TREASURY SELECT COMMITTEE INQUIRY INTO SME FINANCE

BRIEFING PAPER FOR MS. NICKY MORGAN AND THE TREASURY SELECT COMMITTEE

30 MARCH 2018

1. Introduction

1.1 The co-authors of this paper have been working for many years to assist the Treasury Select Committee (TSC) and, in particular, the previous Chairman Andrew Tyrie MP, on key matters arising out of the 2008 banking crisis and, specifically, to establish the truth of alleged wrongdoing by all key parties involved in the failure of both HBOS plc and RBS plc.

1.2 The co-authors of this paper are:-

- **Jim Shannon MP for Strangford Northern Ireland (DUP)** following his election to the House of Commons in May 2010 his initial interest here was in having Messrs. Little (his constituent) and Moore (co-authors of this paper) meet in February 2011 with the former Chair of the TSC Mr. Andrew Tyrie to discuss the serious concerns about the supposed independence of the PwC investigation into the failure of RBS and another investigation the firm carried out in relation to whistleblowing allegations by Brian Little being determined in an unfair dismissal claim being heard in an Employment Tribunal. (akin to APPG – Fair Business Banking proposed Financial Services Tribunal). Both Brian Little and Paul Moore had suffered from the consequences of Big 4 auditors covering up allegations of whistleblowing. In this regard Mr Shannon's comments were reported in May 2011 on the front page of The Daily Telegraph business section set out below (more at P16-17) It was as a result of this meeting and subsequent correspondence by Paul Moore that the TSC took the unprecedented step of appointing independent overseers in relation to the PwC investigation into RBS and subsequently the PRA/FCA investigation into the failure of HBOS.

  The MP's intervention comes at a critical time for PwC, since it is under scrutiny over its "independent inquiry" into the Royal Bank of Scotland's collapse. The "big four" - Deloitte, KPMG, PwC and Ernst & Young - have also been criticised by MPs for "dereliction of duty" during the financial crisis.

Mr Shannon MP has since been closely involved in supporting certain constituents' banking complaints and, following the RBS GRG scandal the proposed policy to introduce a non-judicial complaints resolution process for SMEs whilst considering the FCA proposed expansion of the remit of the FOS.

- **Mr Brian Little** is a constituent of Jim Shannon. Following his own whistleblowing experience (which included what was the longest individual Employment Tribunal hearing in UK legal history at 50+ days), Brian has been working with Jim and Paul Moore and others, especially dealing with the problems associated with the Big 4 Auditors and the FRC's resistance to investigating and enforcing alleged wrongdoing by those firms. He was a co-author with Paul Moore and others of the recent paper to the TSC relating to the decision of the FRC to drop their investigation into KPMG's audit of HBOS. Their final paper is in process.

  He has also been supporting the victims of the HBOS Reading Fraud and other SMEs / whistleblowers about financial matters who have become nationally known, and many who have not.

  Paul Moore was the former Head of Group Regulatory Risk at HBOS. He is often referred to as "The HBOS Whistleblower" following high profile evidence he gave to the TSC in February 2009 disclosing that he was dismissed by the CEO, James Crosby, for raising challenges at Board level of excessive risk taking. His evidence led to the resignation of Sir James Crosby as the deputy Chairman of the FSA and ultimately to him giving up his Knighthood.

  Following a face to face meeting with Andrew Tyrie and Jim Shannon MP and Brian Little, in February 2011, at Andrew Tyrie's request, he provided detailed informal personal advice about how to ensure adequate oversight of regulatory investigations post crisis by requiring independent oversight which the TSC subsequently implemented.

  Paul has given extensive evidence to the TSC and Parliamentary Commission on Banking Standards and regulatory inquiries into HBOS on a whole range of topics from corporate governance to the decision of the FRC to drop their investigation into KPMG's audit of HBOS.

  He has been involved from late 2008 in supporting the key victims of the HBOS Reading Fraud (Nikki and Paul Turner) including giving evidence and advice to the criminal authorities in relation to that matter. He has acted informally for a number of clients in making complaints to the Financial Ombudsman Service and is fully familiar with its approach and processes which, in his view, are not always adequate.

1.3 We are writing this paper to assist Ms. Nicky Morgan and the Committee Members in relation to the TSC's inquiry into SME Finance.

1.4 Before making our more detailed comments in the following sections of this paper, we would make the following preliminary points which can also be used by Committee Members as an executive summary:-

- SME's are the back-bone of the UK economy. As Mr. Shannon MP said in his introductory remarks in the House of Commons Backbench debate on RBS-GRG on 18 January 2018 in Northern Ireland SMEs account for 75% of employment, 75% of turnover and 81% of gross value added and that move to the private sector is central to Northern Ireland moving forward from its "troubled" past.

