HM TREASURY

A new approach to financial regulation:

building a stronger system

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building a stronger system

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the Financial Secretary to the Treasury
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1 Introduction

1.1 The financial services sector has a vital role to play in the UK economy. The sector is, of course, one of the UK's leading employers, exporters, and contributors to GDP. Banks, insurance companies and other financial institutions also play a fundamental role in transforming savings into productive investment in the economy, and in allowing the efficient management of risk. By doing so, they provide businesses with the finance needed to grow, and enable individuals to access services allowing them, for example, to manage their day-to-day finances, cover themselves if things go wrong or buy a home.

1.2 The financial crisis that started in 2007, which began with a run on a major high-street bank and resulted in part-nationalisation of two of the largest banks in the world, has left the UK economy vulnerable. The crisis was caused by the failure of financial institutions to manage themselves prudently, and of regulators to spot the risks that were building up across the system as a whole. Most developed economies – including the UK's – are emerging from the deepest recession for generations. The aftershocks of the crisis are still being felt in a number of countries, as sovereign debt markets get to grips with the fiscal implications of lower output and financial sector rescue packages.

1.3 The Coalition Government has, since taking office, decisively tackled the UK's deficit through a comprehensive spending review which will, over the next three years, return the public finances to health. The Government has also made clear its commitment to restoring the UK economy to sustainable, long-term growth, recognising the crucial role of the financial sector. As they rebuild their balance sheets – often with direct or indirect support from the taxpayer – banks must continue to lend to the businesses that are the engine of economic growth, particularly small and medium enterprises.

1.4 The Government welcomed, last week, the commitment by the UK's biggest banks on lending expectations and capacity, the size of the 2010 bonus pool, pay disclosure and support for regional growth and the Big Society. Barclays, HSBC, Lloyds Banking Group, RBS and, with respect to lending, Santander, have made specific commitments on these issues, following a period of discussion between the Government and the banks, known as Project Merlin.

Reforming financial regulation

1.5 The Government recognises that steps must also be taken to ensure that financial firms are never again allowed to take on risks that are so significant and so poorly understood, resulting in such severe economic consequences for businesses, households and individuals. That is why the Coalition Government made the reform of UK financial regulation, and the replacement of the flawed system introduced by the previous administration, one of its key priorities on taking office in May 2010.

1.6 The reforms to UK regulatory institutions announced by the Government last June, and set out in more policy detail in this document, are part of a wider picture. The Government, supported by the Bank of England (the Bank) and the Financial Services Authority (FSA), has also played a leading role in the international programme of reform which is being taken forward by the Financial Stability Board, the International Monetary Fund, the Basel Committee on Banking Supervision, and within the European Union.

1.7 Furthermore, the Government has also established the Independent Banking Commission, chaired by Sir John Vickers, to consider the structure of the UK banking market, including the question of whether to separate retail and investment banking, and questions of competition in banking. The Commission will report in September 2011, with an interim report due in April.

The Government's proposals

1.8 The Chancellor of the Exchequer announced the Government's plans for reforming the UK's system of financial regulation at the Mansion House speech on 16 June 2010. The Government followed this up with a consultation, *A new approach to financial regulation: judgment, focus and stability,* launched in July, setting out its proposals in more detail. This document sets out the next stage of the Government's thinking, based on the results of the July consultation, and continuing policy development carried out by the Treasury, working with the Bank and the FSA.

1.9 The Treasury Select Committee (TSC) also published a report on UK financial regulation on 3 February 2011. While this consultation document does not fully respond to the issues raised by the TSC – a formal response will be published by the Government in due course – the Government has sought to reflect and respond to the TSC's comments and recommendations wherever possible in this document.

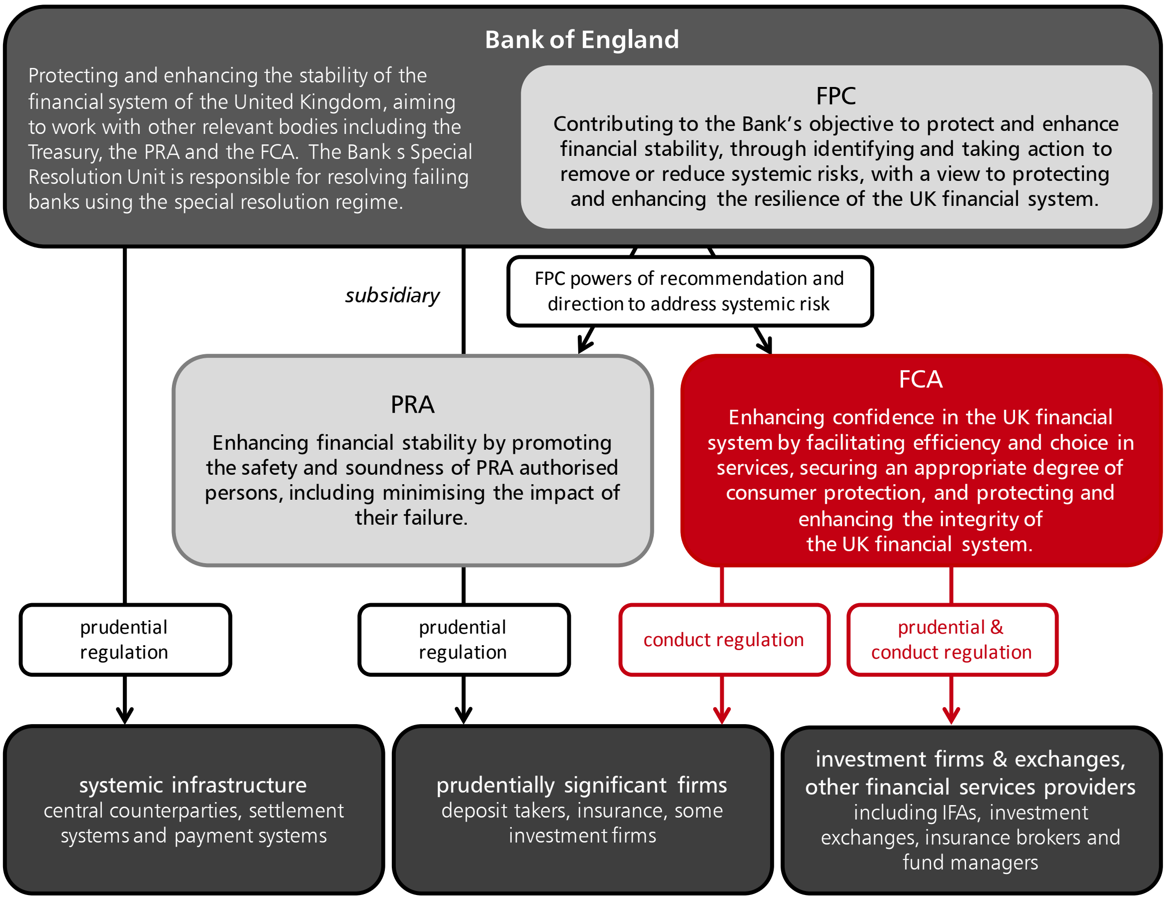
1.10 The Government's reforms focus on three key institutional changes:

- first, a new Financial Policy Committee (FPC) will be established in the Bank of England, with responsibility for 'macro-prudential' regulation, or regulation of stability and resilience of the financial system as a whole;
- second, 'micro-prudential' (that is, firm-specific) regulation financial institutions that manage significant risks on their balance sheets will be carried out by an operationally independent subsidiary of the Bank of England, the Prudential Regulation Authority (PRA); and
- third, responsibility for conduct of business regulation will be transferred to a new specialist regulator, which has had the working title 'consumer protection and markets authority'. The Government has now finalised the name of this body as the Financial Conduct Authority (FCA); the FCA will have responsibility for conduct issues across the entire spectrum of financial services.

1.11 These institutional changes respond to what, in the Government's view, were fundamental failings of the previous administration's 'tripartite' approach to financial regulation and financial stability. Under this framework, the Treasury, Bank and FSA are collectively responsible for financial stability. Unsurprisingly, this fragmentation of responsibilities has had a number of dysfunctional results. For example:

- the Bank of England, while having statutory responsibility for financial stability, has only limited tools to deliver it;
- the FSA, by contrast, has regulatory tools for delivering financial stability, but with such a wide mandate prior to the crisis – including consumer protection, public awareness, market confidence and the reduction of financial crime – was not sufficiently focused on stability issues; and
- perhaps most significantly, the linkage between firm-level and systemic stability issues has fallen between the institutional cracks, with no one body having the remit to tackle this fundamentally important issue. This has created a significant area of regulatory 'underlap' within the UK's framework.

Figure 1.A Roles of the bodies in the new regulatory architecture



1.12 The Government's reforms will deal with these failings directly. The FPC will create the locus for macro-prudential regulation that is missing from the current framework. Responsibility for financial stability will be clearly located in the Bank of England, with macro-prudential policy the preserve of the FPC, and micro-prudential regulation the responsibility of the PRA, alongside the Bank's current responsibilities under the special resolution regime and as a lender of last resort. By locating these distinct but complementary functions within the Bank of England group, the Government will ensure that systemic and firm-specific regulation are coordinated, and that the market knowledge and economic expertise of the central bank is fully brought to bear on financial stability.

1.13 Under the regime introduced by the previous administration, the regulation of conduct of business in financial services has not always received the attention and focus that is necessary to protect consumers and ensure that markets work effectively. Part of the process of rebuilding trust and confidence in financial services will be establishing a new, credible regime for conduct regulation. The FCA will therefore put appropriate consumer outcomes at the centre of the regulatory process.

1.14 The creation of a new conduct-focused regulator in the form of the FCA will ensure that conduct of business issues receive the focus they require, building on progress the FSA has made in recent months through more intensive, issues-based supervision, earlier and more proactive intervention, and credible deterrence through enforcement. The FCA will also provide a centre of excellence for markets regulation, enhancing London's reputation as the world's leading global financial centre, and representing the UK's interests in markets regulation at the new European Securities and Markets Authority.

1.15 The Government is absolutely clear, therefore, that there will be a fundamental change in the way that the new regulatory authorities carry out their functions, to deliver a more judgement-led, focused and effective regulation of the financial sector. These reforms will be implemented through primary legislation amending the Financial Services and Markets Act 2000 (FSMA). This approach, which will involve modifying, adapting, supplementing, and in some cases replacing the current legislative framework, will allow the Government to implement changes more quickly, while minimising the cost and disruption to firms that would arise from repealing FSMA and starting with an entirely new Bill.

Consultation responses

1.16 The Government published a summary response to the July consultation in November 2011.[1] The majority of the approximately 220 consultation responses were also published on the Treasury's website, with the exception only of those responses for which confidentiality had been explicitly requested.

1.17 The overwhelming majority of consultation respondents welcomed the proposed framework for financial regulation; most also supported the specific emphasis on promoting financial stability and the enhanced focus on macro-prudential as well as micro-prudential regulation. Alongside this general support, respondents also highlighted a number of areas for further consideration. The Government identified five key themes in its summary response:

- the need for the regulatory authorities' core statutory objectives to be balanced and supplemented with other factors;
- the importance of accountability and transparency for the PRA, the FCA, and the FPC;
- the need for a strong, coherent markets regulation function within the FCA, including the functions of the UK Listing Authority;
- the importance of the European and international agenda, both during the transition phase and in steady state; and
- the importance of effective coordination between the new regulatory authorities.

1.18 The November summary response set out the Government's emerging thinking on each of these themes. Based on the work carried out by the Treasury, Bank and FSA over the last seven months, the Government is now able to provide far more detailed and specific policy responses in each of these areas. The remainder of this introduction highlights some of the main developments since the July document was published.

Balanced statutory objectives

1.19 While the majority of respondents to the July consultation supported the proposed simplification of core regulatory objectives, many also stressed the importance of balancing or supplementing these objectives with additional factors to which the regulators must have regard. As described in each of the chapters on specific institutions, the Government will legislate to provide for a clear, primary objective for each new authority.

1.20 For the FPC, this objective will straightforwardly be expressed in terms of the financial stability objective of the Bank of England, as follows:

[1] *A new approach to financial regulation: summary of consultation responses*, HM Treasury, November 2010

The Financial Policy Committee is to exercise its functions with a view to contributing to the achievement by the Bank of the Financial Stability Objective.

The responsibility of the Committee in relation to the achievement of that objective relates primarily to the identification of, monitoring of, and taking of action to remove or reduce, systemic risks with a view to protecting and enhancing the resilience of the UK financial system.

These systemic risks include, in particular –

a systemic risks attributable to structural features of financial markets or to the distribution of risk within the financial sector, and

b unsustainable levels of leverage, debt or credit growth.

1.21 The Government recognises that the exercise of the FPC's macro-prudential functions to increase overall resilience and make the financial sector more sustainable may impact upon the capacity of the financial sector to support the economy. Many respondents to the July consultation called for this to be recognised through a specific reference to economic impact in the FPC's statutory objective. The Government proposes to build this factor into the FPC's objective through an additional statutory limb, as follows:

This does not require or authorise the Committee to exercise its functions in a way that would in its opinion be likely to have a significant adverse effect on the capacity of the financial sector to contribute to the growth of the UK economy in the medium or long term.

1.22 The Government will thus ensure that the Committee focuses on financial resilience and stability in a way that takes into account the potential for adverse impacts on medium- or long-term economic growth. The FPC must also, reflecting its role within the regulatory system, have regard to the importance of proportionality and openness, and the need to take into account constraints imposed by international law in directing or recommending other institutions to take a particular action.

Box 1.A: Interim Financial Policy Committee

An interim FPC was created in February 2011 by the Bank's Court of Directors, with members from the Bank, the FSA and the Treasury. Additionally, the Chancellor, working closely with the Governor of the Bank, has also appointed four highly experienced external members to provide vital expertise and independent perspectives. The interim FPC will undertake, as far as possible, the work of the permanent FPC, by identifying and monitoring systemic risks and considering action to address those risks. The interim FPC will also carry out important preparatory work in advance of the creation of the permanent FPC, including in-depth analysis of potential macro-prudential tools, on which it will provide advice to the Treasury.

1.23 For the PRA and FPC, the primary objective will be expressed in terms of an overarching strategic objective, underpinned by operational objectives intended to provide a clear elaboration of how each authority is to interpret, and pursue, its strategic remit.

1.24 For the PRA, the strategic and operational objectives are proposed as follows:

The PRA's strategic objective is: contributing to the promotion of the stability of the UK financial system.

The PRA's operational objective is: promoting the safety and soundness of PRA authorised persons.

Promoting the safety and soundness of PRA authorised persons includes seeking, in relation to each PRA authorised person, to minimise any adverse effect that the failure of that person could be expected to have on the UK financial system.

1.25 This objective ensures that, in regulating the firms for which it is responsible – those with the greatest potential to impact upon financial stability – the PRA will be entirely focused on financial stability. The PRA's operational objective will provide it with a parallel and complementary remit both to regulate firms to promote their safety and soundness and to act with a view to minimise the impact that a failure would cause. This focus on financial stability will be balanced, as recommended by most consultation respondents, by a duty to have regard to a set of regulatory principles (which the PRA will share with the FCA). These principles, which are intended to guide the way in which the regulators will behave, include:

- efficiency and proportionality, to ensure that due regard is paid to value-for-money and cost-effectiveness considerations;
- the principle that senior managers (and not regulators) are ultimately responsible for managing their firms in a way that is compliant with the regulatory framework;
- the principle that consumers of financial services are ultimately responsible for their own decisions; and
- principles relating to openness and transparency, highlighting the importance of openness and disclosure as a regulatory tool in promoting market discipline, and
- the desirability of transparency of process to support trust in the judgements and decisions made by the regulators.

1.26 The FCA's proposed strategic and operational objectives, which will also be balanced by the regulatory principles discussed in the preceding paragraph, are as follows:

The FCA's strategic objective is: protecting and enhancing confidence in the UK financial system

The FCA's operational objectives are:

a facilitating efficiency and choice in the market for financial services;[2]

a securing an appropriate degree of protection for consumers;[3] *and*

b protecting and enhancing the integrity of the UK financial system

The FCA must, so far as is compatible with its strategic and operational objectives, discharge its general functions in a way which promotes competition.

1.27 Competition will be an important new feature of the regulatory remit, incorporated in a way that goes significantly beyond the current FSMA framework. This will provide a significant step forward in terms of recognising the importance of competition in delivering good outcomes for consumers of financial services. In addition to an operational objective which

[2] 'Services' is to be defined broadly to include services provided in the course of carrying on regulated activities (including by persons who are not authorised persons); services provided to issuers in connection with capital raising, services provided by payment services providers; and relevant ancillary services.

[3] 'Consumers' is to be defined broadly to include persons who use, have used or may use "services" or have relevant rights or interests in relation to those services, and persons who have invested in, or may invest in, securities (for example, those listed on the Official List).

recognises the importance of efficiency and choice – two core characteristics of competitive markets – in delivery of the strategic objective, the legislation will place the FCA under a duty to advance its operational objectives, where appropriate, by promoting competition. This will require the FCA to consider competition matters, and to act upon them when it has identified a problem. The Government considers this to be a significant step forward in enhancing the profile of competition within the regulatory framework.

1.28 Finally, the Government also recognises that redress and compensation have a part to play in the regulatory system, to provide consumers – particularly retail customers – with appropriate mechanisms to protect them if things go wrong. Chapter 6 of this document sets out the Government's proposals for maintaining strong, operationally independent mechanisms for dealing with consumer compensation (through the Financial Services Compensation Scheme) and dispute resolution (through the Financial Ombudsman Scheme).

Accountability, transparency and engagement

1.29 As stated in the November summary response, consistent with its wider agenda on the reform of public institutions, the Government is fully committed to the accountability and transparency of the new regulatory institutions. The location of responsibilities within independent, expert institutions is a model of public administration which is well suited to technical issues – such as financial regulation – for which certainty, long-term focus and a degree of insulation from political influence is important. However, the model also depends on there being clear accountability for performance, supported by transparency and, where appropriate, engagement with affected segments of society.

1.30 Each regulatory institution will be subject to internal mechanisms of accountability reflecting the specific nature of the body:

- the FPC, as a policy committee of Court (the governing body of the Bank of England) will be accountable to Court for the contribution it makes to the Bank's financial stability objective;
- the PRA, as part of the Bank of England group will be accountable to Court for administrative matters, including its budget and remuneration policy, value for money and performance against objectives; and as an operationally independent regulator, the PRA will be accountable to its own independent board for performance against its regulatory and supervisory strategy, which will be set by the board. The board will also make all rules; and
- the FCA, as a standalone independent regulator will be accountable for its administrative, operational and strategic performance to its own independent board.

1.31 When dealing with such important public functions, external channels of accountability are also needed. In order to deliver an appropriate degree of accountability, transparency and engagement, therefore, the Government is proposing to legislate for the following provisions relating to the new institutions. With respect to the FPC (full details of which can be found within Chapter 2), there will be:

- twice-yearly publication of a Financial Stability Report containing an assessment of potential and actual risks to financial stability, and action taken by the FPC (including an assessment of their effectiveness), with reports submitted to the Treasury and laid before Parliament;
- a regular twice-yearly update from the Governor to the Chancellor on developments in prudential regulation and financial stability, with a published high-level record of the discussion;

- publication of records of the FPC's quarterly meetings, including decisions taken and the discussion behind those decisions;
- submission to the Treasury of all directions issued by the FPC to either the PRA or FCA, so that these can be laid before Parliament; and
- a flexible mechanism to allow the Treasury to ensure, for each macro-prudential tool provided to the FPC, the most appropriate mechanisms for engagement with industry and other interested sectors apply (for example: a policy statement issued in advance by the FPC setting out how it expects to use the tool, or consultation by the PRA or FCA on the regulatory measures by which the instrument will be implemented).

