A New Approach to Financial Regulation: the Blueprint for Reform – Draft Legislation to Overhaul FSA

June 2011

Summary

On 16 June the Government published its White Paper and draft Bill to change the nature of financial regulation in the UK. The draft legislation confirms and clarifies the broader, more interventionist remit for the new conduct of business regulator originally set out in February.

In addition, following pressure from the industry as well as the CII, the Government has proposed to revise the PRA’s objectives to take into account the distinct nature of the insurance sector. The FSA and the Bank of England are also set to publish a paper specifically about regulating the insurance industry in the next couple of days.

Next Steps:

- 20 June 2011: FSA and Bank of England (BoE) to publish paper on the prudential regulation of insurance.
- Late June: FSA to publish paper on the philosophy of the new conduct of business regulator.
- 8 September: deadline to respond to White Paper.
- Later in 2011: The Bank and the FSA will publish a paper setting out their plans to deliver operational coordination.
- Mid-2012: legislation expected to be passed.
- End-2012: new regulatory framework in place.

1. The Story so Far

In July last year the Government set out its intention to reform the UK's regulatory architecture. The key headline was that the FSA was to be disbanded and a ‘twin peaks’ approach adopted whereby the Bank of England would have responsibility for macroeconomic stability through the Financial Policy Committee (FPC) and prudential supervision for ‘systemically important’ firms through the Prudential Regulatory Authority (PRA).

A new regulator with the working title Consumer Protection and Markets Agency (CPMA) would focus on conduct of business issues and prudentially regulate those firms not covered by the PRA. In addition, economic crime was to be dealt with by a new body called the Economic Crime Agency (ECA), and the UK Listings Authority (UKLA) was to be merged with the Financial Reporting Council (FRC).

The Government consulted on these proposals and published the responses it had received in December. We produced two briefings associated with these developments, one of which summarising the July consultation paper and another analysing the responses to it. We also submitted a CII response to the consultation paper.

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1 The July Consultation Paper, the Treasury’s recent feedback statement, along with all the consultation responses themselves, and can be accessed via: [http://www.hm-treasury.gov.uk/consult_financial_regulation.htm](http://www.hm-treasury.gov.uk/consult_financial_regulation.htm) See also the Chancellor’s Mansion House Speech in June that can be found here: [http://www.hm-treasury.gov.uk/press_12_10.htm](http://www.hm-treasury.gov.uk/press_12_10.htm)
2 All our briefings on this topic can be accessed via: [http://www.cii.co.uk/pages/research/legislationandregulation.aspx](http://www.cii.co.uk/pages/research/legislationandregulation.aspx)
3 The response can be accessed via: [http://www.cii.co.uk/pages/research/responses.aspx](http://www.cii.co.uk/pages/research/responses.aspx)
Interim Developments

Prior to publishing the responses that it received to the July consultation paper, the Government announced that the UKLA – the body responsible for policing companies and their securities – would be merged into the conduct of business regulator rather than being moved into the FRC as had been originally planned. This was widely welcomed and was the focus of concern for many of the respondents to the July consultation paper.

Further consultation

On 17 February 2011 the Government published its second consultation paper setting out more detail about its plans to reform the UK’s regulatory architecture. The big change was that the new conduct of business regulator would now be called the Financial Conduct Authority not the CPMA.

Once again we responded to this consultation, calling for regulators to give greater recognition of firms’ cultures and behaviours to improve risk-based regulation\(^4\). We also called on the Government to take steps to ensure against the emergence of a one-sized fits all approach to regulation – where regulators fail to appreciate the different risks posed by banking relative to insurance. We also published a paper setting out in more detail the reasons for regulating culture and how this might be achieved\(^5\).

2. Refining the Proposals

The latest proposals, which include the draft Bill, retain the core elements of the previous consultation. Financial stability considerations will take precedence over conduct of business issues and this is underlined by the Bank of England gaining responsibility for macro and micro-prudential regulation as well as having the power of veto over the conduct of business regulator in extreme circumstances. **For a diagram of the new architecture please see below.**

**Figure 1. High level Diagram of New Regulatory Structure (HM Treasury Interpretation)**

The remainder of this briefing will discuss the added detail provided in the White Paper.