- Banks do not serve them adequately. Either they don't provide sufficient finance to support growth (and SME's don't bother to ask them for it because they know it is a waste of their time) or they treat them badly as we have seen in numerous ways over recent years

- On the former point (provision of insufficient credit), the facts are clear: UK banks use the vast majority of their credit capacity in financing residential and commercial property loans and financial intermediation. We believe the number is now more than 85% but this can be checked with the Bank of England. Using their lending capacity in this way produces property price inflation and does nothing to support real growth in the economy. Banks are given a licence to create money out of nothing when they issue credit based on small amounts of capital adequacy. They are entitled to charge interest on this money they create – so they obtain profit out of money they create out of nothing. Then they are provided with a state backed depositor guarantee scheme. This position is wrong and has a material impact on the economy. Given the privileged position that banks are given by the licence provided by the state and backed by taxpayers, they must be required to owe not just private duties to shareholders but public duties to the economy at large.

  It should be noted that SME's that rely on retained earnings or personal capital or personal property based capital raising (the vast majority) will grow slower than they could and should because of inadequate access to credit risk capital. And SME's are reluctant to sell equity through the VC market because it takes away control from them and changes the nature of the businesses they have set up.

- On the latter point (banks treating SMEs badly), most SME's are run by entrepreneurs who don't have the financial sophistication that it is assumed they have. Nor do they have access to the

advice and expertise which you would find in large companies who have full-time accountants, lawyers and other experts available to make sure banks treat them fairly. Indeed, most people running SME's have only a minimal amount more financial sophistication and expertise than standard retail consumers. They deserve a similar level of regulatory protection

- **[See section 3.P11-13 below for further detail]** The current position according to the FCA and PRA is that all lending to SMEs is unregulated from a conduct of business perspective and there is nothing they can do to protect SMEs from bad practice by banks or to provide redress or even to supervise banks in this regard. They say that NOT A SINGLE RULE from their Rulebook applies to SME lending. How can this possibly be the case?

  It should be remembered that the statutory objectives of the FCA include consumer protection and, in our view, it is a serious failure of the FSA and then the FCA to write a rulebook that provides not protection whatsoever for SMEs. After all SMEs ARE consumers and the statutory objective could not have been interpreted to exclude all consumers other than ordinary retail consumers.

- **[See section 2:P7-10 below for further detail]** In any event, we fundamentally disagree technically with the FSA's position that all SME lending is totally unregulated. In this regard, we submit in the strongest possible terms that, even though it is clear that there is no specific FCA Conduct of Business Sourcebook with specific rules applies to SME lending, nevertheless the high level Principles for Business do apply.

  In our view, the FSA / FCA should have applied and supervised these Principles for Business from the outset in relation to SME lending and now MUST apply them to past wrongdoing to hold individual banks to account. The Principles include a duty to "treat customers fairly" and this provision is pertinent to the wrongdoing of banks towards SME customers. See section 3 below for our detailed technical reasoning in this regard.

- **[See section 2.P7-10 below for further detail]** We submit that the FCA must be required to accept that the high level Principles did and continue to apply to SME lending and that they should take action accordingly in relation to any relevant wrongdoing by banks. They should also be required to clarify their rules which are currently not as clear as they should be (see section 3 below)

  In addition, the FCA, in consultation with The SME Alliance, the APPG on Fair Business Banking and other interested stakeholders, MUST be required to develop specific Conduct of Business

Rules relating to the sale of loans or other financial products to SME's. In our view, there is no necessity for further primary legislation to proceed with such rule making.

- **[See section 3.P11-13 below for further detail]** On top of all this and given the FCA's current (wrong) interpretation of their duties which provides no protection to SMEs, this means that the only way SME's have of obtaining redress is to go through the standard legal process which they do not have the time or resources or inclination to do. This is in no way surprising as the banks have virtually unlimited financial resources and capacity to "crush" even legitimate complaints with great ease by playing the legal system against them and terrifying them with the prospect of costs.

  It is grossly unfair that SME's have no access to a simple and non-judicial dispute resolution and compensation service like the FOS.

  It is IMPERATIVE that SMEs <u>have access</u> (if they so choose) to such a complaint resolution organisation and procedures either by extension of the FOS' remit OR by the setting up of an alternative tribunal specifically designated to handle SME complaints.