1.32 For the PRA, external accountability to the Government and Parliament will be delivered through legislative provision for:

- full audit by the National Audit Office (NAO), with accountability to the Public Accounts Committee (PAC);
- a power for the Treasury to order an independent inquiry into the PRA's economy, efficiency and effectiveness;
- a power for the Treasury to order an independent inquiry into regulatory failure, carried out by a third party, as is currently provided for in FSMA; and
- a new requirement for the regulator to make a report to the Treasury, to be laid before Parliament where there has been regulatory failure. This report may include the disclosure of confidential information where this would be justified in the public interest.

1.33 The PRA will also have to engage with the regulated industry and the wider public through the following mechanisms:

- a consultation mechanism for rules, substantially unchanged from the current FSMA arrangements;
- a duty to make and maintain arrangements for consulting industry practitioners;
- an independent and transparent complaints procedure; and
- an annual consultation on the PRA's annual report.

1.34 Finally, as set out in the July consultation document, the FCA will be largely subject to the current FSMA provisions governing the accountability of the FSA, with a number of supplementary measures, including:

- as with the PRA, full NAO audit and accountability to the PAC;
- again, as with the PRA, the new Treasury power to require inquiries into regulatory failure;
- establishing the small business practitioner panel on a statutory basis, alongside the existing statutory panels for consumers and practitioners, and a new panel for markets practitioners; and
- the appointment, jointly by the Treasury and the Department for Business, Innovation and Skills, of a proportionate number of non-executive directors to the FCA board with relevant consumer and business experience.

1.35 In addition to these institution-specific measures, there will also be a number of mechanisms for accountability and transparency applying across the framework. First, as stated in the July consultation, the Government expects the TSC to play a key role in scrutinising and holding each institution to account. In its recent report on regulatory reform, the TSC has indicated that it will take a particular interest in the FPC, and hold regular hearings.

1.36 Second, as discussed above, the Government will also legislate for a consistent set of regulatory principles to which the PRA, FCA (and, if appropriate, FPC) must have regard in fulfilling their objectives. One of these key principles refers to the importance of transparency, underscoring the Government's general commitment to transparency in public administration.

1.37 The Government believes that with this package of measures, discussed in more detail in Chapters 2, 3 and 4, it has provided a coherent framework for accountability, transparency and engagement for the new regulatory structure.

A strong markets function

1.38 The Government is committed to establishing the FCA as an integrated conduct of business regulator of the financial services sector. In addition to the regulation of retail financial services, the FCA will also regulate those wholesale activities which flow through to retail financial services; for example, the packaging of specialist types of investments or assets into retail investment funds. This integration will enable the FCA to be effective in protecting the interests of retail customers.

1.39 However, the Government also recognises that there are wholesale and markets activities which do not directly form part of the transaction chain of products and services sold to retail customers. The scale and importance of these activities makes it imperative that they are effectively, and proportionately, regulated in a way which recognises the particular characteristics of participants in these markets.

1.40 The FCA will therefore contain a strong specialist markets regulation function. The Government's commitment to this function was demonstrated in the November summary response, which announced that the UK Listing Authority would be retained within the FCA. The Government also announced in the November document that the FSA's criminal prosecution powers in relation to market abuse will also be retained within the FCA. The markets function will also contain regulation of recognised investment exchanges, multilateral trading facilities, and other trading platforms. The markets function will provide the expertise underpinning the FCA's representation of the UK in the new European Securities and Markets Authority (ESMA), including working with the Bank of England on issues relating to systemic infrastructure.

1.41 The importance of the markets function of the FCA will also be reflected in the new regulator's objectives which, as set out above and discussed in detail in chapter 4, will be drafted in terms which will enable the appropriately tailored and differentiated treatment of markets and wholesale issues within the FCA.

European and international engagement

1.42 Given the significant programme of international and European regulatory reform currently underway, the Government recognises that engagement with these processes will be a vital part of the UK's response to the financial crisis. Respondents to the July consultation underlined this point; Chapter 7 of this document sets out the Government's proposals to ensure effective international engagement.

1.43 Ensuring the right UK representation in European and international forums will be a key part of this. For example:

- the Bank sits on the European Systemic Risk Board (ESRB);
- the PRA, as regulator of banks and insurers, will hold the UK seat on the European Banking Authority (EBA) and the European Insurance and Occupational Pensions Authority (EIOPA);
- the FCA will, as discussed above, represent the UK at ESMA; and
- the Treasury will continue to represent the UK in political-level negotiations on European directives and regulations.

1.44 Representation is, of course, only a part of the picture, particularly given the fact that domestic responsibilities do not currently, and will not in future, map neatly onto the institutional structures in Europe and internationally. As described in detail in Chapter 7, coordination mechanisms will ensure that the regulators are able to represent each other's interests in the various forums. Perhaps most significantly, it will be crucial for the authorities – including the Treasury and the Bank – to approach international and European engagement with a consistent, strategic view of the UK's priorities and interests. The legislation will therefore provide for a statutory MoU between the authorities, covering:

- the process for discussing and agreeing strategic objectives to inform a single UK approach to significant changes in financial regulation;
- which authority represents the UK in each international body and forum;
- how the authorities will coordinate their engagement in international bodies;
- how each authority will consult the others in advance of relevant issues being discussed in international forums; and
- how the authorities will seek the views of other interested parties, including financial sector participants.

Effective regulatory coordination between authorities

1.45 The Government recognises that effective coordination between the PRA and the FCA will be a vital part of the new framework. Chapter 5 of this document sets out in detail the various general and specific mechanisms that will be put in place. Coordination is important because, by ensuring that the arrangements are in place for each regulator to work closely with the other, it enables both regulators to focus on their core remit. It is in this way that the new framework will allow for judgement and expertise to be brought to bear on financial regulation.

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

- a statutory duty to coordinate the exercise of their functions;
- an obligation to prepare a Memorandum of Understanding (MoU);
- cross-membership of boards; and
- a veto mechanism for the PRA to reduce the risk of regulatory actions threatening financial stability or the disorderly failure of a firm.

1.47 In the July consultation, the Government proposed – and the majority of respondents supported – that each regulator should have regard to the objectives of the other. Having considered the practicalities of how such an interlocking set of 'have regards' would operate, the Government believes that the intended outcome – effectively coordinated regulation, allowing each regulator to focus on its responsibilities without placing unnecessary demands on firms – will be better served by a statutory duty to coordinate, as discussed in more detail in Chapter 5. The duty to coordinate will allow each regulator to benefit from the expertise of the other without duplication or confusion, through appropriate consultation mechanisms, and where necessary, specific mechanisms to allow shared regulatory processes to operate efficiently.

1.48 Recognising the primacy of financial stability in some circumstances, the Government also proposes to provide the PRA with a veto, to be exercised when the regulators are unable to agree on a course of action, and the PRA is materially concerned that a proposed action by the FCA would lead to a disorderly failure of a firm or firms, or wider systemic instability. This veto will be limited only to these circumstances, and its use will be subject to transparent safeguards.

1.49 These general mechanisms – together with the detailed coordination processes, described in chapter 5, relating to specific regulatory processes such as authorisation, approval of people carrying out significant influence functions, rule-making and supervision of financial groups – will ensure that the regulatory system operates efficiently and effectively.

1.50 In addition to such statutory mechanisms, non-legislative arrangements, supported by the development of a collaborative working culture between the regulators will also be important. The transitional period of 'shadow running', during which the FSA will begin the process of dividing its operations into prudential- and conduct-focused processes, will provide a firm foundation for this. A number of consultation respondents highlighted the importance of recruiting a chief-executive designate of the FCA to provide conduct-focused leadership. The Government has announced that Martin Wheatley, appointed by the FSA as managing director for consumer protection and markets, will be the first chief executive of the FCA.

1.51 Chapter 2 sets out how in detail the bodies within the Bank of England will coordinate their activities, share information, and engage with the FCA. The chapter also sets out arrangement for cooperation between the Treasury and the Bank group when managing specific risks to stability and preparing for use of the special resolution regime.

Next steps

1.52 This introduction has summarised, against the key themes identified during the July consultation, the Government's developing proposals for reform of the UK financial regulation framework. However, as readers of the document will note, each chapter contains significant detail on how the legislative framework will be constructed in order to deliver the Government's priorities for the framework: judgement, focus and stability.

1.53 This policy update is only the next step in the process. As set out in Chapter 8, the Government will consult on the proposals contained in this document for eight weeks, before publishing a draft Bill in the spring. This draft Bill will then be subject to full, formal pre-legislative scrutiny. The Government will also respond to the TSC report in due course.

1.54 The Government recognises that the consultation period for this policy document is shorter than normal. This expedited process is necessary to enable formal pre-legislative scrutiny to be conducted, without significantly extending the timetable for reform. Pre-legislative scrutiny will, in any case, provide a significant additional opportunity for stakeholders to provide input into the development of the legislative framework.

1.55 To maximise the effectiveness of the shortened consultation period, the Treasury will conduct a proactive and engaged consultation, including through the use of focused round-table discussions and seminars. This will allow the Treasury to proactively seek the views of respondents in a structured way, and to engage in dialogue and discussion so that policy proposals continue to develop through the consultation period and beyond.

1.56 In this way, the Government will ensure that the momentum behind this crucial reform programme is maintained, while maximising the opportunities for industry, consumer groups, and other interested parties, to engage constructively with the process.

2 Bank of England and Financial Policy Committee

2.1 A fundamental objective of the Government's reforms is to place the Bank of England (the Bank) at the heart of the financial system, bringing responsibility for all aspects of financial stability together within the Bank group:

- the Financial Policy Committee (FPC), as a committee of the Bank's Court of Directors (its governing body), will be responsible for delivering systemic financial stability through macro-prudential regulation;
- the Prudential Regulation Authority (PRA), as an operationally independent subsidiary of the Bank, will be responsible for oversight of the safety and soundness of banks, insurers and other prudentially significant firms; and
- other parts of the Bank of England will be responsible for crisis management, including the resolution of failed or failing banks under the special resolution regime (SRR), and regulation of key financial infrastructure such as payment and settlement systems and central counterparties (CCPs). In addition, as part of its central bank responsibilities, it will continue to provide liquidity insurance to the financial sector and, where appropriate, emergency liquidity assistance (ELA).

2.2 This will allow a new judgement-led approach to financial stability, managed within a single institutional structure and building on the Bank's market knowledge and economic expertise. In this way, the Bank will be able to identify interdependencies between different aspects of financial stability and manage them effectively. In the 'tripartite' system, responsibility for financial stability is split between the Bank, the Financial Services Authority (FSA) and the Treasury; consequently, risks to financial stability fell between the gaps.

2.3 The Government is committed to closing these gaps in regulation and addressing the weaknesses of the tripartite system that were exposed during the financial crisis. In addition, the Government will continue to play a leading role in the international debate on strengthening the framework for financial regulation and ensure that the UK keeps in step with international developments in macro-prudential regulation. This will include making sure that the FPC's remit and powers dovetail with those of other systemic bodies such as the European Systemic Risk Board (ESRB) and that as far as possible, macro-prudential tools are agreed and implemented in a way that is broadly consistent internationally.

The Financial Policy Committee

Macro-prudential regulation and systemic risk

2.4 The financial crisis that begun in 2007, and the deep recession that followed it, highlighted major flaws in the existing approach to oversight of the financial system in the UK. In particular, insufficient attention was paid to identifying, monitoring and dealing with vulnerabilities and risks to the stability of the overall financial system. Instead, regulators focused on identifying problems within individual institutions while ignoring common exposures and interconnections between these businesses. During the crisis even financial institutions that appeared sound on a stand-alone basis became vulnerable once strains emerged in other parts of the system.

2.5 Macro-prudential policy seeks to augment the existing regulatory framework by focusing on systemic risk. Systemic risk can be broadly defined as risks to the stability of the whole or a large part of the financial sector. The purpose is to look beyond setting specific regulatory requirements aimed at ensuring the safety and soundness of individual firms, in order to identify desirable safety standards for the financial system as a whole. Macro-prudential regulation is an important addition to existing micro-prudential (or firm-specific) financial regulation. There are many sources of systemic risk, but recent experience and academic research has focused particularly on three aspects, set out below.

2.6 First, structural features of financial markets can make the overall system more vulnerable to adverse shocks. These include:

- **information problems**: a lack of transparency about the volatility of returns on particular securities or poor information about other institutions' balance sheets can lead to the build up of dangerous risk exposures. Notably, in the early stages of the recent financial crisis, little was known about the distribution of sub-prime mortgages and associated securities. Had this information been available, investors might have exercised greater caution in the years preceding the crisis. Also, once losses began to be realised, institutions might have shown greater differentiation in their interbank lending decisions, rather than withdrawing liquidity all at once for fears of counterparty exposures;

- **misaligned incentives**: individual agents will often make decisions, which while sensible and desirable from their own perspective, cause problems elsewhere and result in unfavourable aggregate outcomes. This was clear during the recent crisis, when falling asset prices triggered 'firesales' of distressed assets. This encouraged the widespread withdrawal of short-term money-market deposits, which in turn further weakened bank balance sheets and forced them to sell more of those securities whose values were rapidly declining. Problems with corporate governance and remuneration can also skew incentives. For example, remuneration arrangements in certain areas of banking have sometimes incentivised practices that, though profitable in the short term, do not take account of risk in the long term;

- **market illiquidity**: flaws in the rules around trading platforms or a lack of standardisation in some markets – such over the counter (OTC) derivatives – can discourage investment in these products, contributing to illiquidity during times of stress;

- **contagion**: vulnerabilities in one sector of the financial market can quickly spread into other sectors. In particular, financial innovation over recent years, such as the growth of securitisation markets and the rapid expansion in the use of credit default swaps to transfer risk have increased the complexity and scale of the network of interconnections between financial institutions;

- the existence of **systemically important financial institutions** (SIFIs), the failure of which, even in isolation, would put the system as a whole under strain (see Box 2.A); and

- **inadequate market infrastructure**: financial markets are critically dependent on safe, reliable and efficient payment, clearing and settlement systems, and on secure communication systems for transmitting information and instructions. Failure in any of these systems may lead to serious market disruption and can also amplify the effects of disturbances arising elsewhere.

Box 2.A: SIFIs and the Independent Commission on Banking.

Countries around the world were forced to intervene to support the financial system – including individual firms – as the crisis intensified. These interventions, while necessary to protect the wider economy, have reinforced the market perception that systemic financial institutions are too big to fail. G20 leaders agreed at Pittsburgh in 2009 that the risks presented by 'too-big-to-fail' banks, also known as SIFIs, required serious attention given the risk they pose to financial stability, and taxpayers and the extent to which they undermine market efficiency.

The Financial Stability Board (FSB) was tasked by G20 leaders to develop an internationally consistent SIFI policy framework. The FSB report on SIFIs, which included a work plan for 2011, was endorsed by G20 Leaders at Seoul. The report highlights the need to improve resolution regimes, for SIFIs to have loss-absorbing capacity above that held by non-SIFI banks, for more intensive supervision, improved market infrastructure and for peer review by the FSB. A minimum level of international consistency in measures to address the SIFI problem will be essential if a level playing field is to be maintained.

In the UK, the Independent Commission on Banking, chaired by Sir John Vickers, has been established to look at the structure of banking in the UK and consider how to promote financial stability and competition in the industry. The Commission is due to report to the Government by the end of September 2011.

2.7 Second, the distribution of risk exposures within the financial sector can create systemic risks. A large number of financial institutions might be holding the same mispriced securities (for example, those backed by sub-prime mortgages) or may be engaged in potentially risky activities (such as international carry trades). Similarly, one or several large inter-connected firms might be exposed to risks that, should they materialise, would have serious negative consequences for a much wider range of other institutions. As the recent crisis shows, significant asset-liability mismatches or unsustainable funding positions can also create severe system-wide strains.

2.8 Third, there are important cyclical risks. Financial markets can have a pro-cyclical effect by increasing the amplitude of the wider economic cycle in a number of ways, for example:

- cycles of risk appetite and credit: investors can often underestimate risks when in reality they are increasing; and then become excessively pessimistic when such risks materialise. This is particularly the case when market-based measures of risks are used, which are overly dependent on prevailing market conditions (such as stock-market price-earnings ratios and private sector credit spreads). Banks are more likely to authorise lending during periods of strong economic growth and low defaults, which can act to stimulate unsustainable growth. But if growth subsequently slows, these patterns can reverse abruptly and lenders can become overly cautious about future returns, prompting them to cut back lending sharply. Indeed, credit cycles seem to be closely linked to periods of financial instability; and

- collateral effects: rising asset prices increase the value of lenders' collateral, facilitating further borrowing. If asset prices subsequently decline, balance sheets can deteriorate rapidly.

The FPC's proposed objective

2.9 The FPC's overall objective, as a committee of the Bank's Court of Directors, will be to contribute to the achievement by the Bank of its objective to protect and enhance financial stability.

2.10 As set out previously, the FPC will primarily contribute to the Bank's overarching financial stability objective by focusing on a specific aspect of financial stability – namely, systemic stability (rather than, for example, the stability of individual firms, or the resolution of failing firms, which are the responsibility of other parts of the Bank group). To achieve this, it will develop and implement macro-prudential regulation to address the systemic risks it identifies and so protect and enhance the resilience of the financial system in order to enable it to better withstand system-wide stress and shocks.

2.11 Box 2.B summarises the Bank's financial stability objective and the FPC's objective.

Box 2.B: Summary of proposals for the Bank's and FPC's objectives

The Bank of England's existing financial stability objective will be amended to read:

1. *An objective of the Bank shall be to protect and enhance the stability of the financial system of the United Kingdom (the "Financial Stability Objective").*
2. *In pursuing the Financial Stability Objective the Bank shall aim to work with other relevant bodies (including the Treasury, the Prudential Regulation Authority and the Financial Conduct Authority).*

The FPC's objective is designed to link to the Bank's objective as follows:

1. *The Financial Policy Committee is to exercise its functions with a view to contributing to the achievement by the Bank of the Financial Stability Objective.*
2. *The responsibility of the Committee in relation to the achievement of that objective relates primarily to the identification of, monitoring of, and taking of action to remove or reduce, systemic risks with a view to protecting and enhancing the resilience of the UK financial system.*
3. *These systemic risks include, in particular –*
   a. *systemic risks attributable to structural features of financial markets or to the distribution of risk within the financial sector, and*
   b. *unsustainable levels of leverage, debt or credit growth.*
4. *This does not require or authorise the Committee to exercise its functions in a way that would in its opinion be likely to have a significant adverse effect on the capacity of the financial sector to contribute to the growth of the UK economy in the medium or long term.*
5. *"Systemic risk" means a risk to the stability of the UK financial system as a whole or to a significant part of that system.*

2.12 As set out above, there are many different sources of systemic risk which the FPC will be required to address:

- risks related to structural aspects of the financial system or to the distribution of risk within it. This might mean, for example, looking at the financial infrastructure and the way firms interact within it to ensure that its configuration is not an inherent source of systemic risk; and
- risks related to the economic cycle, such as unsustainable levels of key indicators such as credit growth, debt and financial sector leverage. This could involve the FPC leaning against the pro-cyclical effect of the financial system (its tendency to magnify the fluctuations of the economic cycle, fuelling booms and exacerbating busts). This might mean, for example, ensuring that firms' capital base is large

enough to withstand losses in the event of a downturn, or taking action to tackle general credit exuberance, or unsustainably loose credit conditions in a particular sector.

