaps because of, the draft memorandum of understanding between the FOS and FCA², unclear. The Financial Services Practitioner Panel “has repeatedly pointed out the concern over the FOS’s quasi rule-making abilities and the often blurred line of demarcation between the FOS and the FSA”.³ This will now be compounded by confusion between the FCA and PRA. The impending break-up of the FSA provides the opportunity to simplify the regulatory bodies and the borders between them.

The UK needs one body charged with financial services consumer protection, not two, and one body charges with monitoring the supply-side, namely the PRA. The FOS is driven immediately by consumer complaints and has done well to grow and cope with their rapid expansion. By contrast the FSA allowed bad practices to flourish for five years, e.g. PPI, and then announces headline grabbing large fines. Those are intended to show the FSA as tough guys but the size of the fine is actually correlated with the time the FSA has been asleep at the wheel. As the FCA will inherit the FSA’s consumer protection staff, we can expect the FCA to be similarly incompetent.

The difference is not just the time lag: the FOS is activated by real world consumer claims of unfairness whereas the FSA, and presumably the future FCA, imagines what might be wrong in theory and creates new regulations. We all now know that the financial problems of recent years were not created by poor or inadequate regulations but by the poor performance of the regulators.

For example, the PPI scandal can be attributed to the FSA itself: in 2003 it pressured Independent Financial Advisers to insist on PPI being taken out with every new mortgage. Then it failed to monitor implementation leading to unintended consequences when the market turned sour and banks tried to

¹ http://www.financial-ombudsman.org.uk/about/other_bodies.html, accessed 4th October 2012.

² <http://www.financial-ombudsman.org.uk/about/MoUwithFCA-draft-feb-2012.pdf>, accessed 4th October 2012.

³ The Panel’s 2003 Report.

impose the fine print which consumers, and very possibly the FSA, did not understand.

Recent speeches given by the FCA's CEO designate Martin Wheatley indicate that we can expect more of the same. He talks of market intervention, restricting choice and, in effect, deciding what is best for consumers without leaving them to decide for themselves and then complaining if they are hard done by.⁴ Wheatley also plans to bring in a whole raft of new regulations. To judge by these speeches, the FCA has little understanding of brands or how markets work and is trying to justify its existence. It is reminiscent of the sable rattling employed, to little if any real effect, by its parent. The FSA's methods placed a heavy burden, and costs, on the financial services sector and they are reflected in the prices of financial products. The FCA under Wheatley seems likely to continue the downward pressure, especially on financial advisors and similar small firms. Not only is this piling up of costs damaging, but it is unnecessary as it will achieve nothing more than the FOS, with a little sprucing up, could achieve on its own.

In short, it would be much better to terminate the nascent FCA, transfer supply-side matters, such as involvement in LIBOR setting, to the PRA and focus on improving the FOS to take care of the demand-side. We look at some possible, albeit minor, improvements and then tackle the allegation, made by some lawyers, that the FOS is currently above the law and should be made subject to the courts. The paper then seeks to establish where the border between PRA and FCA should lie before drawing conclusions.

FOS operations

The original concept of an ombudsman was as a citizens' champion capable of standing up to large to government departments and dates from early Chinese or Roman times, as the "tribune of the people". But the modern use of the word "Ombudsman" dates from a Swedish law in 1809 and has evolved to include representing the consumer against large commercial organisations. Ombudsmen operate on basic principles of what is fair and reasonable rather than the arcane legal principles that have emerged in thousands of years of common and statute law.

About one in five of the enquiries to the FOS turn into cases. Both have increased dramatically over the ten years since it was created from the smaller voluntary ombudsmen services that existed previously. The main driver recently has been complaints about PPI. It is simply astonishing that, having stalled as long as they could and then lost the legal case, the large banks did not move promptly to resolve all the complaints that they had already

⁴ See for example John Lappin. "Wheatley: Investment Charges will face 'Intense Scrutiny'", FT Adviser 25th September 2012, and Natalie Holt "Martin Wheatley: FCA will shoot first and ask questions later" MoneyMarketing, 18th September 2012.

documented. Not doing so opened the door to Claims Management Companies trawling the phone networks for their own profit and loss to the rest of the economy.