  In addition, we submit that ANY SME who has a past legitimate complaint against a bank for wrongdoing who has already formally aired their complaint with their MP or otherwise must be allowed to progress their complaint within any such non judicial complaints resolution organisation irrespective of limitation periods.

- **[See section 4.P13-15 below for further detail]** Given the appalling failures of the FSA and FCA to protect SMEs in the past and, more generally, in the public interest for the future, we submit that, henceforth, the FCA must have its standard supervisory oversight function subjected to rigorous risk based quality assurance and audit by the FCA's own internal audit department or, where appropriate by way of external review. Reports from such quality assurance activities should be made public and should be subject to the oversight of the TSC where appropriate.

  Incidentally, this policy proposal is in line with the FCA's own pronouncements on their commitments to quality and transparency. Therefore, no doubt, the FCA will accept it with no resistance?

  Of course, this should specifically involve reviewing the adequacy of the FCA's supervision of lending and the sale of other financial products to SMEs.

- For ease of reference for the Committee, we have set out the formal terms of reference of the inquiry below and marked in bold and block capitals where our specific submissions fit within

Terms of reference for TSC inquiry into SME Finance

This inquiry will consider the state of the SME finance market under the following themes:

Funding options available to SMEs.

- The availability and uptake of different sources of funding for SMEs, including banks, peer-to-peer lenders and crowdfunding
- The level of competition in the SME lending market and the impact of recent regulatory initiatives
- Trends in SME finance and how potential changes to regulation and redress may affect the market
- Any sources of finance which SMEs will not consider or approach and why

The ability of SMEs to resolve disputes and access fair and reasonable compensation when they borrow money.

[SEE SECTION 3.P11-13 BELOW]

- The effectiveness of existing arrangements for dispute arbitration and settlement
- The merits of the Financial Conduct Authority's proposals for expanding SME access to the Financial Ombudsman Service
- The case for establishing a new "tribunal" body for settling SME banking disputes and the means by which such a body could be created
- The design, governance and operation of such a tribunal body, and the potential relationship between it, the Financial Ombudsman Service, and the Financial Conduct Authority
- The impact of additional avenues for redress on (i) the balance of power between SMEs and lenders; and (ii) the supply of, and demand for, credit

The regulation of SME lending.

[SEE SECTIONS 2.P7-10 and 4.P13-15 BELOW]

- The level of protection currently afforded to SMEs when they borrow money
- The case for bringing lending to SMEs within the regulatory perimeter, including (i) the likely impact on the supply of, and demand for, credit; and (ii) lessons learned from past misconduct
- Other non-regulatory or quasi-regulatory options for policing SME lending, such as the establishment of industry codes and standards

2. The level of regulatory protection currently afforded when they borrow money

The application of The Principles for Business to SME lending and the requirement for a new Conduct of Business Sourcebook for SME lending.

2.1 As summarised above, the FCA have stated that lending to SMEs is entirely unregulated and that there are neither specific conduct of business rules that apply nor do the high level Principles for Business apply. This is entirely an unsatisfactory position and incorrect in any event.

Although, we agree that there are no specific conduct of business rules which apply to SME lending, we submit that the high level Principles for Business (set out in full below for ease of reference do apply to SME lending for the following reasons:-

The Principles

1 Integrity	A *firm* must conduct its business with integrity.
2 Skill, care and diligence	A *firm* must conduct its business with due skill, care and diligence.
3 Management and control	A *firm* must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.
4 Financial prudence	A *firm* must maintain adequate financial resources.
5 Market conduct	A *firm* must observe proper standards of market conduct.
6 Customers' interests	A *firm* must pay due regard to the interests of its *customers* and treat them fairly.
7Communications with clients	A *firm* must pay due regard to the information needs of its *clients*, and communicate information to them in a way which is clear, fair and not misleading.
8 Conflicts of interest	A *firm* must manage conflicts of interest fairly, both between itself and its *customers* and between a *customer* and another *client*.
9 Customers: relationships of trust	A *firm* must take reasonable care to ensure the suitability of its advice and discretionary decisions for any *customer* who is entitled to rely upon its judgment.
10 Clients' assets	A *firm* must arrange adequate protection for *clients'* assets when it is responsible for them.
11 Relations with regulators	A *firm* must deal with its regulators in an open and cooperative way, and must disclose to the *FCA* appropriately anything relating to the *firm* of which that regulator would reasonably expect notice.

