BANK OF ENGLAND

Andrew Bailey
Governor

Rt Hon. Mel Stride MP
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House of Commons
Committee Office
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Dear Mel,

Thank you for your letter of 8th March with follow-up questions concerning LCF. The enclosed note provides my responses. There are two more general points which I would like to make. First, I want to emphasise that in no sense do my responses diminish my apology to the bondholders for their suffering. Second, my thoughts on lessons learned are more general ones because it is now over a year since I left the FCA.

I hope these responses are of assistance to the Committee.

Yours sincerely,

Andrew Bailey

1. The use of the term "responsibility"

The term "responsibility" can be used with two very different meanings. One meaning is accountability: as Chief Executive of the FCA I was accountable for everything at the FCA, as I said in my evidence to Dame Elizabeth Gloster. The other meaning is personal culpability. I continue to believe that it was crucial for Dame Elizabeth's draft report to be clear whether it was making statements about accountability or whether it was doing so about personal culpability. In my view, and that of others who read it, this was not the case in the draft report.

I am therefore grateful to Dame Elizabeth for clearing up the substance of the issue in the final report, which stated there was no judgment of culpability.

In my interviews with Dame Elizabeth I stated without reservation that as CEO I accepted responsibility for everything at the FCA. I also accept that Dame Elizabeth was free to criticise individuals if the evidence justified such criticism and doing so advanced the purposes of her report. However, any suggestion of culpability by me or other individuals concerned was not supported by evidence presented in the draft report.

In my view, it was therefore wrong to name individuals in the draft report as it then stood because this would inevitably result in misinterpretation, leading to unjustified accusations of personal culpability. As you have seen from the extract of my representations provided by Dame Elizabeth, I did include the point that naming individuals was not a requirement of the terms of reference, and that this was a free-standing point – in other words, its validity was not specific to my representations about clarity on responsibility. However, I would not have been compelled to make this point if the draft report had been clearer. I would also note that in Paragraph 23.1 of my representations I suggested language that could capture my responsibility as CEO which involved naming me, so I find it hard to understand how my use of the free-standing point on naming could be interpreted as unconditional.

In the event, Dame Elizabeth made a number of important changes to the report. They included: an entirely new chapter about the broader context the FCA faced; a new Annex setting out detail on "responsibilities" in the sense of accountability, as reflected in the FCA's adoption of the Senior Managers and Certification Regime; and new wording to rebut any suggestion of culpability.

Given the extent of these changes, I was surprised that Dame Elizabeth added the paragraph in the final report criticising me and others for making the points that we made. I would have welcomed an opportunity to discuss this new criticism with Dame Elizabeth but she did not invite me to do so[1].

2. Broken Machine

It is important to set out the relevant section of the report (Paragraph 4.1 – Page 145-6).

"In 2015, after the latest iteration of the FCA's strategy for supervising flexible firms had been laid out (although not having been fully implemented or embedded) two new Executive Directors joined the FCA to head the two divisions of the Supervision Division. The Investigation recognises that the problems within the Supervision Division pre-dated their respective arrivals and were not of their making (nor of Mr Bailey who was appointed CEO in 2016); rather they "inherited a broken machine" and had to find a way to address that."

For clarity, reference to flexible firms is to small firms, the vast majority of the FCA population, and the two new Executive Directors were Ms Butler and Mr Davidson. I have not included the relevant footnotes for this section, these are explanatory, including that the quotation on the broken machine was from me.

Context is important here. The report includes many quotes from me, and Dame Elizabeth rightly has been clear where she does not agree with me. I can detect no sense of disagreement here and the text I think can reasonably be interpreted as acknowledging that we had to find a way to address the broken machine.

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[1] In the review of Maxwellisation commissioned by the Treasury Select Committee, which reported in 2016, it was stated that the common law requires that a person be given a fair opportunity to respond to criticism prior to its publication in a report. Specifically, on the point of a new criticism that arises from a Representations Process, the review concluded that it is appropriate to seek the response of the subject of the proposed criticism if that person has not previously had a fair opportunity to respond to it.