2.13 The FPC will not be responsible for delivering any particular level of leverage, debt or credit growth. Rather its role will be to try to ensure that whatever the level of each indicator might be, it is not a threat to the resilience of the financial system. What the FPC considers a sustainable level will naturally vary depending on the prevailing circumstances, for example the position in the economic cycle, and the overall resilience of the financial sector.

Other factors for the FPC to take into account

2.14 As highlighted in the July 2010 consultation, the Government is aware that decisions taken by the FPC could have far-reaching effects on the financial sector and the economy more widely. For example, while improving the resilience of the financial sector, the use of certain macro-prudential tools is also likely to affect the levels of lending to businesses and families and the competitiveness and profitability of UK banks.

2.15 Most respondents to the July consultation emphasised the importance of supplementing the FPC's financial stability objective with secondary factors, in order to ensure that the FPC takes into account the wider impact its actions may have. The Government agrees with this view, although it will be important to ensure that these secondary factors are genuinely relevant to the unique nature of the FPC's work, and that they do not unduly constrain the ability of the FPC to take effective action to address the systemic risks that it identifies.

2.16 In particular, many respondents suggested economic growth as a potential secondary factor for the FPC to consider. The Treasury Select Committee (TSC) also highlights in its report that enhancing financial stability might at some stage involve trade-offs with certain other policy objectives, such as economic growth. This is a question of balance: on one side, costs imposed by very intrusive regulation may restrict the ability of the financial sector as a whole to support economic growth (i.e. through providing credit and maturity transformation); on the other, an under-regulated, unstable financial sector can have devastating effects on the economy by fuelling unsustainable bubbles and causing disorderly firm failure. It is clear that over the long-term financial stability and sustainable economic growth are complementary and not contradictory; financial stability is an essential pre-condition of sustainable economic growth and improved stability as a result of the FPC's actions should secure the foundations of sustainable economic growth over the medium and long-term.

2.17 In considering how best to capture in legislation the balance the FPC needs to strike between making the financial system safer overall without compromising sustainable economic growth in the long term, the Government has looked closely at comparable policy remits. For example, the remit set by the Government for the Monetary Policy Committee (MPC) is a symmetrical one; the target is 2%, but the Governor's requirement to write to the Chancellor is triggered if inflation goes too far above or below that target. This reflects the fact that deflation can be just as damaging to the economy as high inflation.

2.18 The legislative mandate of the ESRB serves as a useful precedent, setting out that it "shall be responsible for the macro-prudential oversight of the financial system within the Union in order to contribute to the prevention or mitigation of systemic risks ... so as to avoid periods of widespread financial distress. It shall contribute to the smooth functioning of the internal market and thereby ensure a sustainable contribution of the financial sector to economic growth".[1]

[1] REGULATION (EU) No 1092/2010 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board, 24 November 2010

2.19 In a similar way, the Government proposes to build the balance between financial stability and sustainable economic growth into the FPC's main objective, as set out in Box 2.B.

2.20 Respondents to the previous consultation suggested a series of other secondary factors that the FPC could take into account, which the Government has considered carefully. Some of the factors put forward (such as innovation, competition and consumer protection) are more relevant to the work of a line regulator, and are not appropriate for a high-level policy committee such as the FPC. The Government proposes to legislate to require the FPC to have regard to a small number of specific factors: proportionality, openness and international law, as described below:

- proportionality: captures the need for the FPC to consider the proportionality of the likely benefits of its actions compared to the costs they would impose and is expected to be worded in a similar way to the proportionality principle being applied to the PRA and Financial Conduct Authority (FCA). This would not require the FPC to produce a formal cost-benefit analysis, but would require it to consider the proportionality of the cost of its actions against the magnitude of the risk that would be addressed;

- openness: aims to underline the importance of transparency in the work of the FPC. As set out in more detail below, public pronouncements and publications (including in the twice-annual Financial Stability Report , or FSR) will be one of the main levers available to the FPC to influence market behaviour and opinions more widely. Of course, the appropriate level of openness will be a matter of judgement for the FPC; disclosure is not always desirable and premature or untimely public pronouncements about some risks may endanger stability;

- international law: is intended to ensure that the FPC, when recommending or directing action to other bodies, takes into account whether there are any international law constraints (especially constraints deriving from EU law) that may prevent those bodies from implementing the action the FPC is advocating.

2.21 In the July consultation document, the Government proposed that the FPC might be required to have regard to the statutory objectives of the PRA and FCA. Having considered this matter further, the Government believes that this aim can be achieved in a more focused way by requiring the FPC, as far as possible while acting to further financial stability, to avoid exercising its functions in a way that would impede the PRA's or FCA's pursuit of their own objectives.

2.22 The Government believes that it is important to provide political authority for the FPC to operate by setting out its objectives clearly in primary legislation, building in the interaction with sustainable economic growth, and creating robust transparency mechanisms to ensure that the FPC can be held to account for its performance, including by the TSC. The Government notes the TSC's suggestion that the Government might publish a remit letter, as it does for the MPC. However, as the TSC acknowledges, financial stability is difficult to define quantitatively or precisely, and is subject to complex trade-offs. The Government nevertheless agrees that the general concept of a remit could be usefully applied, and believes that the Treasury should 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.

2.23 Therefore the Government will legislate to give the Treasury a discretionary power to provide the FPC with guidance in the form of a remit. This will provide an opportunity for the Chancellor to write to the FPC to provide greater clarity on the overall approach the FPC should take in pursuit of its objectives. The FPC will be required to respond to the remit, setting how it has taken the Government's views into account. Both the remit and the reply will be published and laid before Parliament, subject to a public interest test.

Functions

2.24 The Government will legislate so that the main functions of the FPC will be to:

- monitor the stability and resilience of the UK financial system with a view to identifying and assessing systemic risks; and
- use the levers and tools at its disposal to address those risks.

2.25 Once it has identified and evaluated a systemic risk, the FPC will need to decide what action would be most appropriate and effective to address it. To this end, the FPC will have at its disposal a number of different levers, which are set out below. Each lever has its own different characteristics, and each will be more suitable for some circumstances than others. They include:

- public pronouncements and warnings;
- influencing macro-prudential policy in Europe and internationally;
- making recommendations to bodies other than the PRA and FCA; and
- powers over the PRA and FCA: to make recommendations (backed up by a comply-or-explain mechanism), and to direct the regulators where explicitly provided for by macro-prudential tools designed in secondary legislation.

2.26 The levers need not be used in any particular order. For example, in some cases the FPC may choose to start with a public warning in order to encourage the market to take action to address the issue by itself. If this fails to produce the desired outcome, the FPC could instead recommend action to the PRA or FCA to address the problem. In other cases, the FPC may use a direction-making power straight away, for example to adjust a counter-cyclical buffer upwards or downwards or to require firms to disclose certain information. Discussions within the FPC may lead the PRA or FCA to take action independently to address a risk identified by the FPC, without the need for the FPC to issue a formal recommendation.

2.27 More than one lever may be used at the same time to tackle the same systemic risk. For example, if the FPC identifies an emerging trend that could threaten stability it may highlight the risk in its FSR to discourage it domestically, while encouraging that action be taken at the international level to address the risk identified.

2.28 The regulation and supervision of individual firms will remain the responsibility of the relevant regulators: the PRA, FCA and, for financial infrastructure, other parts of the Bank of England. While it is clear that to some extent those organisations that form part of the Bank group will share common leadership and direction, operational decisions will be taken separately. In order to ensure clarity of responsibilities, the Government intends to legislate to exclude individual regulated firms from the FPC's powers. For example, the FPC will not be able to give formal advice to other parts of the Bank on the provision of liquidity to an individual firm, e.g. ELA or the Bank's use of its SRR tools to resolve a failing bank. The legislation will also ensure that directions and recommendations from the FPC to the PRA and FCA cannot be directed specifically at an individual firm.

2.29 In reality, however, the concentrated nature of the UK financial services sector means that the behaviour of a small number of large institutions – perhaps only one or two – could pose a systemic risk. In these cases, the FPC's macro-prudential interventions may be aimed at a very small number of firms that manifest a particular risk. The FPC will need to be aware of the potential for its activities to overlap with the regulators' own responsibilities for supervising individual firms and must take care to ensure that firm-specific decisions (as opposed to measures designed to preserve stability more generally) continue to be taken by the line regulator.

Public pronouncements and warnings

2.30 Public pronouncements can be used to raise awareness of issues, facilitate market-led solutions, or influence domestic and international opinions. For example the FPC may choose to issue a public warning that it has identified a potential mispricing of risk in relation to a certain asset type, or publicise a concerning trend in financial services. The FPC's twice-yearly FSR and its published meeting records are likely to be important ways of raising any concerns, though other forms of communication, notably public speeches, might also be important.

Influencing macro-prudential policy in Europe and internationally

2.31 Clearly, not all systemic risk can – or indeed should – be addressed on a domestic basis only. As discussed in Chapter 7, financial services and markets are truly global and their regulation is increasingly international in nature. Even if a systemic risk could be identified and resolved nationally, in order to be completely effective that solution might also need to be applied in other jurisdictions where the same risk or weakness was present. The TSC highlighted in their recent report that effective participation in international regulation will be a central part of macro-prudential policy. The Government is clear that an important part of the FPC's work will be engaging with the EU and other international forums, whether by contributing its analysis and opinions via the Bank of England's membership of key bodies such as the ESRB, the Basel Committee on Banking Supervision (BCBS) and the Committee on the Global Financial System (CGFS) in the Bank of International Settlements (BIS), or through advising the Government and others (such as the PRA and FCA in the European Supervisory Authorities) on how best to communicate these issues when they represent the UK in international discussions. This will be particularly important where a risk can only be addressed through changes agreed internationally, such as international accounting standards.

Making recommendations on action to be taken

2.32 The FPC, as a policy committee rather than a regulator, will not be supervising financial firms or markets directly. Any regulatory interventions to address systemic risk will need to be implemented by other bodies: primarily the two financial services regulators – the PRA and FCA – but also the Treasury, other parts of the Bank of England itself and other entities which undertake regulatory functions such as the Financial Reporting Council (FRC). The FPC's power to recommend action to the PRA and FCA is set out separately below.

2.33 The Government proposes to legislate to give the FPC a broad power to give advice on financial stability. This power could be used to make recommendations directly to the financial sector, to other domestic bodies such as the FRC or to relevant international and European institutions.

2.34 Within this general power, the legislation will specify particular examples where the FPC can make recommendations in relation to specific relevant functions. These are:

- a power to make recommendations to the Treasury on:
    - the Treasury's responsibility for establishing both the overall regulatory perimeter – which activities are regulated and which are not – and the dividing line between the PRA and FCA. The TSC particularly noted the importance of the FPC's role in monitoring the perimeter; and
    - the Treasury's role in determining the scope of the FPC's direction-making power by establishing the FPC's toolkit in secondary legislation (as described below);
- a power to give recommendations to other parts of the Bank of England on:

- the potential financial stability impact of the Bank's decisions on the provision of liquidity to the financial sector as a whole (but not the provision of liquidity to individual firms); and
- the Bank's role in regulating vital financial sector infrastructure such as payment and settlement systems and CCPs.

2.35 The scope of recommendations will be very broad, covering anything the FPC considers necessary for financial stability. The FPC's recommendations will be made public in its meeting records, creating a powerful incentive for recipients to act on the FPC's advice.

Powers over the PRA and FCA: power to recommend and power to direct

2.36 The primary route by which the FPC can take action to address systemic risks is via the regulatory levers of the PRA and FCA.

2.37 The Government intends to legislate to provide the FPC with two main powers over the PRA and FCA:

- a broad power of recommendation, which will be backed up by a statutory requirement for the PRA and FCA to either comply with the recommendation as soon as practicable, or explain in writing to the FPC why it has not done so; and
- a power of direction, which will allow the FPC to require the PRA or FCA to implement certain macro-prudential tools.

2.38 The FPC will have the flexibility to make recommendations about anything it believes relevant for financial stability, whereas the scope of the direction-making power will be narrowly defined around specific tools. The PRA and FCA will have no choice over whether to implement a direction, whereas they could decide not to comply with a recommendation, although they would need to explain their reasons for doing so.

2.39 The Government's intention is that in principle either of these powers should be able to be used to address any of the different types of systemic risk set out at the beginning of this chapter – structural risks, risks caused by the distribution of exposures and risks associated with the economic cycle.

2.40 In practice, however, the nature of the different types of risk may mean that some systemic risks may lend themselves more to being tackled by a certain type of lever. Structural risks, for example, tend to arise from the way that markets structure themselves and operate, and it is very difficult to predict in advance where these structural vulnerabilities may emerge. Therefore, it is possible that this type of risk may be most effectively addressed via the use of the FPC's power to make recommendations to the PRA or FCA, where it is not necessary for a specific tool to be designed in advance.

2.41 Still, the list of potential tools set out below currently includes tools that are designed to address all three types of systemic risks, including structural risks. And in many cases, macro-prudential interventions will have multiple effects – for example the Basel committee made clear that it expects the main purpose of the counter-cyclical buffer to be to improve resilience, with an additional counter-cyclical effect.

Recommendations

2.42 The nature and content of the FPC's recommendations will depend on prevailing circumstances and therefore cannot easily be anticipated in advance. Therefore, the FPC's power to recommend needs to be broadly defined to allow it to recommend any action it believes necessary to protect or enhance financial stability.

2.43 During the financial crisis that began in 2007, regulators and supervisors underestimated risks that were building up across individual financial firms and markets. These risks were sometimes greater than the sum of their parts due to interconnectedness between firms. In future, the FPC may need to act to tackle such vulnerabilities as they arise in order to improve the resilience of the financial system. The FPC could, for example:

- recommend that firms disclose certain information or information in a specified form – for example, asking firms to disclose that they hold certain instruments;
- recommend that certain types of business be consolidated on to balance sheets. For example, prior to the financial crisis, firms removed certain types of exposures from their balance sheet without actually transferring the risk. The FPC could recommend that firms present such information in their financial accounts;
- recommend action to avoid eroding the regulatory perimeter in ways that are damaging to financial stability. For example, prior to the financial crisis, the calibration of certain bank capital requirements incentivised banks to set up off-balance sheet vehicles which were nominally outside the perimeter of regulation but in fact relied on banks for funding when they experienced liquidity runs;
- insofar as this can be determined domestically, recommend that certain classes of financial contract be traded or settled through central market infrastructure in order to underpin liquidity or to avoid excessive direct exposures building up between financial institutions; or
- within the framework expected to be agreed internationally for regulatory requirements for SIFIs (see Box 2.A), the FPC may wish to recommend that the PRA take a particular approach to the regulation of these firms.

Direction-making powers

2.44 As set out in the July consultation, the Government will provide the FPC with the control of specific macro-prudential tools. These will be specific macro-prudential interventions that are defined and designed in advance by the Treasury. In line with the TSC's recent recommendation, the secondary legislation that establishes the toolkit will need to be approved by both Houses of Parliament. The FPC will be able to direct the appropriate regulator (PRA or FCA) to implement these in pursuit of any aspect of its objective to improve the financial system's resilience – whether by addressing systemic risks relating to the structure of the system and how institutions interact or mitigating the system's cyclicality by addressing imbalances such as unsustainable levels of leverage, debt and credit growth.

2.45 The Government recognises that a power of direction is a significant intervention, and it is vital that the macro-prudential tools be carefully chosen and designed to make sure that they are effective, but also to minimise the risk of unintended consequences, such as the FPC encroaching on decisions that are rightly for the regulators. The Government therefore believes that in order to be considered appropriate for inclusion in the FPC's toolkit, a potential tool should be:

- **specific**: in other words, the power should only extend to regulatory aspects that are clearly delineated. Ill-defined powers in relation to broad and open-ended areas clearly risk encroaching on the regulators' remit;
- **subject to sufficient national discretion**: this means that a direction-making power should not be created where there is little or no scope for changes to be made domestically. An example of this would be accounting standards for companies admitted to trading on a regulated market, which are determined internationally by

the International Accounting Standards Board (IASB) and adopted at EU level for application in Europe;

- **focused on system-wide rather than firm-specific characteristics**: this is in order to prevent the FPC being able to overrule the regulator's decisions on micro-prudential supervision of firms. For example, a direction-making power for the FPC to set the capital levels of individual firms would be inappropriate because this is the responsibility of the regulators, not the FPC.

Potential macro-prudential tools

2.46 A number of potential tools are being considered and developed in international forums, such as the BCBS, CGFS, the EU (via proposed changes to the Capital Requirements Directive), and the International Monetary Fund. The Government believes that macro-prudential measures are likely to prove more effective if the broad framework for their use is designed and adopted at the international level, and the UK authorities will continue to participate actively in ongoing international work on macro-prudential policy with the aim of achieving international consistency and a level playing field.

2.47 As these tools start to take shape, it will be important for the UK authorities to continue to make the case for the right balance between EU coordination and national discretion in EU macro-prudential policy in order to ensure that the UK remains able to exercise discretion in its domestic operation of the macro-prudential framework.

2.48 The list below sets out a series of interventions that have been suggested as possible macro-prudential tools. Some have been considered in some depth at an international level, whereas some have been suggested more recently and are much less developed. Some have been trialled elsewhere in the world, whereas others have never been used. All of the potential macro-prudential instruments described below will need to be carefully considered to determine their likely impact and effectiveness, as well as their potential costs. The majority remain untested, and whatever the final composition of the FPC's toolkit, periods of adjustment will inevitably occur as more evidence becomes available. The interim FPC, established in February 2011 as described below, will play a key role in the development of the permanent body's toolkit by sharing its analysis and advice on macro-prudential instruments with the Treasury, to help inform the Government's proposals for the FPC's final macro-prudential toolkit.

2.49 Establishing the toolkit in secondary legislation will allow the Government to better reflect any international developments in macro-prudential policy, as well as adapt the toolkit once more evidence is available on the effectiveness of individual tools. It will be vital that the FPC set out clearly how it intends to use the tools and its rationale for their use and provide an ongoing assessment of how it believes they are working.

2.50 As set out in more detail below, the Treasury may require the FPC to publish a policy statement in advance, setting out how it plans to employ the tool and the circumstances in which it might be used. In addition, the FPC's twice-yearly FSR will need to include the FPC's assessment of the effectiveness of its actions, although the long-term nature of macro-prudential regulation means that it may be several years before the precise impact of certain interventions are fully understood.

Capital requirements

Counter-cyclical capital buffer

2.51 The final Basel III reforms (see Box 2.C), aimed at strengthening the resilience of the banking system, introduce a new counter-cyclical capital buffer which "aims to ensure that banking-sector capital requirements take account of the macro-financial environment in which banks operate. It will be deployed by national jurisdictions when excess aggregate credit growth is judged to be associated with a build-up of system-wide risk to ensure the banking system has a buffer of capital to protect it against future potential losses."[2] During a downturn, these buffers would be withdrawn, enabling banks to reduce their capital ratios.

2.52 This instrument should also have a damping effect on the credit cycle. Higher capital requirements during a boom should increase the cost of capital for the banking sector and discourage lending. Conversely, if the buffer can be effectively relaxed during a downturn, it might mitigate contractions in lending supply. Basel III promotes a level playing field between domestic and foreign banks through the principle of reciprocity, under which the size of the counter-cyclical capital buffer is linked to the geographical location of all exposures. Under Basel, reciprocity is obligatory for a buffer of up to 2.5 per cent. However, national authorities have the option of requiring their banks with exposures in a foreign jurisdiction to apply a buffer of beyond 2.5 per cent.