FOS - number of new cases

year ended 31 March Number of new cases

2012	264,375
2011	206,121
2010	163,012
2009	127,471
2008	123,089
2007	94,392
2006	112,923
2005	110,963
2004	97,901
2003	62,170

Source: FOS

Payment protection insurance (PPI) cases

year ended 31 March number of complaints

2012	157,716
2011	104,597
2010	49,196
2009	31,066
2008	10,652
2007	1,832
2006	1,315

Source: FOS

The FOS process is at two levels:

1. When a client/customer submits a case an Adjudicator assembles evidence from the complainant and the business and then makes a judgement. If the complaint is upheld the business can either settle the redress order, or have the case referred to an Ombudsman (senior FOS staffer)
2. If the Ombudsman also subsequently upholds the judgement of the Adjudicator, the business must pay whether it agrees or not. It has no right of appeal. Payment is ultimately enforced by the FSA who will at the final account remove the firm's authorisation to trade.

If the complaint is declined, the complainant can appeal to the Courts but this is very rare. No firm figures exist but the FOS considers that they are minimal.⁵

The FOS employs about 1,700 staff and the numbers are growing pro rata with the number of enquiries and cases. 99% of financial services firms never come into the process. The FOS would like to extend the number of cases that small firms are allowed before they start being charged.

No doubt the large firms, who pick up almost all the bill, think it unfair that charges are made for all cases, i.e. including those where the complainants' cases fail. Others would see that as entirely fair given how little the big companies have done to sort out the complaints themselves.

The FOS upheld 64% of complaints in 2011/2 but that is distorted by PPI where the figure was 82%. In general the proportion of complaints upheld is about 40 – 50%.

Given that balance, it is impressive that, according to FOS, 75% of complainants are happy with the service.

Problems with the FOS

1. Some individual advisors believe the system is biased against them. The FOS weighs up the balance of probabilities, as it sees them, and, according to the advisors, errs on the side of the complainant. That may be true or it may just reflect the normal view of the referee taken by the losing side. Whether the concern is real or illusory it needs to be dealt with.
2. Similarly some individual advisors allege that too many judgements have, and may be based upon, factual errors.
3. Currently the FOS is supposed only to take on cases pressed by consumers. In practice it has also been prompted by the FSA. The whole point of an ombudsman is to stand up to the big guys on behalf of the little guys. The FSA has 4,000 employees which, you might have thought, would be enough to investigate its own cases.
4. "In April 2008 Lord Hunt [of Wirral] recommended that FOS should select and publish some of its decisions in full, but in an anonymised form to show the relationship between the broad principles applied to resolution of cases -- which should also be published -- and their application in practice."⁶ The FOS should itself be more transparent and encourage good practice by making malpractice more visible. The FOS has published a

⁵ Telephone conversation with Martyn James of FOS, 20th September 2012.

⁶ "Ombudsmen Who Are An Affront To The Rule Of Law" Talk to the Professional Negligence Bar Association 25 January 2011, p.5 Anthony Speaight QC

nine page document showing the post-Hunt changes they are making.⁷ The government is consulting generally on the publication of ombudsmen decisions.⁸ Even with all this and the admirably extensive plans and annual reviews it publishes, the information is selective. For example, it claims that 75% of claimants are happy with the service but there are no comparable figures for personal advisors or other financial services. Anonymised complaint resolutions, which would help prevent future transgressions, are not published and nor are the track records of the big 10 service providers who make up 75% of the caseload.

5. The rationale for any ombudsman service is to balance the power of consumers who have not had satisfaction from the complaints procedures of large companies. Only 1.5% of FOS cases arise with financial advisers, i.e. business that are themselves very small. We are reluctant to suggest that the FOS should stand aside from these cases as where then would the individual turn to deal with a claim, which could be large for him and too large for the Small Claims Court?