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\(^4\) To view our consultation response please see: [http://www.cii.co.uk/pages/research/responses.aspx](http://www.cii.co.uk/pages/research/responses.aspx)

\(^5\) To view our papers in professionalism please see: [http://www.cii.co.uk/pages/research/papersinprofessionalism.aspx](http://www.cii.co.uk/pages/research/papersinprofessionalism.aspx)
3. Financial Conduct Authority (FCA) – Chief Executive: Martin Wheatley (due to take the helm from 1 September 2011)

Scope

The FCA will regulate approximately 27,000 firms in total for conduct of business and markets related issues. It will also prudentially regulate all firms that are not regulated by the Prudential Regulatory Authority – around 18,500 firms. This will include for example, personal investment firms, investment management firms, mortgage or insurance intermediaries, authorised professional firms, providers of market trading infrastructure, and non-bank mortgage lenders.

The FCA will also take over the FSA’s existing responsibility for the Financial Ombudsman Service, will oversee the Money Advice Service, and have responsibility for the Financial Services Compensation Scheme.

Objectives

The FCA’s principal objective will be to protect and enhance confidence in the UK financial system. In order to achieve this overarching aim the FCA will have three ‘operational objectives’.

a. Promoting efficiency and choice in the market for certain types of services
b. Securing an appropriate degree of protection for consumers
c. Protecting and enhancing the integrity of the UK financial system

The new body must also ensure that, as far as is compatible with these objectives, its activities act to promote competition in financial services (a duty for competition).

CII Commentary

The objectives remain as they were. Despite the demands of the Treasury Select Committee and others for a greater provision for competition the Government believes that the duty as set out in February is sufficient. However, the Government maintains that competition will be at the “heart of the new conduct regime” and the FCA will be given a strong toolkit to do things like promote the switching of bank accounts and improve levels of transparency.

The FCA will also have the power to initiate an “enhanced referral to the OFT where it has identified a possible competition issue that may benefit from technical competition expertise or require recourse to powers under competition law that sit with the competition authorities”.

FCA Spells Increased Intervention

The FCA will have a fundamentally different approach to the FSA in the way it intervenes in the retail investment market. The draft Bill confirms a number of new regulatory initiatives including:

Banning Products (only applies to retail sector)

- Where the FCA identifies a serious problem with a product or product feature, it will be able to take timely and necessary steps to ban it.
- The draft legislation would enable the FCA to make temporary product intervention rules without prior cost-benefit analysis or consultation valid for up to 12 months.
- However, the FCA will not be allowed to immediately renew any temporary product intervention rules when they expire.
- The FCA will be required to consult on a set of principles governing the circumstances under which it will use this power.
- The FCA will only be allowed to use its product intervention powers in relation to retail customers.

Withdrawing Misleading Financial Promotions

- The FCA will be able to take action in relation to misleading financial promotions
- The FCA will also be able to disclose the fact that enforcement action against a firm or individual has commenced.
- The FCA will be required to alert a firm to its proposed course of action, and to allow for and consider representations by the firms before publishing any details of its action.
Early Publication of Enforcement Action

- As with the power to withdraw misleading financial information, the Government believes that greater transparency as to what enforcement action is underway would help to improve confidence by highlighting issues to consumers at an early stage.
- The Government will therefore legislate to allow for publication of the fact that a warning notice has been issued and as well a summary of the notice. This new power will be available to both the FCA and PRA.
- In making a decision whether or not to disclose, the regulator must consider a number of factors set out in statute, including whether publication of the information would be unfair to the person whom the warning notice relates. The Government will not be considering any additional safeguards.

Engagement with the industry

The Smaller Business Practitioner Panel will be placed on a statutory footing and a new markets practitioner panel will be created.

4. Prudential Regulatory Authority – Chief Executive: Hector Sants

Scope

The PRA will be responsible for the prudential regulation of all ‘systemically important firms’ defined as those firms that pose a risk for the financial system if they were to fail. The PRA will be responsible for the regulation of all institutions that accept deposits or which accept insurance contracts. This will mean that the PRA will authorize and supervise all banks, building societies, credit unions and insurers.

In response to concerns voiced by the insurance industry and the CII, the Government has announced that “the distinct nature of insurance business ought to be recognised in the regulatory framework, including the PRA’s objective.” A new section has therefore been added to the draft legislation which makes clear the specific responsibilities that the PRA will face in relation to insurers. The new insurance objective is:

“Contributing to the securing of an appropriate degree of protection for those who are or may become policyholders”

In addition the Bank of England and the FSA will be publishing a paper specifically on the future supervision of insurance firms on 20 June.