Variable risk weights

2.53 While an aggregate capital buffer would apply in the same way to all banks, another potential instrument for addressing systemic risk could be to target capital requirements more specifically on certain sectors or asset classes. One way this could be done is by introducing minimum regulatory 'risk weights' and varying them over time, requiring banks to hold additional levels of capital against asset exposures representing a systemic risk. This would increase the cost of these exposures, and encourage financial institutions to acquire different assets. This instrument might enable a macro-prudential regulator to better target sources of systemic risk, compared to aggregate capital requirements which could encourage banks to converge towards riskier types of lending to maximise their returns. Of course, successfully reducing systemic risk by varying capital requirements requires the source of risks to be correctly identified, and is an information-intensive process.

Leverage limits

2.54 One of the underlying features of the recent financial crisis was the build-up of excessive on- and off-balance sheet leverage in the banking system. In many cases, banks built up excessive leverage while still showing strong risk-weighted capital ratios, due in part to the incorrect risk-weights attached to certain assets such as securitisations. Basel III has therefore introduced a leverage ratio, which is based on Tier 1 capital as a ratio of total adjusted assets. As measures of risk (whether those of the market, the regulator, or the banks' themselves) can be unreliable, a leverage ratio could act as a backstop to risk-weighted requirements (such as a counter-cyclical buffers, or variable capital risk weights).

[2] *Basel III: A global regulatory framework for more resilient banks and banking systems*, Basel Committee on Banking Supervision, December 2010

Box 2.C: Basel III – strengthening international capital and liquidity standards

In December 2010 the Basel committee published the details of a package of reforms known as Basel III. The G20 has fully endorsed the Basel III package and has committed to "implement fully the new bank capital and liquidity standards".[3]

Basel III will significantly strengthen the resilience of the banking system by:

- improving the quality of capital that banks are required to hold, with a focus on loss-absorbing shareholder equity;
- significantly increasing capital requirements, from 2% common equity to a total of 7%, split between a minimum of 4.5% plus a 2.5% capital conservation buffer. Banks will be subject to restrictions on their ability to distribute capital through dividends and bonuses if they fall below the buffer level;
- implementing, on top of this, a counter-cyclical buffer of up to 2.5% equity capital (although in some circumstances national authorities may go above 2.5%) according to national circumstances, with buffers building in times of rapid credit growth to lean against excessive risk taking;
- subjecting banks to non-equity (Tier 1 and Tier 2) capital requirements;
- introducing into the Basel framework, for the first time, a leverage ratio to act as a backstop to risk weighted capital requirements. Moreover, it has been agreed that from 2018 the leverage ratio will be a hard constraint (rather than a supervisory indicator); and
- introducing internationally agreed liquidity requirements, including a stressed liquidity coverage ratio (requiring banks to hold a buffer of liquid assets) and a longer-term net stable funding ratio (designed to incentivise banks to fund their activities through stable sources).

Implementation of the reforms will begin on 1 January 2013 with the majority of the elements of the package phased in by January 2018. Basel III will be implemented into EU law by the Capital Requirements Directive IV.

Liquidity tools

2.55 The Basel III agreement also includes measures to address funding mismatches and vulnerability to liquidity shocks, both of which played a part in the recent financial crisis. The first of these is the Liquidity Coverage Ratio (LCR), which would ensure that institutions' stock of high quality liquid assets covers their net cash outflows over a 30 day period, even under extreme economic scenarios used in stress tests.

2.56 Basel III's second proposal is the Net Stable Funding Ratio (NSFR), which is designed to promote stable funding over a longer period. It is based on the liquidity of banks' assets and liabilities over a one year period, subject to an adverse economic shock.

2.57 These instruments, implemented under Basel III, could enhance the resilience of the overall system. In addition, a new macro-prudential element – such as a liquidity buffer, similar to the counter-cyclical capital buffer described earlier – could be incorporated, to enable the FPC to alter LCR and NSFR requirements according to its assessment of systemic risk. This would mean that at times, financial institutions would need to hold a greater fraction of their portfolios in

[3] The G20 Seoul Summit Leaders' Declaration, 11-12 November 2010, available from www.g20.org/Documents2010/11/seoulsummit_declaration.pdf

low-yielding liquid assets, which in turn could reduce their ability to lend, damping the cycle. However, as with many of the instruments set out here, further analysis is needed to achieve greater clarity on their potential effects.

Forward-looking loss provisions

2.58 This tool would ensure that financial institutions set aside provisions against prospective future losses on their lending. International discussions have focused on two particular variations: 'expected loss' provisioning, and 'dynamic' provisioning.

2.59 The IASB published a proposal on expected loss provisioning, as part of a series of changes to financial instrument accounting in *IFRS9 – Financial instruments*.[4] These revisions are being completed in phases, the first of which, on classification and measurement, was published in November 2009. Under this proposal, provisions reflect the expected future credit losses a bank expects to make on the assets on its balance sheet, taking into account both the specific characteristics of those assets (including their remaining life), and the banks' views of how the broader economic environment is likely to develop during the lifetime of those assets.

2.60 Another model – 'dynamic' provisioning – takes a longer-term 'through-the-cycle' view, and includes provision for assets that are not yet on the balance sheet. Under this proposal, provisions are made against assets using historical average loss rates on similar types of assets over a period including at least one full economic cycle. As this does not take into account the remaining life of assets on the balance sheet, this implicitly assumes that current assets will be replaced by similar assets as they roll off.

2.61 While this approach may provide a larger counter-cyclical buffer in some circumstances, it is not necessarily compatible with current international financial reporting standards, and its implementation may therefore require supervisory intervention.

Collateral requirements

2.62 This type of tool would limit specific types of lending by imposing higher collateral restrictions during times of unsustainable growth in that lending. Examples include loan-to-value (LTV) restrictions on secured lending, 'haircuts' on repurchase agreements and margin requirements on equities.

Loan-to-value requirements

2.63 During periods of buoyancy in the housing market, rising property prices can facilitate additional borrowing and competitive pressures can encourage increases in LTV ratios on new mortgages. If commercial or residential property prices subsequently decline, balance sheets can become stretched and defaults can increase. Some jurisdictions such as Hong Kong have used maximum LTV ratios in an effort to discourage unsustainable mortgage lending and improve the resilience of their banking sectors.[5] However, enforcing LTV limits in relation to commercial real estate could be undermined by cross-border lending.

2.64 There might also be alternative means of achieving the same effect on the property market – for example, by varying risk weights on certain types of mortgage lending (and so the amount of capital banks must hold against their mortgage lending). Alternatively, loan-to-income limits could also be considered.

[4] Available at www.ifrs.org

[5] Report submitted by the Committee on the Global Financial System, *Macroprudential instruments and frameworks: a stocktaking of issues and experiences.* May 2010.

‘Haircuts’ on repurchase agreements

2.65 Repurchase agreements (or ‘repos’)are the primary source of funding for investment banks and the critical determinant of leverage within collateralised borrowing transactions. In a repo, cash is lent at a pre-agreed interest rate against securities that are transferred to the lender for the duration of the transaction. The cash lender applies a ‘haircut’ to the value of the securities which it receives so that the actual market value of the securities is greater than the amount of cash lent. This is known as 'initial margin' and protects the cash lender against default risk. During the lifetime of the transaction if the market value of the securities falls, the cash borrower will have to post further ' variation margin'

2.66 During financial crises, a vicious cycle can emerge, where higher margins and haircuts force de-leveraging and more asset sales, which further increase margin requirements. During boom times, this process reverses, encouraging rapid increases in leverage. Some, including a recent BIS Study Group for the CGFS,[6] have proposed regulators setting haircuts so that they are higher and more stable through the cycle and including a ‘counter-cyclical add-on’, which could be used to make discretionary changes.

2.67 Haircuts could potentially be applied to other areas, such as OTC derivatives.

Margin requirements on equities or other instruments

2.68 Regulators have used margin requirements in the past (notably after the 1930s crash in the US) in an attempt to damp speculative stock purchases. These stipulated the minimum amount of funds investors had to put up to purchase stocks on credit. Historical evidence suggests collateral restrictions on equities are unlikely to be effective because they can be easily circumvented, for example through the use of derivatives. Moreover, damping equity price cycles is likely to be less effective than targeting house prices or commercial real estate prices, which tend to have a more profound impact on the wider economy.

Information disclosure

2.69 The recent financial crisis showed that inadequate public disclosures about financial institutions’ risk exposures can contribute to the freezing of key markets in times of stress. Greater transparency enhances market discipline, facilitates better risk management and contributes to the maintenance of market liquidity in distressed conditions. The FPC will have a role in strengthening the structure of financial markets and improving their resilience – one way they could do this is by identifying information problems and directing the regulators to require firms to disclose certain information, where it feels this would be beneficial for reducing systemic risks.

Stress tests

2.70 While not strictly a tool, the ability to require the PRA (and, if relevant, the FCA) to undertake systemic stress tests might provide a useful way for the FPC to identify and assess systemic risks. The FPC could, of course, conduct its own stress tests, but in some cases it may be more efficient for the PRA to conduct stress tests required by the FPC alongside those it undertakes for its own prudential purposes. Stress tests seek to establish the resilience of the financial system, or important sub-sectors, to plausible but severe adverse developments. These developments range from shocks to individual risk factors, such as exchange rates, interest rates and asset prices, to more complete scenarios, which combine both macroeconomic and financial factors. Typically, such stress tests do not assess the probability of a given adverse

[6] *The role of margin requirements and haircuts in procyclicality*, CGFS, March 2010.

development materialising, but rather the costs of its materialisation. This could then be used to raise awareness of systemic risks, as well as inform FPC policy and advice.

Ad-hoc tools created for specific circumstances

2.71 The Government's expectation is that the FPC will work closely together with the PRA and FCA to ensure that any action the FPC proposes to tackle systemic risks is effective and can be easily implemented. Nevertheless, the possibility still exists that the PRA or FCA could refuse to comply with recommendations from the FPC. Where the FPC does not have a pre-existing tool to direct the PRA and FCA to take the necessary action, this creates the potential for a situation where the FPC is frustrated in its efforts to address a particular systemic risk.

2.72 The refusal of the PRA or FCA could be justified: for example, if the PRA or FCA does not have the legal power to carry out the action proposed, or if the regulator believes that the action would have significant unintended consequences. In these cases the FPC and the regulator concerned should work together to resolve the situation, perhaps by agreeing an alternative course of action to address the risk.

2.73 However, if the Treasury agrees with the FPC that the action needs to be taken in order to protect financial stability and that the reasons given by the PRA or FCA for not complying are insufficient, the Treasury can amend the FPC's toolkit to add a new tool which is specially designed to allow the FPC to direct the PRA or FCA to take action in this area. Once used, the tool could either be removed or retained. As with all of the FPC's direction-based tools, these could not be used to make a firm-specific intervention or override the PRA or FCA on the supervision of specific individual firms.

2.74 Of course, this may need to happen very quickly. Therefore the Government will legislate to ensure that, in urgent cases, the Treasury can amend the secondary legislation containing the FPC's toolkit immediately, with approval by Parliament required in the following 28 days.

2.75 In practice, the Government believes that this mechanism will rarely – if ever – need to be used, and that in the normal course of business, the FPC, the PRA and the FCA will work together to avoid and resolve any potential disagreements.

Box 2.D: Consultation questions

1. What are your views on the likely effectiveness and impact of these instruments as macro-prudential tools?
2. Are there any other potential macro-prudential tools which you believe the interim FPC and the Government should consider?

Membership and governance

2.76 The Government will legislate to establish the FPC as a committee of the Bank of England's Court of Directors, with a total membership of 12, 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.

2.77 The FPC 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. Two Bank executives, responsible for financial stability and markets analysis respectively, will also sit on the FPC.

2.78 The Chief Executive of the FCA will 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. As the TSC rightly points out, these non-Bank members will play a vital role in ensuring that a diverse range of experience and views contribute to the development of macro-prudential policy and it will be essential to ensure that these members have the necessary knowledge, experience and expertise to play this role fully. In particular, it will be important to ensure external members are able to offer insights from direct experience as financial market practitioners – not only in banking, but also other sectors such as insurance and investment banking. At the same time, given the sensitivity of the FPC's discussions and decisions, the external members should not have any significant conflicts of interest, as this would prevent them from fully participating in the work of the Committee.

2.79 The balance currently proposed within the FPC – six Bank members and five members from outside of the Bank (including the CPMA representative) is similar to that of the MPC, where the ratio is five to four. The Government notes the TSC's comments in relation to the balance of membership within the FPC, and will consider this further.

2.80 The legislation will require the FPC to meet at least four times a year and at least seven members (including at least two of the Governor or Deputy Governors of the Bank and at least one external member) must be present for the committee to take decisions. The FPC will take decisions by consensus where possible; otherwise a vote will be taken, with the Chair having a second casting vote.

Transparency and accountability

2.81 As set out in the July consultation document, the Government is committed to creating an open, accountable and effective FPC. The Government will therefore legislate to require the FPC to publish records of its meetings and a twice-yearly FSR. In addition to providing information to the market, the industry and the public about the FPC's activities, these publications should serve to inform any direct scrutiny of the FPC that the TSC chooses to undertake. The Government warmly welcomes the TSC's intention to take a close interest in the FPC and to hold regular hearings.

Financial Stability Reports

2.82 The Government will legislate to require the FPC to publish a Financial Stability Report twice a year. The legislation will set out that these reports will cover:

- the FPC's assessment of the outlook for the stability and resilience of the financial sector at the time of the preparation of the report. This will include the FPC's assessment of developments in the strengths and weaknesses of the UK financial system and a summary and description of the systemic risks and vulnerabilities it has identified, including an assessment of their severity; and
- a description of the FPC's activities in the period since its previous report and an assessment of their effectiveness.

2.83 As set out in the previous consultation, once the FPC has completed and agreed its reports, it will send them to the Treasury, which will, in turn, lay copies before Parliament.

Meeting records

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

2.85 The record will set out the decisions the FPC has taken (including any decision to issue a recommendation or direction, and the contents of these) and an explanation of the balance of arguments behind those decisions. If, in the intervening period between meetings, the PRA or FCA has given the FPC an explanation for not complying with all or part of a recommendation, this will also be included in the record of the next meeting.

2.86 The Bank's liquidity operations are an integral part of both implementing monetary policy and providing liquidity to the financial sector. Decisions about the way in which the Bank's balance sheet is used are rightly reserved to Court, which needs to carefully balance the interaction between the two sides of the Bank's remit. Given the sensitivity of this process, the FPC will not be required to include in its published record any advice it gives on liquidity operations managed by the Bank.

2.87 Of course, some of the matters that the FPC discusses will be highly confidential and market sensitive and their untimely publication could have serious adverse consequences. Therefore the Government proposes to legislate to enable the FPC to exclude from the FSR and meeting records any information whose publication the FPC believes to be against the public interest.

2.88 The Government believes that the ability to redact material in the public interest is an essential safeguard, but that subject to this constraint, the FPC should be as transparent as possible. Placing the FPC under an explicit duty to take into account the importance of openness (paragraph 2.20) will underline that this should be the case. In most cases, the sensitivity of issues considered by the FPC will decrease over time. The Government believes that it is important that information on the FPC's meetings, even if initially unsuitable for publication, should subsequently be made public as soon as possible. Therefore, the legislation will require the FPC to either establish in advance when information redacted from meeting records can be published, or re-assess the situation on a regular basis, with a view to publishing any withheld information at the earliest opportunity.

Accountability for the FPC's use of directions

2.89 The Government's priority is to ensure that as much meaningful information and explanations of the FPC's actions as possible is made public, while ensuring that any mechanisms are designed in a way that does not constrain the ability of the FPC to take decisive action to address risks in a timely way.

2.90 In addition to being included in the FPC's meeting records, any direction given by the FPC to the PRA or FCA will be copied to the Treasury, which will lay it before Parliament (subject to the same public interest test set out above).

2.91 When the PRA or FCA take action to tackle systemic risks on the basis of a recommendation from the FPC, the decision to do so will be taken by the regulator, within its own statutory framework, and subject to its own accountability and transparency mechanisms, such as consultation or cost-benefit analysis. Depending on the prevailing market circumstances, shorter consultation periods may be necessary in order to ensure the timely implementation of the FPC's recommendations.

2.92 In addition, in some cases, the FPC's recommendation will need to be implemented very quickly in order to be fully effective. Any delay by the regulator, for example, in order to undertake consultation, could prove damaging to stability. If a delay could pose a risk to financial stability, both the PRA and FCA will have the ability to waive consultation requirements in order to take action urgently.

2.93 When the FPC directs the PRA or FCA to implement a macro-prudential tool in a specific way, the PRA and FCA will not have any choice over whether to take that action. Therefore, any consultation or impact analysis by the regulator, while useful in terms of understanding how the

PRA or FCA intends to implement the direction and the impact it may have, will not provide a rationale for why the action is being taken.

2.94 The Government does not believe that a single approach will fit all cases. With some tools, a policy statement from the FPC in advance about how it expects to use the tool, and the circumstances in which it would use it, will be of far greater value than a consultation by the PRA or FCA on the specific action (such as rule-making) taken to implement it. In other cases, both a policy statement from the FPC and a consultation by the PRA or FCA on the precise implementation would be beneficial.

2.95 The Government therefore proposes to legislate to enable the Treasury, when setting out the FPC's toolkit in secondary legislation, to specify for each tool:

- whether the FPC should publish and consult on a policy statement in advance of using the tool; and
- whether the existing PRA and FCA procedural requirements (including consultation and cost-benefit analysis requirements) should apply when implementing that tool.

2.96 Under the former provision, the statement will set out under what sort of circumstances the FPC would envisage directing the PRA or FCA to implement a particular specific macro-prudential tool. Where an ad-hoc tool is being created to enable the FPC address a specific prevailing risk, it is likely that the Treasury would not impose a requirement for a policy statement to be in place in advance of the tool being used in order to allow the FPC to take action urgently.

2.97 The latter provision recognises that normal procedural requirements such as consultation or cost-benefit analysis may be of value. Depending on the nature of the tool, directions from the FPC may be high-level, requiring the PRA or FCA to use their discretion to determine precisely how the FPC's aim can be best achieved. But with other tools the direction can be very specific, requiring no discretion whatsoever on the part of the regulators to implement it. In these cases the Treasury will be able to 'switch off' or modify the requirements for the regulators to consult or undertake cost-benefit analysis when implementing these tools.

Interim FPC

2.98 The Government announced that an interim FPC would be created in advance of legislation establishing the permanent body. In February 2011, the Bank's Court of Directors created the interim FPC as a sub-committee of Court. As set out in the July consultation document, the interim FPC will undertake, as far as possible, the statutory FPC's macro-prudential role, in addition to vital preparatory work and analysis into potential macro-prudential tools. The terms of reference of the interim FPC are set out in Box 2.E. The Government welcomes the TSC's support for the interim FPC.

2.99 The composition of the interim FPC's membership resembles closely that of the proposed statutory body. The Bank's Court of Directors has appointed the following members:

- the Governor of the Bank of England, Mervyn King, as Chair;
- the Bank of England's Deputy Governor for Financial Stability, Paul Tucker (who will chair the Committee if the Governor is not present);
- 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 PRA);

- the Chairman of the FSA, Lord Turner;
- the Bank of England's Executive Director for Financial Stability, Andy Haldane; and
- the Bank of England's Executive Director for Markets, Paul Fisher.