<See Annex.1 Points 2.1 – 2.6 for detail email exchanges between FCA and Mr Shannon MP, Mr Little. 2.6 PQ to HMT. Concluding with Point 2.7 with an FCA exchange with Mr Andrew Tyrie MP, former Chair of the TSC in September 2014.>

- Furthermore the Principles apply in the following circumstances:-

See https://www.handbook.fca.org.uk/handbook/PRIN/3/2.html

1. PRIN 3.2 WHAT?

PRIN applies with respect to the carrying on of:

1. (1) *regulated activities*;
2. (2) activities that constitute *dealing in investments as principal*, disregarding the exclusion in article 15 of the *Regulated Activities Order* (Absence of holding out etc);
3. (3) *ancillary activities* in relation to *designated investment business*, *home finance activity*, *credit-related regulated activity*, *insurance mediation activity* and *accepting deposits*; and
4. (4) activities directly arising from *insurance risk transformation*.

- Although lending above consumer credit limits is not specifically a regulated activity, we submit that all lending, nevertheless, falls within Rule 3.3 as an "ancillary activity" in relation to "accepting deposits" because banks accept deposits with the intention of using those deposits to lend money.

- This interpretation is supported by the FCA's Perimeter Guidance Manual (PERG) the purpose of which is described in the rule book as:-

  "The purpose of this manual is to give guidance about the circumstances in which authorisation is required, or exempt person status is available, including guidance on the activities which are regulated under the Act and the exclusions which are available."

- PERG goes on to state –

  The activities which are *regulated activities* are specified in the *Financial Services and Markets Act 2000 (Regulated Activities) Order 2001* (the *Regulated Activities Order*)**: for example, *accepting deposits***

- Later it says:-

  Whether or not *accepting deposits* is a *regulated activity* depends on the use to which the money is put. The activity is caught if money received by way of *deposit* is lent to others

- In our view, therefore, if accepting deposits to lend is a regulated activity and:-

  PRIN applies with respect to the carrying on of:

  (3) *ancillary activities* in relation to …. *accepting deposits*;

  There cannot be any doubt that The Principles do apply to lending to SMEs.

2.3 The FCA should, therefore, be required to review their interpretation and apply The Principles both retrospectively and in the future. Their retrospective review should be reported back to the TSC and if this requires enforcement action or the setting up of appropriate redress schemes for systemic wrongdoing by banks in relation to SME lending, this should be actioned forthwith.

2.4 In addition, it is patently obvious that the FCA rules should be clarified and lending should be defined in the relevant subsidiary legislation i.e. the *Financial Services and Markets Act 2000 (Regulated Activities) Order 2001* (the *Regulated Activities Order*) as a regulated activity. Indeed, it is extraordinary given the statutory objectives of the regime that, it has not always be defined as such.

2.5 In addition, in order to provide adequate and more prescriptive protection for lending to SMEs by banks, the FCA should construct an appropriate and specific Conduct of Business Sourcebook setting or specific selling practices including advertising, product disclosure etc. There MUST be a specific rule that requires all loans to SMEs to be "suitable" to their needs and a requirement for an appropriate fact find and suitability letter. This rulebook should be developed in conjunction with all relevant stakeholders (in particular The SME Alliance and the APPG on fair business banking led by Kevin Hollinrake MP) and brought in draft form to the TSC for discussion.

The absolute necessity for the proper training and competence and qualifications of senior managers and non-executive directors accountable for risk management, compliance and internal audit.

2.6 Although the FCA should be the long stop external organisation to provide adequate regulatory protection for SMEs, Paul Moore, a long term expert in relation to conduct risk, compliance and governance more generally, takes the view that the primary "wicket-keeping" role in protecting customers is that organisation's own "internal control functions" and governance system i.e. risk, compliance, internal audit departments as well as risk, compliance and audit committees.

As he wrote in his paper to the TSC in June 2012 on Corporate Governance in Systemically Important Financial Institutions:- **"We need substantially to increase the capability, competence and credibility of the control functions (risk, compliance and internal audit) by their professionalization**

Believe it or not, you can become a Chief Risk Officer or a Head of Compliance or Head of Internal Audit with no formal qualifications. This is just plain wrong. When Paul Moore was dismissed by James Crosby from HBOS, he appointed a sales manager as the new Group Risk Director. This was wrong at the time and in clear breach of regulatory guidance. Indeed, in Mr Moore's view, it was a clear breach of his fiduciary duties. We have got to prevent this happening again.