In the previous consultation it was announced that the PRA would also be the lead regulator for Lloyd’s as a whole though the FCA will take responsibility for certain conduct of business issues. The draft legislation confirms this:

“The Society of Lloyd’s and Lloyd’s managing agents will be dual regulated firms; Lloyd’s members’ agents and Lloyd’s brokers will be FCA-regulated firms”.

Judgement-led regulation (applies to PRA and FCA)

The PRA’s judgment led approach will be characterised by a move away from rules-based regulation and a focus on forward looking analysis including an assessment of how a firm would be resolved if it were to fail, the impact this would have on the system as a whole and the use of public funds.

The prompt intervention framework will be designed to ensure that the judgment-led approach will be applied proactively where a supervisor has concerns about a firm and where action is taken. The Government argue that it will support “early identification of risks to a firm’s viability and ensuring that firms take appropriate remedial action to reduce the probability of failure”.

The Government says that it will promote judgment-led decision making by limiting the course of action available to the Tribunal in the event it chooses not to uphold the regulator’s decision.

CII Commentary

In future, supervisors will have more discretion to make judgments on firms. However, prudential supervision (as outlined in the recent paper FSA and BoE paper on banking regulation) will still be governed by looking at specific issues that were included in the FSA’s previous risk assessment framework. These include assessing the possible impact of a firm’s activities as well as the operational and financial mitigation work undertaken by firms. The resolvability of banks is however, a new element.
Objectives

As well as having a specific insurance objective the PRA will regulate firms to 1) promote their safety and soundness, and 2) to act with a view to minimise the impact caused by a firm’s failure. These two objectives seek to embed the fact that not only will the PRA have a vital role in promoting the soundness of firms that it regulates, but also that firm failure is a necessary and important part of the financial services sector. The draft Bill also includes an objective to make it clear that the new regime will not be operated on a zero failure basis.

CII Commentary

The Government has always said that the PRA’s remit would be to promote financial stability but the message about whether a systemically important firm could be allowed to fail was unclear and the Treasury Select Committee picked up on this. The draft Bill should provide clarity that the PRA’s aim is not to prevent all firms within its remit from failing but to ensure that if failures do arise then the impact will be minimised.

Industry engagement

The Government has given the PRA a statutory duty to put in place arrangements for engaging with practitioners – though it does not specify in detail what those arrangements should be.

5. Financial Policy Committee – Chair: Sir Mervyn King

Scope and objectives

Run by the Bank of England, the FPC will have responsibility for macroprudential supervision. It will be responsible for spotting the systemic risks ‘attributable to structural features of financial markets or to the distribution of risk within the financial sector’. It will also be responsible for identifying unsustainable levels of leverage, debt or credit growth.

Having identified the risks, the FPC will have the power to take various policy measures to counteract these risks. Possible policy levers may include:

- **Setting countercyclical capital buffers**: Ensuring that banks’s increase their capital in the ‘good times’ so they have protection for the bad. This should also have the affect of tempering lending during a boom and so dampening the effect of the credit cycle.

- **Variable risk weights**: Enforcing targeted capital requirements on specific sectors or asset classes. This could include requiring banks to hold greater levels of capital against asset exposures that represent substantial risk.

- **Leverage Limits**: Limiting excessive build up of on and off balance sheet leverage. As measures of risk can be unreliable a leverage ratio could act as a back-stop to risk-weighted requirements (such as a capital buffer).

The FPC will provide the Treasury with an update on its views about what tools should be permanently at its disposal in time for the Bill’s introduction towards the end of the year and again in Q1 2012.

As well as these financial stability considerations the FPC will also have a statutory obligation to limit the impacts of its policies on economic growth.

Governance

The FPC will have a total membership of 13, comprising six executives of the Bank of England, and five members from outside the Bank. In addition, the FPC will include a non-voting Treasury member. It will be chaired by the Governor, and include the existing Deputy Governors for monetary policy and financial stability, and the newly created Deputy Governor for prudential regulation.