Box 2.E: Terms of reference of the interim FPC[7]

The Committee is appointed by Court in anticipation of legislation envisaged in the Government's consultation document *A new approach to financial stability: judgement, focus and stability*, published on 26 July 2010.

The Chair of the Committee is the Governor and the other members are the two deputy governors, Hector Sants as deputy governor-designate for prudential regulation, two executive directors appointed by the Governor and four independent members appointed by the Chancellor. A representative of the Treasury will also sit on the Committee, but will not be eligible to vote. The future Chief Executive of the FCA will also sit on the FPC in a non-voting capacity.

The Committee will contribute to the Bank's financial stability objective by identifying, monitoring and publicising risks to the stability of the financial system and considering action to reduce and mitigate them. Specifically, it will:

- carry out preparatory work and analysis in advance of the creation of the permanent FPC. Primarily, this will involve assessing and advising on macro-prudential toolkit, particularly while potential tools are being discussed and developed in international fora;
- monitor developments affecting financial stability in the UK and internationally;
- consider interventions that in its final state the Committee might wish to make; and give advice to the FSA and other bodies it feels appropriate about emerging risks in the financial system and recommend possible means of mitigating these risks;
- consider making recommendations to the Treasury about the regulatory perimeter; and
- review and approve the Bank's Financial Stability Report, which will set out its assessment and any recommendations that the Committee may have made.

The Committee must meet at least four times a year.

The quorum at its meetings is seven, to include at least one member appointed by the Chancellor.

The Committee must publish a record of its discussions, setting out any recommendations it has made and the balance of arguments behind those recommendations.

2.100 Working closely with the Governor of the Bank of England, the Chancellor has appointed the following four independent members to the interim FPC:

- Alastair Clark, senior adviser to the Treasury for financial stability and former executive director and adviser to the Governor in the Bank of England;

[7] Bank of England http://www.bankofengland.co.uk

- Michael Cohrs, former co-head of corporate and investment banking and member of the Group Executive Committee at Deutsche Bank;
- Donald Kohn, senior fellow in the Economic Studies Programme at the Brookings Institution and former Vice Chairman of the US Federal Reserve; and
- Sir Richard Lambert, former Director General of the Confederation of British Industry.

2.101 These highly experienced independent members will provide vital expertise and challenge to the Committee's deliberations. The future Chief Executive of the FCA, Martin Wheatley, will sit on the interim FPC once he takes up office on 1 September 2011. A representative of the Treasury will also attend meetings. The FPC's reporting procedures will parallel those proposed above for the statutory body.

2.102 The interim FPC's inaugural meeting is expected to take place shortly. Its first major task will be the analysis and assessment of potential macro-prudential tools, which it will share with the Treasury in due course.

Interaction with monetary policy

2.103 In the July consultation paper, the Government outlined some of the potential challenges facing the Bank of England in managing the interactions between monetary policy and macro-prudential policy. Several recent academic papers have also highlighted this issue[8] and the TSC noted in its report how each committee might affect the other.

2.104 It is important to prevent any dilution of the MPC's inflation remit, which might damage the credibility of the framework. The objectives of price stability and macro-prudential are sufficiently distinct that they should be kept separate and different sets of tools should be used in pursuit of these two objectives.

2.105 The Government believes the approach outlined in July – cross membership between the FPC and the MPC and careful sequencing of meetings – will be sufficient to manage these interactions and avoid potential conflicts. This approach has also been broadly endorsed by the TSC in their recent report. Some macro-prudential interventions have a long time horizon and may be adjusted infrequently, whereas the MPC meets much more regularly. The Government expects therefore that the MPC will be the 'last mover', adjusting its analysis to take account of the likely impact of the most recent action taken by the FPC.

Box 2.F: Consultation question

3. Do you have any general comments on the proposed role, governance and accountability mechanisms of the FPC?

Interaction between macro- and micro-prudential regulation

Role of the FPC in relation to the PRA and FCA

2.106 Respondents to the previous consultation expressed a great deal of interest in the role of the FPC in relation to the activities of the PRA and FCA. The Government envisages that the

[8] *Grafting Macroprudential Policies in a Macroeconomic Framework: Choice of Optimal Instruments and Interaction with Monetary Policy*, Angelini, Neri and Panetta, March 2010; *Countercyclical Macro Prudential Policies in a Supporting Role to Monetary Policy*, N'Diaye, November 2009; *Monetary and Macroprudential Policy Rules in a Model with House Price Booms*, Kannan, Rabanal, and Scott, November 2009.

relationship between the FPC and the regulators take the form of a collaborative two-way exchange of information, advice and expertise relevant to financial stability.

2.107 In order to provide effective macro-prudential oversight of the financial system as a whole, the FPC will need to be kept fully informed of any developments in the spheres of influence of the PRA and FCA that may have an impact on financial stability, including their assessment of the severity of those developments. As set out in the July consultation document, prior to each FPC meeting, the PRA will provide information to brief FPC members on the most significant system-wide and firm-specific risks being tackled by the PRA at the time. In a similar way, the FCA will provide the FPC with information on any significant prevailing issues they are concerned with that could potentially lead to financial stability risks or material change in the behaviour of the financial system.

2.108 In terms of the flow of communication in the other direction, the FPC will provide the regulators with advice and expertise on all matters relating to systemic financial stability and risks to overall stability. The Government would therefore expect the PRA and FCA to consult the FPC's opinion on any matters which may have an impact on systemic stability.

2.109 As set out previously, the Government believes that in order to ensure clarity of responsibilities, the FPC should not have a role in firm-specific regulation of firms. In particular, the Government believes that it would be not be appropriate for the FPC to act as an arbiter for firm-specific disputes within the system of financial regulation. The FPC's expertise will lie in systemic financial stability; it would not be well placed to make informed judgements about the severity or importance of consumer protection or market conduct issues.

2.110 Chapter 5 sets out the arrangements for managing the relationship between the PRA and FCA, including a series of mechanisms to resolve any disputes. Where appropriate, the PRA and FCA may seek the FPC's opinion if a disputed matter could potentially impact on systemic stability. In these cases, the FPC could give advice to the PRA or FCA, subject to the carve-out for firm-specific decisions. The Government believes that this will enable the FPC's systemic expertise to be effectively brought to bear on decisions taken by the PRA or FCA which could have material financial stability effects, without the creation of a potentially bureaucratic statutory process such as an automatic requirement for the regulators to consult the FPC on rules.

Interaction within the Bank group and with the FCA

Information gathering and sharing

2.111 Information sharing will be an important element of effectively integrating macro-prudential regulation of the system with firm-specific regulation. This is a particularly important consideration for the Bank of England and the PRA, which will form part of the Bank group and pursue the same objective of financial stability. The Government anticipates a close and constant working relationship between officials in the Bank and the PRA, with changes to the regulatory architecture driving a new culture of cooperation.

2.112 This integration will require information relevant to financial stability to be shared freely between the PRA and the Bank. For example, the PRA will pass information relating to the risks firms are managing to the Bank, to inform the FPC's analysis of risk across the financial sector. In turn, the Bank will pass to the PRA detailed information about overall levels of risk, to help inform the PRA's analysis in respect of individual firms.

2.113 The Bank and PRA will put in place information systems to ensure that there will be a ready exchange of information. However, the Government will also put in place a number of other provisions to ensure close cooperation between the PRA and the rest of the Bank of England group and to ensure that the Bank has access through the PRA to all of the information it needs to carry out its financial stability function. The Government will also put mechanisms in place to ensure that the relationship between the Bank and the FCA is equally cooperative.

Duty on the PRA to provide information that the Bank needs, and Bank power to require information

2.114 As set out at the beginning of this chapter, the Bank has a range of functions, responsibilities and powers connected to its objective of delivering financial stability. This includes the work of the FPC and the SRU, the Bank's liquidity operations, and its supervision of payment systems, clearing houses and settlement systems. To deliver these effectively, it will need a significant amount of detailed information about firms.

2.115 The Bank, PRA and FCA will have powers to gather information from the firms that they regulate directly. The PRA will have specific powers to gather information from unregulated persons for financial stability purposes, replicating those currently available to the FSA. The Bank will retain its powers to gather information in connection with the regulation of payment systems.

2.116 The PRA will gather the information that the Bank group requires from PRA-regulated firms and unregulated persons (except for information relating to its monetary and liquidity functions, which the Bank is able to collect directly under the Bank of England Act 1998). The PRA will be under a statutory duty to provide the Bank of England with the information that the Bank, including the FPC, needs for the exercise of its financial stability functions, including operation of the special resolution regime.

2.117 The FCA will be an independent regulator, pursuing its own strategic objective of promoting and enhancing market confidence. Nonetheless, the Government expects that the relationship between the Bank and the FCA will be cooperative, similar to the existing relationship between the Bank and the FSA. There will therefore be a statutory duty on the FCA to cooperate with the Bank, including on information sharing.

2.118 The Government intends that in the normal course of business the Bank will receive all of the information it needs to fulfil its financial stability functions from the PRA and from the FCA where appropriate. However, as a backstop the Treasury proposes to legislate to provide the Bank with the power to direct the PRA and FCA to gather and provide information that the Bank needs for the purposes of carrying out its financial stability functions. The Bank will be required to assess the proportionality of the direction, having regard to the views of the regulator about the burden on firms that will arise from gathering the information. Any such direction from the Bank to the PRA and FCA will be published, with a delay subject to financial stability considerations.

2.119 Because all information-gathering will be carried out by the regulatory authority in direct and routine contact with the firms, the regulators will be able to monitor the information requirements that are being placed on firms. As discussed elsewhere in this document, the PRA and FCA will need to have regard to ensuring that regulation is proportionate, and will be under a statutory duty to coordinate their actions in relation to firms, including when gathering information. Taken as a whole, these measures will help to ensure that firms are not burdened with duplicative or disproportionate demands for information.

Statutory bar on disclosure of information that falls within the Bank of England's Freedom of Information carve outs

2.120 The Government's intention is that the PRA and FCA will have privileged access to certain sensitive information held by the Bank of England that would not normally be made available to Government departments or regulators. Information relating to the Bank's liquidity operations to support financial stability, information used by the Bank to analyse monetary policy and information relating to the Bank's private banking operations are not covered by the normal provisions of the Freedom of Information Act 2000 (FOIA). Information about monetary policy and liquidity operations is excluded because of its extreme sensitivity, and the fact that disclosure could undermine the effective operation of the central bank. The Bank's operations as a private bank are excluded because private companies providing comparable services are not covered by FOIA.

2.121 At present, this information is not generally shared outside the Bank of England because of the possibility that if it is held by another public body, it might become subject to release under the FOIA. The Government believes that if there is to be a proper integration of micro-prudential and macro-prudential supervision, there needs to be a much closer relationship between the Bank and the regulatory authorities than has existed in the past, including increased flow of information. For example, it is important that the Bank should be able to pass full details to the PRA about firms that are receiving liquidity support from the Bank, including details of discussions between the Bank and the firms. The PRA would likely want to intensify the supervision of a bank receiving a significant amount of liquidity support. It may also be important for this information to be disclosed to the FCA.

2.122 However, the current information-sharing arrangements between the Bank and the FSA inhibit the free flow of information, to the detriment of effective regulation. The Government does not wish to exclude the PRA and FCA from the FOIA. However, balanced against this it is essential that information can be freely transferred between the Bank and the regulators.

2.123 The Government proposes to put in place a statutory bar, making it illegal for the PRA and FCA to disclose information received from the Bank which is excluded from the FOIA. The information would then be covered by section 44 of the FOIA, which puts in place an absolute exemption from disclosure where there is a statutory prohibition on disclosure in place.

Systemically important infrastructure

2.124 As set out in the July consultation, the Bank of England will be directly responsible for supervising the providers of systemically important infrastructure. The Bank of England will, therefore, remain the regulator of payment systems under Part 5 of the Banking Act 2009 and it will take over the FSA's responsibility for regulating settlement systems under the Uncertificated Securities Regulations 2001. The Bank of England will also be the regulator of central counterparty recognised clearing houses (RCHs) under Part XVIII of FSMA.

2.125 This section sets out the main changes that are proposed in relation to each of these regulatory regimes. These are intended to ensure that the Bank has the necessary powers to enable it to conduct an effective supervisory regime, by allowing for graduated intervention. In many cases this will involve aligning the regime applying to securities settlement systems and clearing houses with that which already applies to recognised payment systems under the Banking Act 2009.

Settlement systems

2.126 For settlement systems, changes will be made to the Companies Act 2006 so as to enable the Uncertificated Securities Regulations to be revised in a number of ways, including:

- providing for a power to be conferred on the Bank of England to issue Codes of Practice for settlement systems. This will align the Bank's powers in relation to settlement systems with those relating to payment systems;
- providing for settlement systems operators to be given immunity from liability in damages for action or inaction taken in accordance with certain types of direction issued by the Bank. This will also align the provisions relating to settlement systems with those relating to payment systems;

- designating the Bank as the regulator for settlement systems rather than, as at present, only doing so by making the Treasury the regulator but allowing it to subdelegate its functions to the FSA. This will simplify the regulations and make the real distribution of functions clearer.

2.127 The Government also proposes to make further direct amendments to the Uncertificated Securities Regulations using the existing power in the Companies Act 2006. These include:

- enabling the Bank to impose a greater range of penalties for compliance failures by settlement system operators. This will align the Bank's powers in relation to settlement systems with those relating to payment systems;

- removing the special provisions in the Uncertificated Securities Regulations for the prevention of anti-competitive practices and replacing them with arrangements similar to those in Part XVIII of FSMA to prevent the introduction of excessive regulatory provision. This will align the requirements for settlement systems with those applying to RCHs (see below) and recognised investment exchanges (RIEs) (see Chapter 4); and

- improving the information gathering powers available to the Bank. This will broadly align the Bank's powers in relation to settlement systems with those relating to payment systems and RCHs.

Payment systems

2.128 The Government also proposes to make a number of changes to Part 5 of the Banking Act 2009 to make some technical improvements to the regulatory regime for payment systems. The measures include:

- clarifying the existing power of direction can be used for financial stability purposes and not just for payment system oversight purposes;

- replacing the current power for the Treasury to confer immunity by Order with a provision directly conferring immunity from liability in damages on persons who act at the direction of the Bank, where the direction is given only for broader financial stability purposes (i.e. beyond payment system oversight purposes);

- allowing for recognition orders to be amended without issuing a new order. This will ensure that the description of the arrangements which constitute the system can be kept up to date without needed to go through the procedure of revoking and reissuing orders.

Recognised clearing houses

2.129 Many of the regulatory provisions relating to RCHs now included in FSMA Part XVIII or in UK secondary legislation will be superseded by a directly effective EU regulation on derivative transactions, central counterparties and trade repositories (commonly called the European Markets Infrastructure Regulation, or EMIR). Detailed technical standards will be made by the Commission on the advice of the European Securities and Markets Authority (ESMA) under powers conferred by EMIR.

2.130 EMIR is expected to be approved during the current Hungarian presidency, and the regulation itself and the associated technical standards are likely to come into force at about the same time as the regulatory reforms take effect. EMIR will apply directly in Member States and therefore will not need transposing, though UK legislation will need to provide the necessary legislative framework, to enable, for example, the enforcement of EMIR's requirements. Any redundant domestic legislation will need to be revoked or repealed.

2.131 The Government does not propose, therefore, to make major changes to Part XVIII in respect of RCHs in this Bill. Should any significant legislative measures be needed to allow the Bank of England to fulfil its responsibilities as a competent authority under EMIR, provision may also be made using the powers in section 2 of the European Communities Act 1972.

2.132 The Government proposes, nevertheless, to introduce changes to Part XVIII of FSMA to ensure that the Bank has a graduated set of powers in respect of RCHs. In many cases this will involve aligning the regime applying to securities settlement systems and clearing houses with that which already applies to recognised payment systems under the Banking Act 2009. These measures will include, but are not necessarily limited to, the following:

- simplifying the procedure for issuing directions and allowing the Bank to impose penalties on RCHs – other changes to enforcement powers may be made to ensure that the Bank is able to enforce requirements imposed by or under EMIR;
- extending information gathering powers;
- removing the special competition regime in Chapter 2 and Chapter 3 of Part VIII of FSMA – in practical terms, this regime has been largely overtaken by a new procedure allowing the FSA to prevent the introduction of excessive requirements in RCH rules brought in under the Investment Exchanges and Clearing Houses Act 2006. The UK competition authorities have sufficient powers to investigate competition concerns under their own legislation while EU law also applies to prohibit anti-competitive practices in RCH rules.

2.133 In addition to these amendments to Part XVIII, the Government is also considering whether the Bank will need additional powers to future-proof the RCH regime as set out in EMIR. Certain risks to financial stability may emerge in future, which require the Bank of England to be able to impose additional requirements (possibly including in the form of rules) on a RCH. Given that the regulation of RCHs across Europe will be so clearly set out in European law, the Government's general approach to dealing with such emerging developments will be for them to be addressed at the European level, to ensure that a level regulatory playing field is maintained across the single market.

2.134 However, in some circumstances, the process involved with making changes to European rules may not be consistent with the Bank dealing with a new risk expeditiously. In such circumstances, reserve powers for the Bank to take direct regulatory action – assuming such action is permissible under European law – may be necessary. The Government is considering what powers should be provided to the Bank to deal with this possibility.

Coordination

2.135 Although the Bank of England will be the regulator of RCHs, it will have to work closely with the FCA in respect of a number of key issues, including:

- linkages with RIEs and other trading platforms regulated for both prudential and conduct purposes by the FCA;
- in relation to self-clearing exchanges (i.e. RIEs that also provide their own clearing facilities as a central counterparty) and groups which include separate RIEs and RCHs; and
- UK representation in ESMA (in which the FCA will represent the UK);
- any conduct of business issues relating to central counterparty RCHs.

2.136 The authorities are considering how best to ensure effective working relationships and division of responsibilities in this area; the details can only be finalised in the light of the final shape of EMIR and the supporting technical standards. In general terms, the Bank and FCA will adhere to the relevant general principles (governing coordination of the PRA and FCA) set out in Chapter 5.

Box 2.G: Consultation question

4 Do you have any comments on the proposals for the regulation of systemically important infrastructure?

Crisis management

Coordination of crisis management

2.137 As set out in the July consultation, the Bank group (as central bank, macro- and micro-prudential regulator and resolution authority) will be responsible for designing and executing most elements of the regulatory and resolution response to an emerging financial crisis. However, the Treasury will remain in control of any decisions on the use of public funds.

2.138 Performing these discrete – but complementary – roles effectively will clearly require close cooperation between the Treasury and the Bank group when managing a specific risk to stability. As announced in the previous consultation, the Government will legislate to put in place two specific mechanisms to frame and support this close cooperation:

- a regular twice-annual update from the Governor to the Chancellor on developments in prudential regulation and financial stability; and
- a statutory duty on the Governor of the Bank to notify the Chancellor as soon as it becomes clear that there is a potential risk to public funds.

2.139 The twice-annual meetings will take place as soon as practicable after the FPC's publication of its FSR. The Treasury, in consultation with the Bank, will draw up and publish a high-level record of the meeting. Any market sensitive elements of the discussion would not be included in the published record. The legislation will be framed in a way that does not prevent the discussion going wider than the FSR, nor preclude the Governor and Chancellor from having other meetings during the year to discuss financial stability.

2.140 These mechanisms are deliberately framed around the personal interaction of the Governor and the Chancellor to reflect the fact that the Bank and the Treasury will be the key players in any crisis situation, with this bilateral relationship forming the central point of the exchange of information and the taking of any decisions about a specific threat.