In my view, the senior roles in risk, compliance and internal audit should now be treated as equally important as other senior executive roles e.g. CFO, Head of Sales and Marketing etc etc. These functions provide the appropriate checks and balances and separation of powers in large companies. We now need to introduce similar qualifications for these roles as for lawyers, accountants, actuaries and other professions. The curriculum needs to be properly designed and cover more than just the technical aspects of the roles. It needs to cover skills as well (such as ethical decision making) which are often for more important than technical knowledge in performing these roles well. It needs to be both classroom and "articles" / on the job training based. Mr Moore would be willing to provide detailed input in this area. The current competence frameworks for these functions concentrate far too much in the technical and far too little on the skills and leadership capabilities.

2.7 This issue is still a fundamental lacuna in the regulatory and governance regime. There needs to be a properly constituted Chartered Institute for Risk, Compliance and Internal Audit Professionals and the curriculum and assessment should be equivalent to those applicable to lawyers, accountants and actuaries. There should be a Code of Conduct and Ethics and appropriate enforcement procedures in relation to such professional.

2.8 In addition (and this is equally as important), no key non-executive accountable for chairing a control function committee (risk, compliance, audit) should be treated as fit and proper and competent without the relevant knowledge skill and experience.

2.9 In addition, all heads of control functions **should only formally report** for appointment or dismissal purposes to the non-executive to avoid the risk of the executive dismissing them because he or she does not like the challenge that has been made to corporate strategy and operations.

2.10 Some may say that the FCA's new Senior Manager and Certification Regime takes care of this. IT DOES NOT. There are no clear competence or professional standards laid down in any of THE SMF roles defined by the FCA. This matter needs to be rectified as a matter of importance and urgency. Conflicted and incompetent control functions are at the heart of regulatory failures.

3. The ability of SMEs to resolve disputes and access fair and reasonable compensation when they borrow money.

3.1 Copied in Annex 1 are relevant letters in relation to SMEs for FOI requests and email correspondence in relation to both the FOS and FCA during 2017 and 2018 – for example FOS statistics for complex financial complaints since August 2015 at Point 3.2 etc . We consider this to be important background information to inform the debate.

Key background

3.2 John Glen MP – Economic Secretary – Backbench debate - 18 January 2018

"*As the industry, the FCA and the Treasury progress discussions on this issue, all avenues will be considered. The FCA is undertaking a review, and it launched a discussion paper on SMEs in November 2015. I feel that that is a very long time ago, so I am reassured to be able to report to the House that it will be making a statement on Monday 22 January on its 2015 SME paper and on its consultation on widening SME eligibility for the Financial Ombudsman Service. I shall look carefully at what it comes up with***.**"

3.3 22 Jan "FCA Consultation (CP18-03) Q4. Do you agree that the changes introducing small businesses as eligible complainants should come into effect on 1 December 2018 and that they should apply only to complaints made to a firm regarding acts or omissions of the firm which occur from 1 December 2018? If not, what transitional period do you consider appropriate?"

Our recommendations

3.4 In short we strongly recommend that **SMEs should have the CHOICE of options in seeking redress within two parameters:-**

- Within **FOS** with an expanded remit for claims / awards of up to £500,000 for businesses which are currently trading. This implemented after appropriate training and resourcing, management and governance reviews in FOS to establish that FOS fit for that purpose. We believe that the overall principles of providing a "fair and reasonable" solution is an appropriate ADR mechanism and it is a matter of implementation and culture – not more law.

  OR

- A “Financial Services Tribunal” as proposed by The APPG Fair Business Banking. We understand that this proposal is predicated on Employment Tribunal principles and available for any claims of £10,000+ for those SMEs which continue to trade AND for those SMEs and Guarantors which have been the subject of insolvency or bankruptcy proceedings. This solution is quasi-judicial and is most appropriate for the highest value complaints.

3.5 We note with endorsement that The All Party Parliamentary Group on Fair Business Banking (APPG) has announced that a research project will be carried out into the best way of establishing an independent resolution mechanism for complex financial disputes. The Centre for Policy Studies will produce policy recommendations into how this mechanism will be set up, how it will be funded, who will be able to access it and on what basis it will make decisions”. As co-authors we look forward to contributing to this research. We would add that we consider the recent article in the Law Society Gazette by Mr Richard Samuel on 5 February 2018 headed “Banking disputes: time for a tribunal” in which , in our view, he sets out compelling logic of why we should have both the FOS and Tribunals, is convincing.

3.6 Sir Jeffrey Donaldson MP (DUP Whip) and Mr Shannon MP plan to bring to the House after the Easter Recess an Early Day Motion which they expect should command cross party support across the House. Mr Shannon MP has also put down four relevant Parliamentary questions to HMT. (Annex 1: Points 2.6, 3.4 and 3.5)

Retrospective complaints outside the limitation periods

3.7 At present the FCA have the powers to set the scope and rules for the FOS. These are published as part of the Financial Conduct Authority’s handbook, in the section called Dispute Resolution (“DISP”) rules: complaints. DISP 2.8.2 found within Chapter 2.