3. Contact Centre

There are two points here: the number of calls received by the Centre per annum, and the development of systems and reports to utilise information received by the Centre.

I gave the figure 200,000 calls a year at the hearing. I did not refer to consumer calls only. This is important because the Centre took calls from consumers and firms. I included calls from firms not only because they are an important part of the Centre's work, but also because in Recommendation 9, Dame Elizabeth states that the FCA should consider whether it can improve its use of regulated firms as a source of market intelligence. I agree with Dame Elizabeth on this recommendation.

For the five years from 2015 to 2019, the average annual number of calls received by the Centre from consumers and firms was 212,095.

Dame Elizabeth states in the report that the highest number of consumer calls received by the Centre in a year was 126,500 in 2015. The records show that 2015 was the most active year for consumer calls. In fact, the total that year of 126,432 was the sum of calls, emails, web forms, web chats and letters (all communications from consumers received by the Centre). I should clarify that I did not at the time of the hearing appreciate the distinction between the number of calls and other methods of communication as quoted in the report (I thought calls meant calls only). But Dame Elizabeth is correct to use the wider basis, and so to be consistent the average annual number of all contacts from consumers and firms for the five year period was 275,095.

Turning to the systems used to extract information from the calls, I will start with the situation in 2015, prior to my arrival. My understanding is that the Centre used a form that sought to log basic information from a call. This process was criticised in the PA Report in mid-2016.

It is important to note again that at that time the FCA was not supervising small firms proactively on an individual basis. Instead, it was gathering information to identify sector wide issues based on grouping firms. Moreover, the supervision sector teams were focused on activities within the regulatory perimeter. The collection and use of information was therefore set up to service the assessment of sectors and not firms, though as the PA Report set out there were serious problems with this approach to sectoral analysis.

From my arrival in mid-2016, we took the following steps to improve the situation on the use of Contact Centre information, largely as part of the two major change programmes (Delivering Effective Supervision and Delivering Effective Authorisations).

- September 2016: we introduced a monthly one page report of firm contacts (from firms) showing volumes by sector and contact reason. This followed a somewhat similar report introduced in June 2016 breaking down consumer contacts by sector and contact reason.

- January 2018: we introduced speech and text analytics allowing the searching of all calls, emails and web chats for words and phrases, and thus enabling analysis of themes and root causes.

- July 2018: we introduced a monthly report summarising contact from consumers and firms, including most common firms and key topics.

- November 2018: we introduced dashboard functionality which allowed supervisors to search and create reports to summarise both historic and real-time contact to the centre. We enhanced this functionality further in December 2018 and May 2019.

I hope this gives a sense of the work we undertook to tackle the issue of acting on information coming in to the Centre. The FCA is best placed to provide more details.

4. Lessons Learnt

You asked if I can describe the lessons that I learnt from LCF. I will focus on five lessons. Of course, I am no longer involved in the FCA. I have sought to highlight broad lessons, but the FCA may or may not agree with me.

The first lesson concerns the challenge of a regulator like the FCA that has to rigorously prioritise its use of resources as it cannot cover its entire landscape with the same intensity. At my appointment hearing with the TSC in July 2016, the then Chair put it to me that the FCA would only ever be able to investigate a fraction of all instances of misconduct, and that we would always be dealing with a huge volume which we would not be able to cope with. My concern was that the 2014 FCA strategy (which the then TSC Chair described as an upmarket picture book and virtually content free) had not conveyed the need to prioritise. In the FCA Mission I set out to correct this and emphasise the necessity to prioritise. This was supported by the publication by the FCA of its annual Sector Views and Business Plan, setting out in detail its assessment of risks and choice of priorities. The Board was a very strong advocate of this process of transparency around priorities. But the lesson I take from LCF is that I am not sure the FCA was able adequately to convey the message that this prioritisation took place, and of its consequences in terms of firm and issue coverage.