2.141 The duty on the Governor will operate to ensure that the Bank informs the Treasury as soon as it considers it possible that:

- the Government may need to provide financial assistance for the purpose of resolving or reducing a threat to UK financial stability;
- the Treasury may need to incur expenditure as part of a resolution under the SRR; or
- the FSCS may have to request a loan from the National Loans Fund (NLF) in order to pay out compensation.

2.142 This duty will not be triggered by risks managed solely on the Bank's own balance sheet, such as liquidity operations.

2.143 Framing the duty in terms of a 'possibility' makes clear that the Bank must inform the Treasury in the very first stages of contingency planning – as soon as a risk becomes apparent. This will ensure that the Treasury will be made aware of a potential risk to public funds well in advance of any decision needing to be taken in order to allow the Chancellor to consider and discuss a range of options. The Chancellor will have the final decision on any use of public funds.

2.144 As highlighted in the previous consultation, and by the TSC's recent report, the notification set out above is only the first stage of the crisis management process – from this point the Treasury and the Bank (and other relevant authorities) will need to work closely together to develop sufficiently robust contingency plans that minimise the call on public funds while securing financial stability.

2.145 The Bank group will need to keep the Chancellor regularly updated on the status of the risk, providing an assessment of the different options for managing that risk. If appropriate, the Chancellor should be able to request that the Bank consider different alternatives.

2.146 In order to establish clear procedures for how this process will be managed, the Government will legislate to require the establishment of a statutory Memorandum of Understanding (MoU) on crisis management. This MoU will principally be between:

- the Treasury, responsible for public funds and accountability to Parliament; and
- the Bank group, comprising the Bank itself, as resolution authority and central bank and the PRA, as prudential regulator and responsible for triggering firms into the SRR).

2.147 This MoU will set out how the authorities will work together to identify and manage specific threats to stability. In particular, it will supplement the duty on the Governor to notify the Chancellor of risks to public funds by setting out what happens after the notification is made. For example, it will establish how the Bank group will keep the Chancellor updated about a specific threat, what information will be shared with which authorities and which different resolution options would be considered. The MoU may also set out specific responsibilities for the FCA, for example in assessing any impact on consumers or market integrity of a particular resolution option.

2.148 Clearly, no two crises will be the same, and it is therefore vital to create flexibility within these arrangements for the authorities to respond in the most appropriate way to the challenges they face, within a context of clearly understood roles and responsibilities. The Government believes that the arrangements set out above will provide this flexibility, while ensuring that both the Treasury and the Bank group can fulfil their respective responsibilities in a crisis.

Changes to the special resolution regime (SRR)

2.149 The SRR is the UK's statutory toolkit for resolving failing banks and building societies. As set out in the July consultation document, the Government does not intend to use this legislation to make substantive changes to the SRR other than to take account of the authorities' new roles. The Bank and the PRA will have distinct roles and responsibilities under the SRR:

- the Bank will continue to lead on the operation of the SRR. Resolution will be managed within the Bank under the Deputy Governor for Financial Stability; and
- the PRA will have responsibility for triggering the stabilisation options under the SRR (that is, making the assessment that the conditions specified in section 7 of the Banking Act 2009 are met). The PRA will need to exercise its expert regulatory judgment in assessing whether the conditions in section 7 are met. As set out in Chapter 3, the PRA will be operationally independent in the exercise of its statutory

functions, and this includes the function of 'pulling the trigger' to bring an institution within the SRR.

2.150 The FCA will not have the power to pull the section 7 trigger for the SRR. This is because the SRR can only be triggered if it is clear that a deposit taker will not be able to continue as an authorised person. The PRA, as prudential regulator of banks and building societies, will be best placed to make this assessment.

2.151 As discussed above, the new arrangements will create a closer working relationship between the authorities, which will be even more important in the run-up to resolution. In particular, the new arrangements will enable a freer flow of information between the PRA and the Bank of England's Special Resolution Unit in preparing for an exercise of the SRR stabilisation options (transfer to a private sector purchaser or bridge bank or, if exercised by the Treasury, temporary public ownership). This will ensure that in the run-up to resolution, the Bank of England can develop effective resolution options for failing institutions that can be implemented causing the minimum disruption and uncertainty to consumers, creditors and financial markets.

2.152 A number of respondents to the July consultation asked how conflicts would be managed under the new arrangements in which the PRA will be part of the Bank of England group. The Government's view is that the potential for conflicts to arise is limited (for example, around the triggering of the SRR), because the roles and legal responsibilities are clear, and because, as set out in Chapter 3, the PRA will be operationally independent of the rest of the Bank. However, the Government will consider whether it is appropriate to make specific provision in the SRR Code of Practice about managing conflicts, deal with this explicitly in the crisis management MoU outlined above, or both.

2.153 The Government proposes that the FCA should have the ability to apply for the bank insolvency procedure (BIP), on the same grounds as the PRA and subject to the same procedure. If the FCA identifies grounds for the winding up of a failing bank or building society, it would want to apply for the BIP (rather than using normal liquidation proceedings), as the BIP is designed to assist with depositor protection. Where FCA wishes to apply for the BIP, it will first have to gain the consent of the Bank and the PRA.

2.154 In addition to the above changes reflecting modifications to the regulatory architecture, the Government will make some minor and technical changes to the SRR, which will be consulted on separately.

EU crisis management

2.155 A number of respondents to the July consultation emphasised the importance of ensuring consistency with the European and international agenda, and argued that the UK authorities should continue to play an active role in EU and international developments in relation to crisis management.

2.156 The European Commission launched its consultation on an EU framework for crisis management on 6 January 2011.[9] The Government is continuing to engage with the Commission's work. The Government:

- is pushing for all European Member States to have robust resolution tools and powers to enable authorities to address the risks to financial stability from firm failure, comparable with the UK's SRR.

[9] *Technical details of a possible EU framework for bank recovery and resolution*, European Commission, 6 January 2010, available from the Commission website, http://ec.europa.eu.

- argues that there should be a flexible framework for authorities to use these tools and powers within the parameters of their own national arrangements; and
- is strongly supportive of the use of recovery and resolution plans as a key diagnostic and resolution tool, as well as the establishment of a preventative and early intervention framework.

2.157 The consultation period will end on 3 March 2011, and it is expected that the Commission will publish a draft legislative proposal by the end of summer 2011. The Government will continue to engage with the Commission and will publish a full response to the detailed proposals in the consultation document.

3 Prudential Regulation Authority

3.1 Some types of financial services business involve, by their very nature, the measurement, assumption, and management of risks by firms. Banks lend money they have taken in as deposits, based on assumptions about the ability of debtors to repay and the time at which savers will seek to redeem their deposit. Insurers aggregate and invest premiums from many customers, offering to cover the costs of risks which they anticipate will only arise for a proportion of them. And investment firms deal in securities, derivatives and other financial instruments, both on their own account and on behalf of clients, the value of which can be subject to significant fluctuations. All of these activities require firms to manage risk effectively.

3.2 One of the key lessons of the financial crisis has been that financial firms, regulators and policy-makers did not understand sufficiently the risk that such firms were building up, both collectively and individually. Some firms – particularly in the banking and investment banking sectors – clearly lost control of these risks, and as a result were responsible not only for their own demise, but for threatening the stability of the system as a whole.

3.3 Regulators, too, were responsible. Regulation of such firms failed to be sufficiently robust or challenging, and was not based on a sufficiently deep understanding of risk in firms and across the system as a whole. This gap is one of the key issues the Government is seeking to address through its regulatory reforms. As the Government set out in *A new approach to financial regulation: judgement, focus and stability*, the fundamental defining characteristic of the new Prudential Regulation Authority's (PRA) regulatory approach will be the greater use of supervisory judgement. PRA supervisors will focus on developing a clear understanding of the financial soundness of firms and risks to their business models, informed by an assessment of exposure to other financial firms given failure for each firm, including the exposure of public funds.

3.4 The PRA's supervisory approach will be underpinned by its regulatory and legislative frameworks. The Government's approach, as set out in the last consultation and endorsed by respondents, will be to start from the Financial Services and Markets Act 2000 (FSMA), and make the necessary changes for the PRA to give effect to its new approach. The proposed changes are described in the remainder of this chapter.

3.5 The Government also recognises that organisational, operational, and cultural changes will be just as important to the PRA's effectiveness as a genuinely judgement-led regulator. These changes will be introduced as the FSA continues towards its transition. The FSA and the Bank will be publishing more detail on this transition, and the PRA's supervisory approach, later in spring 2011.

The PRA's proposed objective

3.6 Both the PRA and Financial Conduct Authority (FCA) will work to their own strategic objectives and a set of operational objectives. The PRA will have a strategic objective focusing on financial stability, with an operational objective that highlights the role of the PRA in promoting the soundness of firms in a way that does not rule out the possibility of firm failure. The strategic and operational objectives proposed for the PRA are detailed in Box 3.A.

Box 3.A: Summary of proposals for the PRA's objective

1. *In discharging its functions the PRA must, so far as is reasonably possible, act in a way which*
    a. *is compatible with its strategic objective, and*
    b. *advances its operational objective.*
2. *The PRA's strategic objective is: contributing to the promotion of the stability of the UK financial system.*
3. *The PRA's operational objective is: promoting the safety and soundness of PRA authorised persons.*
4. *Promoting the safety and soundness of PRA authorised persons includes seeking, in relation to each PRA authorised person, to minimise any adverse effect that the failure of that person could be expected to have on the UK financial system.*

3.7 The strategic objective will be similar to that of the Bank and the Financial Policy Committee (FPC), recognising the overriding importance of financial stability as a goal of the regulatory system. The operational objective explains how the PRA will contribute towards achieving stability: by promoting the safety and soundness of firms, including (as part of this) seeking to ensure that the failure of the firm would have minimal systemic consequences. These objectives embed two vital attributes of the Government's proposed regulatory approach – that the regulator has an important role in promoting the soundness of firms that it regulates, but also that firm failure is a necessary and important part of a healthy financial services sector. The PRA will not be judged to have failed if a firm that it regulates fails. Equally, the PRA must take steps to ensure that the impact of this failure on the rest of the system is minimised.

Regulatory Principles

3.8 In the July consultation document, the Government asked whether the PRA should continue to be subject to the 'have regard' factors which the FSA must take into account. The Government notes the Treasury Select Committee's (TSC) view that they would prefer the authorities to pursue secondary objectives, rather than factors to which the authorities must have regard. However, the Government would prefer the authorities to work to a narrower set of strategic and operational objectives to ensure that the regulators have a clear mandate and focus. The Government also notes that while there was much discussion of specific have regards in responses to the July consultation document, there was widespread support for the general concept. Therefore, the Government has decided to retain the basic concept of the 'have regard', while simplifying its implementation by reducing the number of factors to a common set of regulatory principles which both the PRA and FCA must take into account. Box 3.B outlines the regulatory principles.

3.9 The 'efficiency' and 'proportionality' principles will ensure that the regulators pay sufficient regard to the cost-effectiveness and value-for-money of regulation.

3.10 The 'responsibilities of senior management' principle enshrines in statute the concept that senior management of regulated firms is responsible for securing compliance with the regulatory framework. The PRA will, however, be expected to hold senior management accountable for ensuring their firms meet regulatory expectations and to be prepared to take action if they fail to do so.

Box 3.B: Regulatory principles to be applied to both regulators

The regulatory principles applied to the PRA and FCA are:

1. *the need to use the resources of each regulator in the most efficient and economic way;*
2. *the principle that a burden or restriction which is imposed on a person, or on the carrying on of an activity, should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction;*
3. *the general principle that consumers should take responsibility for their decisions;*
4. *the responsibilities of the senior management of an authorised person in relation to compliance with requirements imposed by or under this Act;*
5. *the desirability in appropriate cases of each regulator making information relating to authorised persons or recognised investment exchanges available to the public, or requiring authorised persons to publish information, as a means of contributing to the advancement by each regulator of its strategic and operational objectives; and*
6. *the principle that the regulators should exercise their functions as transparently as possible.*

3.11 The principle that consumers are responsible for their own decisions is clearly more relevant to the FCA than the PRA, and is discussed in more in Chapter 4. The two 'responsibility' principles, although different in their purpose, together serve to delineate the limits of regulatory action. For example, while the PRA will intervene if, in its judgement, actions taken by management threaten the prudent management of the firm, responsibility and accountability for the firm will remain with its management, directors (and, ultimately, the equity holders whose interest those directors are intended to represent).

3.12 The openness and disclosure principle, relating to the availability of relevant information, highlights the importance of openness and disclosure as a regulatory tool. This recognises the importance of the availability of clear and objective information in ensuring ongoing market discipline. This principle is balanced against the fact that it will not always be appropriate for information to be disclosed, for example where disclosure would harm the regulator's achievement of its objectives.

3.13 Finally, the transparency principle underscores the importance of ensuring that the regulated community and general public are able to understand about regulatory processes and how they operate, for example, procedures dealing with complaints.

3.14 In addition to these principles, both regulators will also be subject to certain specific requirements deriving from EU law.

Other policy considerations

3.15 As noted above, the Government has considered the views of consultation respondents on whether the PRA and FCA should have regard to other policy considerations affecting the financial services sector, for example competition, diversity, innovation and competitiveness.

3.16 The Government wants to see a competitive, world-leading financial services industry in the UK. Financial stability, supported by a rigorous and effective regulatory framework, provides a strong platform for this industry's sustainable growth and success. It is also important that firms operate in an environment in which regulators can provide them with sufficient certainty about their expectations and likely actions, and where unnecessary regulatory burdens are minimised or eliminated.

3.17 Bearing in mind the importance of allowing both new authorities the freedom to focus on a single primary objective (while having regard to the regulatory principles discussed above), the Government is of the view that neither the PRA nor the FCA should be required to have regard to additional factors. Some of the additional factors proposed by consultation respondents included:

- competitiveness: the PRA will contribute to the competitiveness of the UK economy and financial system through promoting its stability and through ensuring that its approach to do so is proportionate. Similarly, the FCA will play a vital role for example in promoting the clean, fair and efficient markets, again in a proportionate manner, that make London a world-leading location for financial services activity;
- innovation: the Government does not consider it appropriate for either regulator to have to have regard to the desirability of facilitating innovation. As the events of the last few years have shown, a more nuanced approach to innovation in financial services is required, including a regulatory environment in which innovation can deliver desirable outcomes for users of financial services, instead of promoting or discouraging innovation per se; and

3.18 The Government noted the responses from those who argued for the regulators to have an active role in promoting diversity in ownership models in financial services, through the promotion of mutuals in particular. Creating a regulatory regime that supports different ownership models was set out in the coalition agreement as a desired outcome, and this has informed the design of the new architecture. The Government considers that instead of a requirement on the FCA or PRA to have regard to diversity, there should be an approach that spans both the PRA and FCA. This is set out in the box on mutuals in Chapter 5.

3.19 The Government consulted in July on whether the PRA should also have regard to the objectives of the FCA (and vice versa). As discussed in Chapter 5, the Government is proposing to deliver the intended effect – which was strongly supported in consultation responses – through a general duty on both authorities to coordinate and consult each other on their views.

Box 3.C: Consultation question

5 What are your views on the (i) strategic and operational objectives and (ii) the regulatory principles proposed for the PRA?

Scope

3.20 The TSC rightly notes that the reforms should not be concerned exclusively with banking, and that it will be important to avoid confusion about "which firms will be regulated, or part-regulated, by which regulator."[1] As set out in the July consultation document, the PRA will be responsible for the regulation of all institutions that accept deposits or which effect insurance contracts. This will mean that the PRA will authorise and supervise all banks, building societies, credit unions and insurers.

3.21 The Government is clear that the general principle underpinning its model of dual regulation – that conduct of business and consumer protection issues are the preserve of the FCA, while the PRA will focus on soundness of firms and stability of the system – will also apply

[1] *Financial Regulation: a preliminary consideration of the Government's proposals,* Treasury Select Committee, February 2011, page 10

to insurance regulation. The FCA will be responsible for supervising the day-to-day conduct of insurance firms in dealing with their customers and clients. The PRA will be responsible for promoting their long-term soundness and stability. In fulfilling these responsibilities, the PRA will act in a way that recognises that insurance business models are different to those of banks, especially in terms of liquidity risk and the fact that insurance firm failure is generally less likely to be of systemic importance. This means that effective supervision of insurance firms for soundness and stability by the PRA may be achievable through a less intensive supervisory approach than would need to be the case for a bank.

3.22 At the same time, the PRA and FCA will also need to consider how their supervisory approaches should reconcile conflicting issues of policyholder protection and expectation of future return, and balance sheet soundness – particularly in relation to 'with profits' business. These, and potentially other, characteristics specific to insurance firms will need to be reflected in the detailed approach that the PRA will take to supervising insurance firms for soundness and stability purposes. The Government, the Bank of England and the FSA will continue to consider how the characteristics of insurance firms should be recognised appropriately within the regulatory framework.

3.23 In addition to deposit-taking and insurance, the PRA will be able to designate certain investment firms for prudential regulation by the PRA where it determines that they could pose significant risks to the stability of the financial system or to one or more PRA-regulated entities within their group. These risks are likely to arise through the scale or complexity of such a firm's operations and its interconnectedness with other firms or the system as a whole.

3.24 In order for PRA designation to have value, the risks posed by the firm must be of a kind that can be mitigated through prudential regulation. It is therefore envisaged that designation would apply only to firms which have permission to 'deal in investments as principal' and are therefore subject to substantive prudential requirements. As there are a large number of firms who have permission to carry out this regulated activity, objective criteria will be set out in secondary legislation to refine the number of firms that are capable of being designated for prudential regulation by the PRA. Ultimately, this will be a matter of judgement for the PRA to ensure that, where it is desirable and appropriate, the PRA is responsible for the prudential regulation of certain investment firms.

3.25 It is currently proposed that investment firms that are classed as 'BIPRU €730k'[2] firms will be capable of being designated by the PRA. Further minimum capital requirements may also be appropriate, as well as a set of indicators for assessing whether the firm's systemic importance or interconnectedness with PRA regulated group companies require it to be prudentially regulated by the PRA. Further development of the appropriate additional criteria for firms dealing in investments as principal will form part of the PRA's development of its supervisory approach, and will be subject to consultation with firms.

3.26 The decision-making process to determine whether the PRA should be the prudential regulator of an investment firm will be subject to certain procedural safeguards:

- the PRA will have to make a statement of policy stating how it would exercise its responsibilities in this area;
- the PRA will have to consult the FPC on its statement of policy, as well as further public consultation;
- the FCA will have to be consulted prior to decisions on individual firms, and firms will be given the opportunity to make representations; and

[2] A bank, building society or investment firm that is subject to the Capital Requirements Directive but is not a BIPRU 50K firm, nor a BIPRU 125K firm, nor a UCITS investment firm.

- firms will have the ability to appeal the PRA's decision to designate.

3.27 In addition, the FPC will be responsible for advising the Treasury on any changes to the perimeter of regulation that it believes necessary in order to ensure financial stability.

Lloyd's of London (Lloyd's)

3.28 Given the importance of prudential supervision in ensuring that the claims of Lloyd's policyholders are met, the PRA will be the lead regulator for Lloyd's as a whole. However, the FCA will also play a significant role by regulating conduct in relation to certain aspects of the activities of Lloyd's, its members and other participants in the Lloyd's market including the dealings with policyholders, customers and investors. In broad terms, the Government would therefore expect the PRA to take responsibility for prudential and organisational rules relating to Lloyd's and to be the lead authority in relation to Part XIX of FSMA, while the FCA would take responsibility for conduct of business rules.