3.8 2.8.2 of these rules States:

“*The Ombudsman cannot consider a complaint if the complainant refers it to the Financial Ombudsman Service more than*

(a) six years after the event complained of; or (if later)

(b) three years from the date on which the complainant became aware (or ought reasonably to have become aware) that he has cause for complaint

Unless the complainant referred the complaint to the respondent or to the Ombudsman within that period and has a written acknowledgment or some other record of the complaint being received" and …….EDM wording"

3.9 We strongly recommend that the FCA should now also immediately include and additional proviso that *in this rule relating to limitation periods that any complainant should be allowed if they brought their complaint to their sitting Member of Parliament at any time* ***from 1 September 2007 to 21 April 2018 an****d has a written acknowledgment or some other record of action on the complaint, (including but not limited to the FSA, FCA, FOS, HMG) from their sitting Member of Parliament (MP) during that period."*

This addition (within the FCA Handbook powers alone) would provide a credible OPTION for "ineligible" SMEs up to make a claim up to £500,000 Claim. And, most importantly it recognises that there have been many past victims of the Banking crisis who have not have been provided with redress solutions because appropriate regulatory processes have not been available to them. This is also true for businesses which were "forced" in to insolvency and bankruptcy proceedings.

4. Final additional submission – the crucial importance of overseeing and transparent reporting on the quality of the FCA Supervisory Oversight Function

4.1 Given the clear failures of both the FSA and the FCA in carrying out their duties and meeting their statutory objectives both before and after the financial crisis, it is vital to implement a regime of transparent quality assurance of their work.

4.2 If you refer to Annex 1 Point 4.1 we believe you will find a letter from Mr Andrew Bailey Chief Executive of the FCA to my DUP colleague Mr Gregory Campbell MP which we believe is typical of the response that MPs and members of the public receive from him. "*We receive information about regulated firms from a variety of sources, including firms themselves. We use this information to build a holistic view of individual firms to determine the level of seriousness of the risks it presents to our statutory objectives. Once established we decide the most appropriate regulatory response. However, as this information is confidential for the purposes of Section 348 of the Financial Services and Markets Act, I am unable to share with you the nature of any action we may, or have taken, in relation to Danske Bank.*

Whilst I appreciate that this letter doesn't provide you with the information you are seeking I hope you found the explanation helpful."

No doubt, the TSC will recognise this type of "side stepping" and unhelpful response as common.

4.3 In such circumstances of poor long term performance, it becomes even more essential that the regulator pays close attention to the subjects of quality and transparency so as to earn the confidence, respect and trust from the consumer, taxpayer and public.

4.4 In the Annex 1 at point 4.2 the TSC can read the current Transparency version on the FCA website (Point 4.2 Page 16-18). In particular we draw the TSC attention to "*We publish internal audit reports as agreed with the Treasury Select Committee and external reviews*".

4.5 Notwithstanding this apparently positive commitment to quality and transparency, the TSC will be surprised to learn that there appears to have been only one single such internal audit report related to the operation of the crucial FCA "Supervisory Oversight Function" (SOF) Point 4.3 page 19-22) published since the inception of the FCA, in April 2014.

4.6 This function reports the Chief Executive and its main purpose is to "*provide FCA executive management with assurance over the effectiveness of regulation by assessing retrospectively the quality of regulatory judgments and outcomes*".

4.7 That internal audit review, in fact, found a major failing in the SOF which is so crucial to the proper working of the regulatory system, (Point 4.4 page 20-22)

"We found that the purpose and remit of the SOF was not clear to the stakeholders we interviewed both within and outside of the SOF. The lack of clarity over the SOF's role and position in the FCA's three lines of defence model, and the conflict of interest presented by the appointment of a new Head of Department for the , who is also Head of Client Assets Supervision (an area within the SOF's scope) adds to this confusion. In our view, the lack of clarity over the SOF's purpose and remit across the organisation and the resulting perception that the SOFs work is not highly valued by the Executive had adversely impacted on the SOF's ability to deliver its desired outcomes."

4.8 We were extremely surprised and disappointed that this was the only report we could find as we would have expected to see an annual Internal Audit of Bank Oversight by the FCA.