The Chief Executive of the FCA will also sit on the FPC, as will a further four independent external members, appointed by the Chancellor and recruited in a similar manner to the current external membership of the MPC.
Members of the Interim FPC:

- the Governor of the Bank of England, Sir Mervyn King, as Chair;
- the Bank of England’s Deputy Governor for Financial Stability, Paul Tucker;
- the Bank of England’s Deputy Governor for Monetary Policy, Charlie Bean;
- the Chief Executive of the FSA, Hector Sants (in his capacity as future Deputy Governor for Prudential Regulation of the Bank of England and Chief Executive of the Prudential Regulation Authority);
- the Chairman of the FSA, Lord Adair Turner;
- the Bank of England’s Executive Director for Financial Stability, Andy Haldane;
- the Bank of England’s Executive Director for Markets, Paul Fisher;
- the Chief-Executive-designate of the Financial Conduct Authority Martin Wheatley; and
- a Treasury member.
- External member: Alastair Clark
- External member: Michael Cohrs
- External member: Donald Kohn

The Government has noted the importance of external members having direct market expertise in areas such as insurance. “The Government and the Bank of England are committed to ensuring an appropriate balance and breadth of expertise for both the interim FPC and the permanent body and will make all efforts to ensure this is the case”.

Accountability

The Treasury will be able to provide the FPC with guidance in the form of a remit alongside its statutory objectives, to help shape its pursuit of financial stability. The FPC will be required to respond to the Treasury’s recommendations, setting out to what extent the committee agrees with the remit and what action it intends to take in response to them. However the FPC may reject any recommendations from the Treasury which it does not agree.

CII Commentary

Accountability of the Bank has been one of the big issues raised by respondents during the consultation process including the Treasury Select Committee. This additional clarification on the relationship with the Treasury and the Bank means that the Bank will retain independence over decision making from the Treasury. Government will therefore only be able to influence rather than direct.

The Government will legislate to require the FPC to publish a Financial Stability Report twice a year. Once the FPC has completed and agreed its reports, it will send them to the Treasury, which will, in turn, lay copies before Parliament.

The Government will require the FPC to publish a record of each FPC meeting within six weeks. These meeting records will describe the FPC’s discussions in broad terms, but without identifying the contributions of individual members.

There must also be a mechanism to allow the Treasury to ensure that for each macro-prudential tool provided to the FPC, the most appropriate mechanisms for engagement with industry and other interested sectors (this could include a policy statement setting out in advance how it expects to use the tool).

6. Coordination

The Government will legislate to provide a number of general coordination mechanisms:

- A statutory duty on the PRA and the FCA to coordinate their activities (including consulting with one another to gather views where necessary)
- An obligation to prepare a Memorandum of Understanding (including setting out the role of each regulator and how they are interlinked)
- Cross-membership of boards
- A veto mechanism for the PRA to reduce the risk of regulatory actions threatening financial stability or the disorderly failure of a firm. The draft legislation will allow the PRA to use its veto if the failure of a firm would be disorderly even if those wider effects do not threaten financial stability.
A requirement that the PRA and FCA include in their annual reports an account of how they have coordinated during the year.

Later in 2011 the Bank and the FSA will publish a paper setting out their plans to deliver operational coordination.

7. European Representation

The Government has set out how the new regulatory structure will engage with Europe. With regards to representation within the various European bodies the following has been decided:

- The Bank of England will sit on the European Systemic Risk Board (ESRB)
- The PRA, as a regulator of banks and insurers, will hold the UK seat on the European Banking Authority and the European Insurance and Occupational Pensions Authority
- The FCA will represent the UK at the European Securities and Markets Authority
- The Treasury will continue to represent the UK in political-level negotiations on European directives and regulations.

In order to ensure a consistent strategic view across the different regulatory bodies there will be a memorandum of understanding covering:

- The process for discussing and agreeing strategic objectives
- Which authority represents the UK in each European body
- How the authorities will coordinate their engagement in international bodies
- How each authority will consult the others in advance
- How authorities will seek views from interested parties in advance of meetings

8. Next Steps

- Late June: FSA to publish paper on the philosophy of the new conduct of business regulator.
- 8 September: Deadline to respond to White Paper.
- Later in 2011: The Bank and the FSA will publish a paper setting out their plans to deliver operational coordination.
- End of 2011: Introduction of Financial Services Regulation Reform Bill to Parliament
- Mid-2012: legislation expected to be passed.
- End-2012: new regulatory framework in place.

Useful Links

Link to White Paper on regulatory reform: [http://www.hm-treasury.gov.uk/consult_finregBlueprint.htm](http://www.hm-treasury.gov.uk/consult_finregBlueprint.htm)


Link the Chancellor George Osborne’s speech at Mansion House: [http://www.hm-treasury.gov.uk/press_58_11.htm](http://www.hm-treasury.gov.uk/press_58_11.htm)

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