3.29 The division of regulatory responsibility will therefore largely follow the division of interests between the PRA and FCA as they would apply in relation to insurance business or activity generally but will also take account of the unique nature of Lloyd's, including the way it operates as a specialist financial market and the distinctive roles played by certain participants in this market. The Government proposes, therefore, that the Society of Lloyd's and Lloyd's managing agents should be dual-regulated firms with the PRA responsible for prudential regulation (including the activities of ensuring the adequacy of members' resources and Lloyd's central assets) and the FCA responsible for conduct regulation. The Government also proposes that members' agents and advisers, and Lloyd's brokers should be FCA-regulated firms.

3.30 The arrangements for cooperation and coordination between the FCA and the PRA (discussed in detail in Chapter 5) will take account of the position of Lloyd's.

Box 3.D: Consultation question

6. What are your views on the scope proposed for the PRA, including Lloyd's, and the allocation mechanism and procedural safeguards for firms conducting the 'dealing in investments as principal' regulated activity?

A judgement-led approach

3.31 The PRA will take a judgement-led supervisory approach to the firms it regulates. While this approach will focus on forward-looking analysis, it will also include an assessment of how the firm would be resolved if it were to fail and the impact this would have on both the financial system as a whole (including other PRA firms) and the possible use of public funds. The PRA will draw on this analysis as part of its proactive approach to identifying weaknesses within firms, supported by intervention to require firms to address these weaknesses, where appropriate.

3.32 The PRA's objectives and approach will also be reflected in specific aspects of its legislative framework:

- rules: the PRA will make greater use of principles in implementing its approach and will enforce a 'purposive' application, and enforcement, of PRA rules requiring compliance with the 'spirit' as well as the letter of the rules in order to tackle attempts by firms to circumvent the intended purpose of a rule while still complying with its specific requirements. To support this, the PRA will be required to include short statements of purpose in relation to the rules that it makes to allow regulated firms to understand the rationale behind the rules and the desired outcome. As such, it is envisaged that the PRA will not require a power to make statutory guidance;

- **authorisation:** when exercising its judgement over firms' entry to the financial system, the PRA will take a 'whole firm' approach to considering applications, and only approve those applications where it is comfortable that the firm will be prudently managed with a viable business model (in relation to all its activities) and effective controls for risk mitigation. This could lead it to impose limitations and requirements on any part of the business model;

- **approved persons:** – the PRA will apply a judgement-led approach to determining whether individuals are fit and proper to exercise significant influence over the financial soundness of dual-regulated firms; and

- **enforcement**: the Government is considering how the PRA's decision-making process and appeals of supervisory decisions should reflect the fact that they are judgement-based. The Government is considering whether appeals from judgement-based supervisory decisions should be heard by the Upper Tribunal on limited grounds (those which could be raised on a judicial review) rather than the 'full merits review' currently provided for in relation to FSA supervisory decisions which engage the statutory notice procedure.

Proactive Intervention Framework

3.33 The PRA will also establish a Proactive Intervention Framework (PIF) to reduce the risks of regulatory forbearance from acting on concerns over individual firms. The framework will have two clear purposes: firstly, to create presumptions that regulatory actions will be taken at certain points with a view to increasing probability of recovery, and secondly to initiate coordination measures between the authorities so that the failure and/or resolution can be more effectively controlled with minimum systemic disruption. The introduction of this framework will ensure that the judgement-led approach will be applied proactively where a supervisor has concerns and that action is taken.

3.34 The PIF will set out a number of clearly demarcated stages and a list of presumed actions at each of those stages. Firms will move between those stages depending on the PRA's views of the risks they face. It is envisaged that the framework would be applied across all sectors regulated by the PRA, with the framework tailored to different types of firms and sectors. There will be no automatic trigger for a firm to be placed within the PIF and the decision to place a firm within a particular stage will be based on the assessment of a number of indicators, including capital adequacy, liquidity profile, and governance and risk management.

3.35 More detail on the intended structure and operation of the PIF will be announced by the FSA and the Bank of England in due course.

Box 3.E: Consultation question

7 What are your views on the mechanisms proposed to make the regulator judgement-led, particularly regarding: rule-making; authorisation; approved persons; and enforcement (including hearing appeals against some decisions on a more limited grounds for appeal)?

PRA governance

3.36 As set out in the July consultation document, one of the weaknesses in the 'tripartite' regulatory system has been that no one authority had overall responsibility for promoting financial stability. The Bank of England has had a financial stability objective since 2009, but to date has had inadequate tools to deliver it. By making the PRA part of the Bank of England group, these reforms will bring macro-prudential and micro-prudential regulation together under the auspices of a single institution; and re-establish the link between the Bank of England's financial stability functions on the one hand and the prudential regulation of financial services on the other. To ensure that these benefits are fully realised, the new architecture will need to be underpinned by effective governance arrangements, including suitable checks and balances.

3.37 In carrying out its statutory responsibilities in relation to prudential regulation, the PRA will be fully operationally independent. A number of respondents to the July consultation sought clarity on how far this operational independence would extend, and whether specific provision would be needed to secure the PRA's operational independence within the Bank of England group. Currently, the FSA's operational independence arises from the fact that it has specific statutory powers that cannot be exercised by others. Similarly, the PRA will have statutory functions for which it is responsible, and which cannot be delegated (to the Bank of England or to anyone else). The PRA is legally responsible for the exercise of these statutory functions, and accountable to Ministers, Parliament and the wider public for the way that it does so. This is not affected by the PRA's status as an entity within the Bank of England group. The PRA's operational independence will be supported by the fact that the PRA will have a strong, independent board with a majority of non-executives.

3.38 The TSC has recommended that the Government should give a full explanation of the reasons for making the PRA a subsidiary of the Bank of England.[3] The main effect of bringing the PRA within the Bank of England group will be improved coordination and harmonised action between the micro-prudential regulator (which will be addressing firm-specific risk), and the Bank of England (which will have the tools to address system-wide risks).

3.39 As set out below, key PRA decisions involving major firms or other high risk issues will be taken by an executive committee of the board, comprising the Chairman, PRA executives and the Deputy Governor, Financial Stability. The example given in the TSC's February 2011 report of coordination in the run-up to the resolution of a failing firm using the special resolution regime (SRR) shows the benefits and challenges of this arrangement. The TSC notes that there are challenges with a system in which one organisation (the PRA) 'pulls the trigger' to put a firm into resolution, and another (the Bank) designs and carries out the resolution.[4]

3.40 Under the new arrangements set out in this chapter, the PRA is part of the Bank of England group, with shared staff at the top of the organisations, and information flowing freely between them. This will mean that in the period leading up to a resolution, the organisations will share a common analysis of the risks, including a shared understanding about the likelihood of failure, and the most appropriate response. They will also be better equipped to deliver a coordinated and harmonised response. However, balanced against this, the PRA will be operationally independent in its decision to 'pull the trigger' to put the failing firm into the SRR. This means that the final decision to put the firm into resolution will ultimately lie with the PRA executive. The PRA will be fully accountable (and legally responsible) for that decision. The next section sets out the governance arrangements that will underpin that relationship.

The relationship between the PRA and the Court of Directors of the Bank

3.41 As set out in the July consultation, the PRA will be a separate legal entity established as a subsidiary of the Bank of England. It will, like the FSA, be a limited company. The Bank will be the sole member of the company.

[3] Treasury Select Committee, page 33

[4] Treasury Select Committee, page 62

3.42 The PRA will be accountable to Court of Directors of the Bank of England for administrative matters, including its budget and remuneration policy, value for money and performance against objectives. Court will also review the PRA's strategy. Provisions about the relationship between the Bank and the PRA (and about the Court's role) will be set out in the PRA's articles of association. This will mean that the PRA and Bank of England will have substantial flexibility in determining how the PRA will interact with other parts of the Bank group, and ensure that the arrangements can evolve over time as necessary. These articles will be drafted jointly by the FSA and the Bank, and approved by the Bank. The Government has asked the Bank to produce draft articles in time for the introduction of the legislation, in order to assist with Parliamentary scrutiny of the new framework.

3.43 The Government expects that the articles of association will make provision about the relationship between Court and the PRA. It is likely that consideration of important matters about the administrative functioning of the PRA will be reserved to the Court of the Bank of England:

- approval of the PRA's objectives for funding and financial management;
- approval of the PRA's annual operating and capital expenditure budgets and any material changes to them;
- approval of the PRA's remuneration policies for staff; and
- appointments (on which the Court's Nominations Committee will advise) and remuneration of non–executive directors of the PRA (on which the Court's Remuneration Committee will advise).

3.44 The Government does not intend to make prescriptive provision in legislation about the relationship between the Bank and the PRA. However, where governance matters are at present expressly dealt with in FSMA, legislative provision will be made, rather than leaving it to the articles. In particular:

- the legislation will make Court responsible for determining the terms of service (including remuneration) of executive and non-executive members of the governing body; and
- the legislation will also require Court to prepare a report on the discharge of its functions in relation to the PRA for inclusion in the Bank's annual report.

The PRA board

3.45 As set out in the July consultation document, the Governor of the Bank of England will be ex officio chair of the PRA and the Bank's Deputy Governor for Prudential Regulation will be its ex officio CEO. The Bank's Deputy Governor for Financial Stability and the Chief Executive of the FCA will also serve on the PRA's governing body.

3.46 The Government will legislate so that the PRA will be bound by principles of good corporate governance.[5] The board will be collectively responsible for the long-term success of the PRA. It will determine PRA's strategy, its supervisory approach, and its attitude towards risk in its supervisory judgements. The Governor of the Bank of England, as Chair, will be responsible for leadership of the board and ensuring its effectiveness on all aspects of its role.

[5] The effect of this is to require the PRA to have regard to such generally accepted principles of good corporate governance in managing its affairs as it is reasonable to regard as applicable to it. Such principles might include those contained in the UK Corporate Governance Code. The Code and associated guidance are available from the website of the Financial Reporting Council, www.frc.org.uk. Some principles will not be relevant to the PRA and so need not be taken into account.

3.47 The role of the non-executive directors will be to constructively challenge the executive and help develop proposals on strategy and policy. To ensure that the PRA board can perform a robust challenge function, the Government will legislate to provide that the board will have a non-executive majority. The legislation will also provide that non-executive directors must be independent and free from material conflicts of interest.

3.48 The board of the PRA will be responsible for:

- proposing the overall budget of the PRA for the Court of Directors of the Bank of England's approval;
- the management of its resources within the budget set by the Court of Directors of the Bank of England in an appropriate, proportionate and risk-based manner; and
- making prudential rules.

3.49 The PRA will be a focused regulator, dealing only with firms that manage significant risks on their balance sheets. This increased focus will mean that the PRA board will be able to take a much closer interest in regulatory decision-making. With the move away from 'tick box' regulation, the Government expects that PRA board members will take significant roles in critical firm-specific decisions.

3.50 The previous consultation document proposed that the legislation should require that significant regulatory decisions on specific firms would be taken by an executive committee, or a committee in which the executive members are in majority. On reflection, the Government believes that it would be more appropriate to give the PRA flexibility to establish appropriate decision-making structures, involving the non-executives as appropriate in line with principles of good corporate governance.

3.51 The Government proposes that there should be no requirement on the PRA to establish a non-executive committee. Some of the functions that would normally be carried out by the non-executive committee (for example, setting remuneration of directors) will be carried out by the Court of the Bank of England. It will be within the power of the PRA's board to establish such a committee and confer functions on it if appropriate.

Appointments to and dismissals from the board

3.52 The legislation will provide that appointments to the board of the PRA will be made by the Bank of England with the approval of the Treasury. The Bank will, as far as possible, run the appointments process in accordance with the Code of Practice for Ministerial Appointments to Public Bodies published by the Commissioner for Public Appointments. The legislation will provide that the Bank will be able to dismiss any member of the PRA board (except the ex officio members) with the approval of the Treasury. A board member may only be dismissed on grounds of incapacity, serious misconduct or material conflict of interests.

Box 3.F: Consultation question

8 What are your views on the proposed governance framework for the PRA and its relationship with the Bank of England?

Accountability

3.53 Transparency and accountability are key elements of the Government's efficiency and reform agenda. As described above, the most immediate line of accountability for the PRA will be to the Court of the Bank of England, which will hold the PRA accountable for budget and remuneration policy, value for money and other matters. As set out in the previous consultation document, Parliament, and specifically the TSC, will take the primary role in holding the PRA to account.

3.54 The Government envisages that in the new system:

- Treasury Ministers will satisfy themselves that the regulatory system as a whole is functioning properly, and will be accountable to Parliament on that basis;
- Parliament will hold the PRA publicly accountable for the achievement of its statutory objective and 'have regards'; and
- the general public, as the ultimate stakeholder in the regulatory system, has a right to information about the operation of the system and the way that the PRA supervises.

Accountability to Ministers and Parliament

3.55 The legislation will provide mechanisms to enable Treasury ministers to satisfy themselves that the regulatory system as a whole is functioning properly, and account to Parliament on that basis. In addition to existing FSMA provisions, accountability will be strengthened by a new measure, requiring that where there is a significant regulatory failure, the PRA must make a report to the Treasury, which will then lay the report before Parliament.

Reviews of economy, efficiency and effectiveness

3.56 The PRA will be expected to run itself in an efficient manner, ensuring that the costs it incurs in carrying out its regulatory functions are reasonable. The PRA will be accountable to Court for its efficiency and effectiveness. However, it will also be important to retain the Government's powers in this area, so that ministers can account to Parliament for the overall functioning of the regulatory system that has been established. Treasury ministers will therefore retain the power in FSMA section 12 to commission independent reviews of the economy, efficiency and effectiveness with which the PRA has used its resources.

3.57 Respondents to the July consultation document generally welcomed the proposal that the PRA should be audited by the NAO. The Government confirms that the PRA will be subject to full audit by the National Audit Office and accountable to the Public Accounts Committee.

Independent inquiries into regulatory failure

3.58 FSMA sections 14 to 18 provide the mechanism for the Treasury to appoint a person to hold an independent inquiry into the circumstances surrounding regulatory events which give rise to serious questions or public concern about the regulatory framework or the effectiveness of regulation in practice. The FSMA provisions established a statutory basis for launching the type of inquiry that had been conducted into the failures of the Bank of Credit & Commerce International (BCCI) in 1991 and Barings in 1995. The Bingham Inquiry into BCCI was conducted on a non-statutory basis and therefore had no powers to require witnesses to attend or give evidence. The Barings Inquiry was conducted by the Board of Banking Supervision (an advisory body within the Bank of England). The Government intends to retain an equivalent to the FSMA section 14 power in the new legislation, enabling the Treasury to order inquiries by an independent third party into any regulatory failure by the PRA and FCA.

Accountability to Parliament

3.59 The Government recognises that, where there has been a significant regulatory failure, it is appropriate that there is a substantive analysis of what went wrong, and what lessons can be learned. It is also appropriate for Parliament and the public to be able to see this report and, where necessary, hold the regulator to account. The Government will create a new requirement for the regulator to make a report to the Treasury where there is a regulatory failure, addressing the regulator's action and decision making and considering what lessons can be learned by firms and regulators. The legislation will define a trigger for when a report must be produced. The Treasury will also have a power to direct the regulator to produce a report when that would be in the public interest. Such reports will include confidential information where its disclosure would be justified in the public interest. The Treasury will subsequently lay the report before Parliament.

Public accountability

Complaints

3.60 Under the current structure, the FSA is required to maintain arrangements for the investigation of complaints. Complaints may be made by anyone directly affected by FSA actions or inaction. In particular, this is likely to include regulated firms, employees of firms, listed companies, and consumers. The complaints procedure deals with issues of maladministration or incompetence; examples are circumstances in which sensitive information belonging to a bank has not been treated with due care, or where an authorisation process has taken an unreasonably long time.

3.61 When a complaint is made, the FSA must conduct an internal investigation. However, it is also required to maintain a system for an external investigation if the complainant is dissatisfied with the results of the internal investigation. The FSA has appointed a Complaints Commissioner, whose role is to investigate complaints and report to the complainant and the FSA. The report may include recommendations to the FSA (for example, an ex-gratia payment to the complainant). The FSA decides whether to make any such payments.

3.62 The Government believes that it is important that the PRA maintains a system for the investigation of complaints. The PRA will therefore be required to have a complaints procedure, distinct from the complaints procedure for the FCA. Legislation will provide that external scrutiny of complaints will be carried out by an independent person appointed by the Bank. This could be a non-executive director on the Court of the Bank of England, in keeping with Court's role in challenging and holding the PRA to account on certain matters. The Government expects that the PRA will put in place arrangements to ensure that the complaints process is sufficiently transparent.

Freedom of information

3.63 In line with the Government's transparency agenda, the PRA will be fully subject to the Freedom of Information Act 2000 (FOIA). However, some additional safeguards will be put in place to ensure that information can flow freely between the Bank and the PRA without undermining the limitations on the application of FOIA to the Bank of England. This is discussed in more detail in Chapter 2.

Box 3.G: Consultation question

9 What are your views on the accountability mechanisms proposed for the PRA?

Consultation

3.64 One of the key themes from responses to the July consultation document was a desire for greater clarity about how the PRA will engage with industry and the wider public. Engagement with industry will be important in helping the PRA to carry out better and more effective regulation. The new framework will ensure that there are effective channels for the PRA to engage with industry and industry bodies, including channels for industry to make public its views about the PRA's approach. As set out below, in a number of areas the new framework will replicate the existing provision of FSMA with minor changes where appropriate to ensure that the PRA can take a suitably judgement-led approach.

Consultation on rules

3.65 The majority of respondents to the July consultation emphasised the importance of retaining the existing safeguards around rule-making, including consultation. The TSC also emphasises the importance of effective cost-benefit analysis.[6] A number of respondents suggested there were some circumstances where the requirement to consult could be streamlined, for example when implementing EU rules, or in emergency situations.

3.66 Reducing the burden of regulation, and improving the quality of regulation, is a key priority across Government. The purpose of consultation is to require policymakers to think carefully about the case for regulation; and where intervention is required, to explore in full the opportunity for non-regulatory and self-regulatory approaches before considering regulatory measures. The Government proposes that there should be no significant reductions to the existing requirements to consult set out in the Financial Services and Markets Act. The PRA will be under an obligation to publicly consult when it makes rules except where to do so would be prejudicial to its objectives.

3.67 The Government's view is that new regulators must be rigorous in their analysis of the impact of regulation on industry. As a judgement-based regulator, the PRA must focus on increasing the quality of regulation rather than its quantity. However, it is clearly unrealistic to expect that the regulator will produce quantitative cost-benefit analyses especially where it is not possible to monetise or quantify costs and benefits in a meaningful way. The existing FSMA framework allows a substantial amount of discretion to be exercised; the Government believes it will be appropriate to clarify how proportionality will be applied in analysis by the regulators as part of the CBA process. The Government will also give further consideration to the question of whether the requirement to consult could be streamlined when implementing EU rules.

Engaging with practitioners and consumers

3.68 Many respondents to the July consultation recommended retaining the Practitioner Panel and Consumer Panel, in order to ensure that the PRA maintains contact with industry and the wider public.

3.69 The role of the existing Practitioner Panel is to consider how far the FSA is meeting its statutory objective and balancing its 'have regards' from an industry standpoint, and how far it is giving due regard to the considerations set out in the legislation. It is independent and free to publish its views on the FSA's work. It will be essential for the PRA to engage practitioners if it is to regulate effectively, and to engage with trade bodies and industry representatives where they have appropriate expertise. However, in line with the new 'judgement-based' approach, the Government intends to give the PRA flexibility in deciding what kind of arrangements it wants to establish, but to require that whatever arrangement is put in place is transparent and public.