4.9 Mr Shannon MP in his email Annex 1 Point 4.4 (Page 23) concludes:-

"Why does the FCA Internal audit not do this for the Banking Supervision Teams for the main banks etc? Who in turn would be required to produce an annual report, which could be published for transparency purposes, for each major Bank and which could be the subject of annual Internal Audit inspections as appropriate? Perhaps you could refer these matters to the specific individuals with that responsibility or should we write to your CEO Mr Andrew Bailey directly?"

4.10 The TSC will of course be familiar with the Financial Reporting Council but some Members may not be aware that it has an Audit Inspection Unit (AIU) which publishes annual reports for each major auditor with comments on their findings on the quality of their audits. Members can read the FRC Audit Quality Review website information at Point 4.5 (Pages 24-25). On pages 27 to 30 you can read extracts of the comments published on KPMG (auditors for HBOS, Carillon etc) for four periods from 2007 audits to 2017. We are left wondering, in light of those AIU highly relevant Observations, how the separate function of FRC Enforcement found no credible basis for any action against KPMG. For completeness we have included an extract of the CEO Mr Stephen Haddrill's speech on 25 October 2017. We are delighted to see that the SOS BEIS has recently announced an independent inquiry in to the operations of the FRC.

4.11 So in conclusion we think the TSC should be more specific about the FCA Internal Audit reports it wishes to see and have published on an annual basis and the co-authors would be willing to support that process of identifying same.

4.12 Furthermore the FCA Board should have a non-executive Director lead a Public Interest Board sub-committee to ensure that there is an appropriate balance of discussion around public interest as part of the statutory objectives within the FCA and at its Board. .

5. Conclusion and summary of recommendations

5.1 Banks serve SMEs badly. This means they serve the economy badly. The licence they receive from the state to create money out of nothing when they issue credit and then charge interest on it is a public privilege. They should have public duties not just private duties to enrich their shareholders. They create 97% of the money supply; where they direct it should be subject to some form of central control.

5.2 Contrary to the incorrect interpretations of both the FSA and FCA, the Principles for Business in the FCA Handbook do apply to SME lending. These require Banks to treat customers fairly. The FCA should determine whether any past actions of the banks in lending practice have been in

breach. Victims should be supported in obtaining redress as they were in relation to the mis-sale of IRHP. The FCA should now supervise all banks compliance with the Principles in relation to their lending business.

5.3 Lending should henceforth be specifically included as a regulated activity under the relevant secondary legislation / statutory instrument. This requires no further primary legislation.

5.4 Lending requires its own Conduct of Business Sourcebook and specific rules. These should cover marketing, sales, product disclosure and suitability. The rules should be developed in consultation with key stakeholders like the APPG on Fair Business Banking and the SME Alliance.

5.5 SMEs cannot afford the time or money or risk of adverse cost orders to obtain truth and justice in relation to their complaints. They must be provided with a choice of an alternative complaint resolution procedure similar to the FOS or a Financial Services Tribunal as described above.

5.6 When this is set up, retrospective victims who fall outside the standard limitation periods applicable to FOS complaints should still be able to progress their complaints through the new system if they have formally raised the matter with their MP or otherwise (e.g. Solicitor) since 1 September 2007.

5.7 The regulators have done a poor job over the years. Their work must be subjected to transparent internal or external quality assurance work and this work should be overseen by the TSC itself. Their own pronouncements on quality assurance and transparency support this. We recommend that prior to each calendar year, a programme of internal or external reviews is agreed with the TSC covering the areas of greatest regulatory concern and risk at the time. The reports can be discussed at scheduled TSC meetings.

The authors of this paper are available to give oral evidence to the TSC and expand and explain the above matters

Paper dated 30 March 2018 and co-authored by

Mr Jim Shannon MP

Mr Brian Little

Mr Paul Moore

Expanded Personal Background

Jim Shannon MP for Strangford - following his election to the House of Commons in May 2010 his initial interest here was in having Mssrs Little and Moore meet with the former Chair of TSC Mr Andrew Tyrie re RBS report and independence of PwC in February 2011 during part of an Employment Tribunal (akin to proposed Financial Services Tribunal). This was reported in the front page of Business Section in Daily Telegraph and was part of the reason why the TSC appointed and move forward with independent assessors in various inquiries/reports since. UK Daily Telegraph – 4 May 2011 : ***PwC faces probe over removing client criticism from report***

PriceWaterhouseCoopers has been reported to the accounting regulator, after agreeing to remove criticisms about its client from a £1.5m independent report into allegations made by a whistleblower

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Jim Shannon, MP, has written to the Financial Reporting Council asking them to investigate a report prepared by PwC in 2007.