⁷ <http://www.financial-ombudsman.org.uk/publications/policy-statements/accessibility-transparency-updateMar11.pdf>, accessed 4th October 2012.

⁸ <http://www.financial-ombudsman.org.uk/publications/consultations/Publishing-decisions-summary-2012.pdf>, accessed 4th October 2012.

Possible FOS improvements

1. The remit of the FOS should be extended from consumers and “micro-enterprises”⁹ to all Small and Medium sized Enterprises (SMEs) who, like private individuals, do not have the resources to take on the big guys. 75% of the FOS cases are complaints about just 10 of the largest financial institutions, mostly the big four banks.¹⁰
2. The standards prevailing at the time of the alleged malpractice should be used in reaching determinations, not current standards.
3. The quality and consistency of FOS decision-making should be subject to some form of annual independent review by a qualified academic or accountant. They should report on the quality of determinations and their factual accuracy. They should look for signs of bias. Whilst financial service providers should not be able to appeal individual cases, they should be able to lodge evidence from their perspective with the reviewer.
4. Furthermore, to address the allegations of bias, the FOS should involve independent or retired financial advisors in complaints against financial advisors.
5. As well as monitoring consumer satisfaction, the FOS should monitor service provider satisfaction and respond to grievances where they are well-founded.
6. The demise of the FSA should confirm the independence of FOS which should in future report to the Bank of England.

Is the FOS subject to the law?

Anthony Speaight QC in a hard-hitting 2011 speech concluded “Financial services professionals are now subject in an unbalanced process to unappealable decisions arrived at by the application of a so-called law, which has not been made by Parliament or any democratic body, and unpredictable policies. The process is secret; hearings non-existent; and challenge to evidence forbidden. There are doubts as to the independence of the tribunal. There is no public judgment.”

He, and many of his lawyer colleagues no doubt, are affronted by an organisation that keeps business away from the courts and makes decisions according to its own lights of what is fair and reasonable. One is reminded of Professor Higgins: “O why can’t a woman be more like a man?”

Alan Lakey, partner of Highclere Financial Services, asks “Is the FOS a workable adjunct to an already creaky legal system or is it a monster, out of

⁹ An EU term for the smallest businesses, i.e. those which have an annual turnover less than €2M and fewer than ten employees

¹⁰ 2011 Data, FOS.

control and careering across the financial services landscape doing immeasurable harm?” and concludes that it is the latter.¹¹

On the one hand, Speaight is correct. In 2001, the then head of the FOS, Walter Merricks said “We do not have to pretend to ‘find’ what the law is. We unashamedly make new ‘law’”¹², although he later withdrew the remark and quite rightly so: the role of the FOS is not to create law but to mediate between disputants. Their job is to level the playing field as much as they can and encourage the disputants to agree a deal, never mind the rules and regulations. It is not an “adjunct to the legal system” as Lakey suggests but a completely different system.

Of course the FOS is unbalanced and needs to be so to restore the overall balance between the individual consumer and the large organisation about whose conduct he is typically complaining. Consumers can appeal FOS decisions to the courts but rarely if ever do so because they cannot afford the costs which the financial giants can. If the latter were allowed to appeal to the courts, they would never lose a case. In any case, the largest redress the FOS can impose is £150,000 - chicken feed to large City groups albeit not to individual financial advisers.

Similarly, the FOS only holds hearings once in 10,000 cases because the introduction of lawyers would turn the process into that of a courtroom. Indeed it only does hold a hearing when it expects the case to go to court.

Despite all this, the FOS does wind up in court from time to time when one or more financial services giants decides to challenge its process or conclusions, e.g. in the case of PPI (Payment Protection Insurance) fines, and the FOS’s record in such cases is good.

Looking ahead, the EU seems to be suggesting that the conclusions of Ombudsmen and similar resolution bodies will not be legally binding.¹³ At this stage that is only draft law and it may well be clarified in favour of the FOS. Or it may be argued that, legally binding or not, failing to comply with a FOS ruling will result in a firm losing its trading licence.

