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Lend me your ears

As the FSA's Caesar, Hector Sants, exits stage left, ***Julian Sampson*** *examines his legacy and the outlook for firms under the changing regulatory regime.*

"Friends, Romans, countrymen," cried Mark Antony in Shakespeare's *Julius Caesar*. "I come to bury Caesar, and not to praise him." And as the FSA's own Caesar leaves the stage, having fallen on his own sword rather than at the hands of assassins, we can now begin the process of assessing his legacy and the impact of his departure for firms.

There has certainly been praise, from George Osborne and Adair Turner down. Osborne said that Sants had "successfully overseen planning for the transition to the new supervisory structure." He added: "I am very grateful for all the good work that Hector has done. He has been an outstanding public servant." According to Turner, Sants "leaves behind a transformed organisation, safe in very capable hands, with a robust blueprint for the future."

And to be fair, much has been done. Few others would have taken on the role of transforming the FSA from an integrated organisation into one prepared to implement the Coalition Government's election promise of abolishing the FSA and replacing it with two new organisations – the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA).

But Mark Antony delivered a warning about legacies. "The evil that men do lives after them; the good is oft interred with their bones." The risk for firms and for the FSA itself is that this will be the case with Sants – whatever he has successfully achieved will not be remembered in the long term. What will be remembered is what doesn't work. And there is much that has the potential not to work for a very long time.

Take, for example, the Twin Peaks organisational structure that Sants outlined in his swan-song speech of 6 February. Firms that are experiencing ARROW visits from now until the demise of the FSA will be guinea pigs for the new working practices that will eventually be rolled into the FCA and PRA.

Speaking of the new operational changes, Sants said: "From a firm's perspective the key operational change will be that the existing ARROW risk mitigation programme will be split between those actions which are relevant to the conduct supervisory groups' objectives and those that relate to the prudential supervisory group. From 2 April onwards, the two supervisory units will run their own risk mitigation programmes and firms will have two separate sets of mitigating actions to address."

So, as if planning and managing an ARROW visit was not enough for firms, they now face a doubling of that burden, as they have to deal with two discrete supervision teams. Sants spelt it out: "Each supervisory group may well ask apparently similar questions, but it needs to be understood that the purpose will be different." He used the example of the firm's board processes being of interest to both prudential and conduct supervisors.

That might be manageable, if, for example, both sets of supervisors visited the firm on the same day. But don't hold your breath – that's unlikely to happen. Said Sants, "they will coordinate internally to maximise the exchange of information… but to be clear, they will act separately when engaging with firms."

After the visit – or more likely, visits – Sants was sanguine that these teams will coordinate their views. "Be assured," he said, "we will coordinate the presentation of the conclusions of the assessment to the board of the firm and deliver a single pack of documentation summarising our views." But don't put out the bunting yet – although the board will get one pack of documentation, this will contain two separate reports and risk mitigation programmes. "There will not be a consolidated list of the required actions arising from the two supervisory groups," he said.

And if you don't like that, don't blame Hector. As he (almost) said, it's not his fault. It's the fault of those

chaps down in Westminster: "Central to the concept of genuine Twin Peaks is that both sets of regulatory objectives are different and determined by Parliament to be of equal importance." That is, if you don't like Twin Peaks, don't blame me, blame the Government – or words to that effect.

However, the reality of regulation is that the above will impact on very few firms. Even now, the vast majority do not receive an ARROW visit. This trend will accelerate as the FSA and its successors continue to focus resources on the prudential regulation of systemically important firms. Conduct regulation will be by means of themed visits. In Sants' words, "[I]t will be more efficient to undertake firm assessments through a more flexible resourcing approach and to make more interventions on a thematic basis. This means, that the conduct supervisors will reduce the level of resources dedicated to proactive firm specific work overall and increase its thematic resource…"

Therefore, most firms will look forward to increasingly infrequent and episodic contact with the FSA. And this is where, for firms, the greatest danger lies. Such visits will inevitably be short, intense affairs. The supervisors will not be used to the firm and will not know or necessarily understand its business model. And the firm may have forgotten how to handle a supervisory visit – assuming it had one in the past. The scope for misunderstandings is therefore much greater. And it is on these occasions that the firm is most vulnerable to the FSA's shiny new weapon – judgement.

Yet it's not really fair to call this "new". The FSA has been speaking of the need to make judgements since the Turner Report was published in March 2009. What is new, however, is the tone of how the FSA is thinking that judgement should be exercised.

The danger of "judgement" is that it is inherently one-sided. The model is as follows: the FSA makes a judgement on your business; they tell you of it, and require you to make changes so that your business no longer offends that judgement; you take issue with their judgement and then – well, there is no "then", because once the regulator has made up its mind about your firm, that's it. As Sants made clear: "The essence of a judgement-based approach is a willingness to intervene when the regulator judges the outcomes will, in the future, be at variance to [the regulator's] mandate, *even if the firm does not agree"* (emphasis added).

Sants has always been quite open that this process of judgement could lead to mistakes being made by the regulator, mistakes which can only be seen with the benefit of hindsight. Thus he admits, "there are times when both firms and the regulator will make judgements which in hindsight are found to be wrong". However, he seems oblivious to the fact that when this hindsight judgement comes to be exercised, the firm in question, and its shareholders, awaiting their vindication, will at best be considerably poorer from having had to accede to what is then correctly seen to be the FSA's erroneous judgement or, at worst, will have been put out of business by it.

But Sants probably believes this to be a price worth paying. As he said earlier in the same speech, "proactive intervention needs to be proportionate and justified, but if we are to improve outcomes and meet the expectation of Parliament and society, such judgements will have to be made." So watch out.

But it is when Sants speaks of the wider needs of society as a whole that firms should really be concerned. As if the array of intervention and enforcement powers at its disposal were not enough, Sants seeks to ally the interests of the regulator with those of society as a whole, and place the firm outside that consensus. Thus he said, "it would be preferable if firms recognise the importance of aligning their goals with those of the supervisors and with society as a whole." He continued, "I am suggesting that [firms] dragging their feet in complying with requests when it is obvious to all that the outcome is in the best interest of society as a whole, is not a behaviour which should survive in the new world."

Hold on a minute – where did this come from? Since when did Hector Sants – or anyone else at the FSA – have the right to speak for "society as a whole"? Who elected them? And just when is it "obvious to all" that something is in "the best interest of society"? The whole point about having to exercise judgement is that one does so in cases where things are not "obvious". That's why one is exercising judgement. If you're going to exercise your judgement, do so, but don't cloak it with the dignity that such judgement is "obvious" and in the interest of society as a whole. Life's not that simple.

For the regulated firm on the wrong end of the FSA's judgement, this considerably raises the stakes. It's no longer possible, under this philosophy, to have an honest and open disagreement with your regulator. To disagree with the FSA is to disagree with society. The FSA is already using its new powers of early public notification and will be likely to do so to warn "society" of risks it perceives in firms' practices. Firms wishing to protect their public reputation will find it very difficult not to accede to the FSA's (possibly erroneous) judgement in such circumstances.

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All of this makes for a volatile mix, which the smaller firm should handle with care. Looking on, like the Roman citizen listening to Mark Antony, the firm will be swayed in all directions by the increased demands placed upon it.

For the FSA and its successors, the challenge is to avoid the civil war that followed the death of Caesar, work through these issues and avoid making Mark Antony's prophesy come true. As the soothsayers pore over the entrails, the auguries are not good. Sants resigned on 16 March, one day after the 15th – the ides of March.

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