The second lesson is quite closely related to the first. The FCA has a statutory objective to secure appropriate protection for consumers. Alongside this, the legislation requires the FCA to take into account the principles of good regulation, one of which is that consumers should take responsibility for their decisions. The Mission sought to interpret how the FCA should interpret these two together, and in particular that the vulnerability of a consumer was an important determinant of the ability to take responsibility. In practice, this led the FCA to prioritise tackling high-cost consumer credit, because of the situations of the consumers involved. But vulnerability is a hard concept to define with precision. The lesson from LCF is whether this approach can in practice work?

The third issue follows directly from the first two. While I have described the task the FCA faced with prioritising and whether that can be effective, it is not the case the FCA took no steps to limit the likelihood of harm, consistent with balancing the objective of consumer protection and the responsibility of consumers themselves. Of specific relevance here is that in 2014 the FCA introduced rules in relation to non-readily realisable securities (NRRS). Most mini bonds would have been defined as NRRS before the FCA introduced new rules in 2019 (these new rules had the effect of classifying those mini-bonds where the proceeds are invested in third parties or property as speculative investments which are subject to a mass-marketing ban).

The rules required firms either to categorise retail investors as sophisticated or high net worth, or (if the retail investor is neither) to seek the investor's confirmation that they will limit their investment in NRRS to 10% of their net investible assets (excluding their home and pension). Investors further had to acknowledge that they understood that they faced a significant risk of losing all the money invested.

Faced with a prioritisation choice between allocating resources to investments where consumers have made such declarations and areas such as high cost credit where vulnerable consumers were subject to evident harm, it seemed reasonable to prioritise as we did. I believe the outcome on high cost credit has been a huge benefit for those who were, and would have been, victims, but LCF has raised serious questions on the effectiveness of the NRRS rules with attendant lessons. As a result, the FCA has banned marketing of such high risk investments.

The fourth issue concerns on-line advertising of financial products and the scope for fraud and misconduct. The lesson here is that the online world is not subject to the same legal duties as the more traditional media. There is consequently no adequate shared responsibility with online service providers and consumers are at much greater risk. This could be tackled through the Online Harms Legislation, but the experience so far, and thus the lesson, is that there is strong resistance in other parts of the official sector to extending the legislation to financial services. This is a serious problem.

The last lesson concerns the regulatory perimeter. In the 2017 FCA Mission we changed the approach of the FCA to make clear that if we believe that an issue is serious, but the relevant activity falls outside the perimeter, we may still be able to act. Whether we would do so would depend on the circumstances of the case. Nevertheless, we continued to take the view that the perimeter was set in legislation for a reason, and that when it came to prioritisation we should prioritise inside the perimeter. This did not mean that we should not go outside the perimeter, and that has happened. But the lesson is that when things go wrong, that judgement on prioritisation across the perimeter will be a matter of dispute.

5. Financial Promotions

The best recent explanation of how the financial promotions regime differs, and is less effective as a consequence of the approach taken in the legislation (FSMA 2000), is contained in the consultation issued last July by HMT (Regulatory Framework for Approval of Financial Promotions). The effect of the regime is that a firm not authorised under FSMA must have their promotions approved by an authorised firm before they are communicated.

But the important difference is that approving financial promotions is not itself a regulated activity under FSMA. Thus, any authorised firm can conduct the activity by virtue of being authorised to conduct some other activity. As the consultation sets out, this makes the task of regulating promotions inevitably reactive and thus less robust. Moreover, the approving firm may have no relevant expertise in promotions.

I hope this helps to explain my answer to Julie Marson’s question, namely that the promotions regime is both different and less robust.

6. Prioritisation

You asked me to set out the other example as well as high cost credit. It was Self Invested Personal Pensions (SIPPS). The FCA undertook substantial supervisory work on SIPPS during 2015 and 2016 to establish the nature and scale of a problem that had built up between 2007 and 2014. At the heart of the problem was the acceptance of high risk non-standard investments into SIPPS, which were estimated to total around £1.3bn. It was therefore a major undertaking from 2015 onwards to do as much as possible to establish and mitigate this problem. I should add that SIPPS are inside the perimeter.