Establishing the border

The opportunities for confusion between the PRA and FCA are clear from the original FSA June 10 announcement:

¹¹ *MoneyManagement*, Friday , April 21, 2006

¹² June 2001 speech to the Financial Regulation Industry Group.

¹³ Michael Trudeau “Fos decisions may not be legally binding under EU draft law”, FT Adviser, 19/9/12

“In 2013, the FSA will be replaced by two new regulatory bodies that will carry forward our philosophy of outcomes-based regulation, intensive firm supervision and credible deterrence:

- The Prudential Regulation Authority (the PRA), which will be a subsidiary of the Bank of England, will be responsible for promoting the stable and prudent operation of the financial system through regulation of all deposit-taking institutions, insurers and investment banks.
- The Financial Conduct Authority (the FCA) will be responsible for regulation of conduct in retail, as well as wholesale, financial markets and the infrastructure that supports those markets. The FCA will also have responsibility for the prudential regulation of firms that do not fall under the PRA’s scope.”¹⁴

So all banks and insurers will now, according to this plan, be regulated as to what they do by both FCA and PRA, who, if they are to avoid countermanding each other, will have unending committees demanding unending paperwork. What a mess! How could any legislator have failed to note the overlap between one regulating the whole “financial system” and the other regulating the “financial markets and the infrastructure that supports those markets”? If the latter is not the “financial system”, what is?

Markets are made up of sellers and buyers. It is straightforward to have one regulator keeping an eye on markets from the sellers’ perspective, namely, the PRA and one doing so from the buyers’ perspective, namely the FOS.

To separate the roles in this way would require some small revisions, namely the transfer of all supply-side responsibilities, e.g. LIBOR, to PRA without limiting it to deposit takers, insurers and investment banks. Whilst we are on the subject reforming LIBOR does not need the complexity accorded to it by Martin Wheatley’s 10 point plan.¹⁵ All that is needed is for the independent collater of the data also to be responsible for the collection of the data. Wheatley is, however, right to propose that the data should reflect real trades, not made up numbers.

That leaves one category which is neither a seller nor buyer: financial advisors are, technically, agents of the buyers. The FOS is not organised to regulate them and should not be expected to do so apart from dealing with complaints about their conduct. Financial advisors are professional people who need to be professionally qualified. The provision of qualifications is patchy at present with the Chartered Insurance Institute, for example, being one of many.

New Zealand has an Institute of Financial Advisors and there is no reason the UK could not do likewise as it has for over a century for accountants and lawyers. They have, as an IFA should, complaint processes and the FOS would

¹⁴ http://www.fsa.gov.uk/about/what/reg_reform/background accessed 3rd October 2012.

¹⁵ 28th September 2012.

stand behind that where necessary. This would go a long way to deal with the current feeling among financial advisers that they are not properly represented.

Conclusion

The FOS operates according to basic equity, namely what its adjudicators consider fair and reasonable. It seeks to mediate rather than arbitrate. It is a cheaper, quicker and may well be a fairer system than that to be found in courtrooms. Consumers and micro-enterprises, the buyers not the advisers, can appeal FOS decisions to the courts but the giant groups cannot use their greater resources to oppress the little guys. Small financial service providers are little caught up in the system as a whole but at the individual level they can be badly impacted. The effects of redress orders in these cases are proportionally far more onerous. The whole concept of an Ombudsman service is to deal with the large organisations and so, in the case of small providers, the FOS should do more to ensure that individual financial advisers believe that the FOS is fair.

Improvements have been suggested but four main conclusions emerge:

1. The roles of a supply-side regulator, the PRA, and a single demand-side protector should be more distinct with a clear border between them. The PRA is already defined to be responsible for the “financial system” and that must include markets.
2. The FOS has coped impressively well with the rapidly growing and complex problems with which it has had to deal. This provides a strong base for broadening its responsibilities.
3. The Bank of England should put large financial institutions under pressure to improve their complaint handling procedures and thereby greatly reduce the number of cases coming to the FOS.
4. The proposed FCA will do nothing that the FOS and an institute for financial advisers cannot do better. It should be terminated at birth.