The MP's intervention comes at a critical time for PwC, since it is under scrutiny over its "independent inquiry" into the Royal Bank of Scotland's collapse. The "big four" - Deloitte, KPMG, PwC and Ernst & Young - have also been criticised by MPs for "dereliction of duty" during the financial crisis.

Mr Shannon's concerns relate to an independent report that PwC was hired to write for Magellan Aerospace Corporation, a Canadian aircraft parts company. PwC's brief was to look into a whistleblower's claims that Magellan's order book had been inflated.

However, criticism of Magellan's "poor" accounting was left out of PwC's final version – at the request of the client's audit committee.

Furthermore the TSC will find in the Annex 1 to our submission relevant letters in relation to SMEs for FOI and email correspondence in relation to both the FOS and FCA during 2017 and 2018 – for example FOS statistics for complex financial complaints since August 2015 at Point 2.1 etc

- **Mr Brian Little** : who is a constituent in Jim Shannon's constituency in Northern Ireland. His evidence is of relevance for a "Financial Tribunal" proposal for redress and experience of FOS. Mr Little was plaintiff as Director of a Company in the longest running individual case (50+ days) in an Employment Tribunal from 2007 to 2012, during which the advocacy for the majority of the

time was by himself. Latterly Mr Moore and a pro bono barrister assisted in Closing Submissions. The Tribunal found in 2012 that he had made 12 Protected Disclosures in relation to financial matters in the business.

Since the case he has been assisting other whistleblowers and recently has made a "tribunal – type" quality submission to the FOS on behalf of a large dairy farm with Mr Gregory Campbell MP and Mr Shannon MP where the complainants assert being mis-sold a £1m Fixed interest loan – IHRP at the height of the 2008 financial crisis. Mr Shannon MP used this case study in his recent speech during the backbench debate on 18 January 2018. In another case in Mr Shannon's constituency he is working with the Directors of a former SME which was bankrupted by the Bank with a complex financial product etc – insolvency. Mr Little therefore has some practical experience and views on the appropriateness of having each of all three Options available in redress (FOS , Financial Tribunal (akin to ET) and Court) in support of research in SMEs. Mr Little has been working with Mr Shannon and Mr Moore and others, especially dealing with the problems associated with the Big 4 and the FRC as well as supporting the victims of the HBOS Reading Fraud and RBS GRG activities. He has also practically supported in counselling some of the victims of the HBOS Reading Fraud, the RBS GRG wrongdoing and other nationally known and unnamed whistleblowers. Finally he was a co-author of the recent October 2017 paper to the TSC relating to the decision of the FRC to drop their investigation into KPMG's audit of HBOS whilst their final submission to the TSC is under preparation.

For completeness Mr Little was a Director of the Company Mayflower Aerospace which went into administration at the hands of the predecessor of RBS GRG - SLS as the first UK company in September 2003 to go into administration under the new Enterprise Act (2002) where RBS effectively took some additional £2.3M in overdue PAYE tax as HMG was no longer a preferential creditor.

- **Paul Moore** was the former Head of Group Regulatory Risk at HBOS responsible for conduct risk assessment and financial crime policy and oversight. He is often referred to as "The HBOS Whistleblower" following high profile evidence he gave to the TSC in February 2009 which led to the resignation of Sir James Crosby as the deputy Chairman of the FSA.

  Prior to HBOS he was a lead partner in KPMG London advising on risk, regulation and corporate governance in the banking, asset management and insurance sectors. He has over thirty years' experience as a qualified lawyer in financial sector law, regulation and practice.

  Following a face to face meeting with Andrew Tyrie and Jim Shannon MP and Brian Little, in February 2011, at Andrew Tyrie's request, he provided informal advice about how to ensure

adequate oversight of regulatory investigations post crisis by requiring independent oversight in support of Mr Shannon's observations and his constituent MR Brian Little's similar experience.

Later, in June 2012, also at Andrew Tyrie's specific request, he gave further detailed evidence (41 pages plus attachments) on Corporate Governance in Systemically Important Financial Institutions.

In October 2012, he gave evidence to The Parliamentary Commission on Banking Standards' investigation into the failure of HBOS which led to Sir James Crosby giving up his Knighthood. It was that work that led to the FCA setting up the Senior Managers and Certification Scheme which significantly strengthens the person accountability of senior managers in banks and the rest of the financial sector by imposing s "duty of responsibility" to take reasonable steps to ensure compliance with regulatory requirements.

Subsequently, he gave evidence to the PRA / FCA investigation into HBOS.