3.70 The PRA will therefore be under a duty to make and maintain arrangements for consulting practitioners on the extent to which its policies and practices are consistent with its role as prudential regulator, and to make the arrangements public.

3.71 A number of respondents to the July consultation suggested that the PRA should be required to maintain a standing consumer panel, for the purposes of seeking views from consumers about the effectiveness of its regulation. While consumer issues will be integral to the new regulatory structure – particularly with the creation of a dedicated new consumer protection regulator – on reflection the Government does not think that it will be necessary to

[6] Treasury Select Committee, page 50

retain the consumer panel for the PRA. The PRA will be focused exclusively on prudential issues. Where the PRA believes that its decisions will have a material impact on consumers, it will be required to consult the FCA to take advantage of its expertise, as set out in Chapter 5. As set out in Chapter 4, the FCA will be required to maintain a consumer panel, consistent with its consumer protection role.

Annual consultation on strategy and approach

3.72 As set out in the July consultation document, the PRA will be required to produce an annual report which the Treasury will lay before Parliament. The Government proposes to supplement this with a requirement for the PRA to consult industry and the wider public about the extent to which its strategy and approach are delivering effective prudential regulation. In line with the new judgement-based approach, the Government intends to give the PRA flexibility in deciding what kind of arrangements to establish.

3.73 Therefore, the legislation will put the PRA under a legal duty to run an annual consultation process, inviting comment from industry and the wider public on the content of the annual report, and the extent to which the PRA has achieved its objectives. The legislation will require that the process that is adopted is open, clear, transparent and open to the general public.

Box 3.H: Consultation question

10 What are your views on the Government's proposed mechanisms for the PRA's engagement with industry and the wider public?

4 Financial Conduct Authority

4.1 Good conduct of business is an essential element of a strong and efficient financial system able to play its vital role in supporting the real economy. The willingness of consumers, whether retail customers or financial professionals, financial firms or large corporations, to enter into financial transactions will ultimately depend on the extent to which they have confidence that regulated firms will conduct themselves appropriately.

4.2 Conduct of business regulation has a fundamental role to play in protecting and enhancing that confidence in the UK financial system. First, in setting out the standards to which firms are expected to adhere; and second, in monitoring and enforcing compliance by firms with these standards. In the retail sphere, in which the relationship between customer and provider is generally balanced significantly in favour of the provider, effective conduct regulation is a particularly important way of protecting and enhancing consumer confidence. In regulating specialised wholesale and markets activities undertaken between professional counterparties, a more nuanced regulatory approach will be appropriate. However, in regulating wholesale markets, the regulator must also be mindful of the links that exist, through the transaction chain, between retail products and services and wholesale market activity.

4.3 The Government believes that, under the regime introduced by the previous administration, the regulation of conduct in financial services has not always received the attention and focus that it requires within the integrated FSA. Part of the process of rebuilding trust and confidence in financial services will be establishing a new, credible regime for conduct regulation.

4.4 The Government welcomes the work already done by the FSA to achieve this goal. For example, the FSA has introduced a new enforcement strategy of credible deterrence, resulting in a number of successful prosecutions for insider dealing. On the retail side, the FSA has adopted a new consumer protection strategy, which incorporates earlier identification of risks, sector-wide interventions, and greater scrutiny of products and their governance, among other elements. The FSA has set out its thinking on earlier intervention in the product lifecycle in more detail in its recent discussion paper on product intervention (DP 11/1[1]), and the Government views this as a timely contribution to the public debate on the extent of regulatory intervention on behalf of retail customers. This work will continue throughout the transition.

4.5 Notwithstanding these efforts, the Government is clear that more wide-ranging reform is needed to ensure proper conduct regulation of the UK's financial system. The fundamental component of this reform will be the creation of the right institutional framework, one that gives conduct of business regulation the required mandate and prominence. This will be achieved through the establishment of a separate and focused conduct regulator with tailored objectives, functions and powers.

4.6 The Government's July 2010 consultation document therefore set out plans for the creation of a new conduct regulator with the working title 'consumer protection and markets authority'. In order to reflect more directly its role and focus on conduct of business issues, the Government has decided that the new authority will be named the Financial Conduct Authority (FCA).

[1] http://www.fsa.gov.uk/pages/Library/Policy/DP/2011/11_01.shtml

4.7 As a focused conduct of business authority, the FCA will have, as its core purpose, protecting and enhancing the confidence of all consumers of financial services – from retail customers choosing a current account to a hedge fund engaging in multi-million pound derivatives trades. However, as set out in this chapter, much of the FCA's focus will be on developing a new model of conduct regulation in the retail sphere, using early and proactive intervention to ensure that the interests of retail customers are protected.

4.8 This will involve a fundamental shift in approach, particularly with respect to retail customers. In the past, the regulatory approach was based on the assumption that effective retail customer protection could be achieved by scrutinising sales processes to make sure that customers were treated fairly and received appropriate and transparent information. This may still be the case for those customers who are more financially capable or for financial professionals. But this focus on the point of sale has not always been effective in preventing large-scale detriment among retail customers. The FCA will therefore have a greater willingness to intervene in the early stages of the product lifecycle where appropriate to deliver better outcomes for retail customers, as described in more detail in this chapter.

4.9 It is in this sense – that of putting appropriate consumer outcomes at the centre of the regulatory process – that the FCA will be a 'consumer champion'. While many respondents to the July consultation welcomed this concept, other respondents as well as the Treasury Select Committee (TSC) in its interim report published on 3 February 2011 raised concerns with this formulation, suggesting that it could be seen to undermine the impartiality of the regulator in its dealings with firms. The Government has noted these concerns; there are a number of important respects in which this concept can be explained and clarified:

- the Government recognises that, as a regulator, the role of the FCA should not be confused with that of consumer advocate organisations, which themselves have a vital and distinct role to play. The FCA will be an entirely impartial regulator from whom firms and consumers can expect fair treatment;
- the Government believes that the FCA's regulatory focus on achieving better outcomes for consumers of financial services must be pursued in a way which recognises not only the limitations of regulation, but also the potentially negative effects of excessive regulation on market efficiency and consumer choice;
- proportionality will be crucial; the FCA, as an integrated regulator of retail, wholesale and market conduct will need to take a tailored approach to thinking about the interests of the consumers of products and services in each of these market segments. The interests of retail customers seeking financial advice will be different from those of pension funds purchasing investment management services, or from investment banks dealing in equities on their own account using hypothecated client assets. The degree and type of regulatory protection afforded to them should be tailored to their needs and expertise. The FCA will take these differences into account in determining what sort of regulatory action to take in each sector, on a case-by-case basis; and
- the concept of the responsibility of consumers for their own choices will also be important. The Government recognises, however, that for retail customers the Consumer Financial Education Body (CFEB) will have an important role to play in educating retail customers so they are empowered to take decisions confidently.

4.10 As described in the July consultation, the FCA will also contain a strong markets regulation function, responsible for ensuring high standards of wholesale conduct by financial services firms (including imposing disciplinary measures against those found to have committed market abuse) and for regulating the listing process, recognised investment exchanges and other trading platforms. These responsibilities, which have to date been performed effectively by the relevant specialist functions within the FSA, will be largely transferred intact across to the new FCA. As discussed below, the objectives and functions of the FCA will be defined in a way that allows wholesale and markets regulation to be carried out as a core part of the FCA's regulatory approach, with the flexibility required to ensure that the specialist requirements of these markets are appropriately reflected and recognised.

4.11 Furthermore, the FCA will play a key role in maintaining the UK's regulatory standing and influence through its seat on the new European Securities and Markets Authority (ESMA). It will use its knowledge and expertise to play a full part in developing and shaping rules and standards as they affect the UK, not just in the EU but also internationally. It will be important, therefore, that the FCA can represent the interests of all UK bodies that have responsibilities that overlap with ESMA's mandate, particularly including, in relation to clearing and settlement infrastructure, the Bank of England. The mechanisms for ensuring this is the case are set out in more detail in Chapter 7.

4.12 The legislative framework – building on that established by the Financial Services and Markets Act 2000 (FSMA) – will of course only be the starting point for the creation of the FCA as the new conduct regulator. A new corporate culture, new operational models and renewed focus on conduct issues will also be essential, highlighting the importance of leadership. As announced on 2 February 2011, Martin Wheatley has been named as the Chief Executive-designate of the FCA. He has been appointed by the FSA as managing director responsible for consumer protection and markets, and will take up this post in September, when he will also join the FSA Board, playing a central role in shaping the transition to the FCA. Once the FCA is established, Mr Wheatley will take up his role as the head of the new organisation.

The FCA's proposed objectives

4.13 As set out in the previous consultation, the FCA will have a single strategic objective to protect and enhance confidence in the UK financial system. This strategic objective will be complemented by three operational objectives (see Box 4.A) to make clear how the FCA may go about protecting and enhancing confidence. As discussed in more detail below, the new legislation will include an explicit new provision making clear that, in discharging its general function, the FCA must, wherever appropriate, seek to promote competition.

4.14 Each of the operational objectives will, in different circumstances, apply to a greater or lesser extent to either the retail, wholesale or markets regulation functions of the FCA, although none of them is intended to be exclusively focused on any particular function. Instead, they are designed to provide the foundation for an integrated conduct regulator, while still giving the right degree of emphasis to the separate elements of the FCA's work. For example, the definition of the term 'consumer' in the second operational objective will be widely drawn, to cover users of services provided in the course of carrying on a regulated activity by any person, as well as investors participating in primary markets.

Box 4.A: Summary of proposals for the FCA objectives

1 *In discharging its functions the FCA must, so far as is reasonably possible, act in a way which*

a. *is compatible with its strategic objective, and*

b. *advances one of its operational objectives.*

2 *The FCA's strategic objective is: protecting and enhancing confidence in the UK financial system*

3 *The FCA's operational objectives are:*

a. *facilitating efficiency and choice in the market for financial services;*[2]

b. *securing an appropriate degree of protection for consumers;*[3] *and*

c. *protecting and enhancing the integrity of the UK financial system*

4 *The FCA must, so far as is compatible with its strategic and operational objectives, discharge its general functions in a way which promotes competition.*

Facilitating efficiency and choice in the market for financial services

4.15 The first operational objective is based on the Government's view, supported by many consultation respondents, that the FCA's remit should reflect the importance of competitive markets in delivering better outcomes for consumers. The objective captures two crucial elements of competitive markets – efficiency in terms of pricing and delivery, supported by an appropriate degree of choice (in products, services and/or providers), and it reflects the FCA's important role in removing regulatory barriers, where possible, to greater efficiency and choice. This is clearly an issue of primary importance along the whole financial value chain and for all consumers of financial services. However, it is especially relevant in relation to wholesale markets, where the regulator may focus less on proactive intervention and protection and more on promoting better outcomes by facilitating a level playing field.

Ensuring an appropriate degree of protection for consumers

4.16 Where the first operational objective is concerned with delivering the right outcomes, the second focuses on the role of the regulator in securing an appropriate degree of protection where consumers face actual or potential detriment. The objective is intended to be broad enough to enable the regulator to take action to prevent detriment from occurring where a risk has been identified, as well as to take action once harm has actually been done, including for example by the imposition of redress.

4.17 Nevertheless, as set out below, the Government does not believe that this objective should shift the responsibility for taking decisions from the consumer on to the regulator. The term 'appropriate' reflects the fact that different consumers require different degrees of protection, depending on their capability and personal circumstances, the product they are buying, and the channel through which they are buying it. This objective therefore makes clear that the regulator may differentiate its approach according to the consumer in question, with a marked difference

2 'Services' is to be defined broadly to include services provided in the course of carrying on regulated activities (including by persons who are not authorised persons); services provided to issuers in connection with capital raising, services provided by payment services providers; and relevant ancillary services.

3 'Consumers' is to be defined broadly to include persons who use, have used or may use "services" or have relevant rights or interests in relation to those services, and persons who have invested in, or may invest in, securities (for example, those listed on the Official List).

between the level of protection afforded to a retail customer and the level appropriate for a professional market participant.

Protecting and enhancing the integrity of the UK financial system

4.18 While not exclusively a 'markets' or 'wholesale' objective, this operational objective particularly reflects the FCA's remit in markets regulation, as well as its work on countering financial crime across the financial system (see Box 4.B).

4.19 Measures taken to enhance 'integrity' may include actions taken to:

- address the extent to which the UK financial system may be used for the purposes of financial crime;
- protect and enhance the soundness, stability and resilience of the UK financial system; and
- improve the functional integrity of the markets that form part of the system, including the reliability of the price formation process.

Competition

4.20 A significant number of consultation respondents, including the Independent Commission on Banking, called for the FCA to have a primary statutory objective for promoting competition. The recent TSC report also makes this recommendation.

4.21 As noted, the Government recognises the important role of competition in delivering good outcomes for consumers, and has framed the first operational objective of the FCA to reflect this. Nevertheless, the Government wants to go further and make clear that, where appropriate, the FCA can and should take action in respect of competition more broadly, and in pursuit of any of its operational objectives, not just that of efficiency and choice. The Government will therefore elaborate on the FCA's objectives to ensure that the FCA must, wherever appropriate, exercise its general functions in a manner intended to promote competition.

4.22 This will go significantly further than the 'have regard' approach taken in FSMA in incorporating competition into the regulator's remit, resulting in the outcome desired by consultation respondents and key stakeholders as noted above. The Government believes that this approach is more appropriate than providing the FCA with a primary objective explicitly focused on competition alone, for a number of important reasons:

- it focuses on the positive outcomes of greater competition, rather than on competition per se;
- it reflects the fact that actions taken in pursuance of any of the operational objectives may impact on competition;
- it reflects the Government's approach of providing each authority with a single strategic objective to ensure clarity of purpose and focus - given this approach, the FCA's competition mandate needs to be balanced carefully alongside its primary objective. The FCA will not be expected to pursue greater competition in a way that is incompatible with its strategic objective, or indeed any of its operational objectives;
- furthermore, in key regulatory areas potentially impacting on competition, the PRA will have a major role, over which the FCA will have limited or no responsibility or locus – accordingly the proposed approach realistically reflects the way the FCA will be able to achieve better outcomes for consumers; and
- it reflects the continuing role in this area of the competition authorities.

Regulatory principles

4.23 As set out in the previous chapter, the Government recognises that additional statutory factors to which a regulator must have regard provide useful guidance and elaboration on how the regulator is expected to act. The Government will therefore provide for a consistent set of regulatory principles to which both the PRA and FCA must have regard in exercising their general functions (see Box 3.B). This section provides more detail on how these principles will apply to the FCA.

4.24 First, the 'efficiency' principle straightforwardly refers to the responsibility of the regulator to use its resources in the most efficient and economic way; but this will be further reinforced by NAO audit of the new regulator.

4.25 Second, 'proportionality' is the principle that a burden or restriction imposed on a person or activity should be proportionate to the benefits which are expected to result. In the responses to the July consultation, there was particularly strong support for this principle to be retained for the FCA. Proportionality also means that the regulator must tailor its actions to the specific characteristics of the sector being regulated; interventions in retail and retail-related wholesale markets will be different from those in pure wholesale or specialist markets.

4.26 Third is the principle that 'consumers are responsible for their decisions'. The Government recognises that consumers, particularly retail customers, are often at a relative disadvantage when engaging with financial services, given information asymmetries, product complexity and long-term product payoffs. It is for this reason that the FCA's remit includes objectives capturing better outcomes and adequate protection for consumers. But consumers are ultimately responsible for looking after their own interests and the choices they make; indeed informed and capable consumers exercising power through market discipline can be far more powerful than regulatory action, particularly in wholesale and markets spheres. The Government does, however, recognise that retail customers may require additional support to empower them to engage with confidence in financial services, and therefore remains fully committed to a strong and independent Consumer Financial Education Body (CFEB). Its role, and the interaction with the FCA, is described in more detail in Chapter 6.

4.27 Fourth, 'responsibilities of senior management' enshrines the principle that senior management of authorised persons are responsible for securing compliance with the regulatory framework. The regulator cannot replace the proper decision-takers in regulated firms in respect of financial transactions, compliance and other business decisions. This links to the Government's view that the FCA should not as a general principle take on the role of vetting and pre-approving products. The FCA will, however, be expected to hold senior management accountable for ensuring that their firms meet regulatory standards and to be prepared to take action if they fail to do so.

4.28 Fifth, the principle of 'openness and disclosure' recognises the importance of the availability of clear and objective information in delivering ongoing market discipline. The principle also recognises the role of using disclosure of supervisory or regulatory decisions as an indirect way of bringing about best practice. However, the Government recognises that necessary restrictions on disclosure exist in UK and EU law, and also that it will not always be appropriate for information to be disclosed, for example where the disclosure of information would be incompatible with the objectives of the regulator, or where disclosure could harm a current or intended investigation or inquiry.

4.29 Finally, the importance of ensuring that the regulator conducts its business 'as transparently as possible' was raised by many respondents to the previous consultation. The transparency principle recognises the importance not only of ensuring that appropriate information is provided in respect of regulatory decisions, but also that the regulator is more open and accessible both to regulated community and general public.

4.30 In addition to these principles, the regulators will be subject to the usual requirements as public bodies to act in accordance with duties arising under UK and international law. As described in detail in Chapter 3, the Government has also considered whether the new regulatory authorities should have regard to broader considerations, such as the competitiveness and innovation, and concluded they should not. The Government has concluded that the proposed framework of clear objectives supported by a short list of regulatory principles will better provide for the judgement-led and focused approach the new regulatory system must deliver, without inappropriately compromising other desirable features of the market for financial services.

4.31 The Government has also ruled out applying a number of additional have regards specifically to the FCA:

- **public understanding**: the Government recognises the importance of increasing public understanding and awareness of the financial system and retail financial products and services. The Consumer Financial Education Body (CFEB) was established last year as a dedicated independent body, with a clear and focused remit to promote and enhance consumers' financial understanding. The FCA will take over the FSA's responsibility for providing oversight to the CFEB and working with the CFEB to improve consumer outcomes. Further detail on how the FCA and the CFEB will work together is set out in Chapter 6;
- a number of respondents suggested that the FCA should have regard to promoting **financial inclusion**. The Government agrees that financial exclusion is an important issue that needs to be addressed and that the FCA's efficiency and choice objective and the proportionality regulatory principle provide the mandate for the regulator to do so. However, a more formal have regard would be inappropriate as this is a matter of social rather than regulatory policy and therefore should fall to Government.
- **diversity** is discussed in Chapters 3 and 5.

Box 4.B: Consultation Question

11 What are your views on the (i) strategic and operational objectives and (ii) the regulatory principles proposed for the FCA?

Financial crime

4.32 Financial crime as a regulatory issue most often arises as a conduct (rather than prudential) issue. The Government has therefore decided that responsibility for taking regulatory action to counter financial crime will transfer to the new FCA.

4.33 Actions the FCA may need to take to counter financial crime will be taken in pursuance of one or both of its 'integrity' and 'consumer protection' operational objectives. This will involve the FCA using its regulatory powers to seek to counter the extent to which regulated business might be used for the purposes of financial crime (for example by requiring firms to maintain adequate policies and procedures to minimise the risk that they are used to facilitate illegal activities such as money laundering).

4.34 Reflecting the importance of this issue, the Government will give the FCA a free-standing duty, in discharging its general functions, to have regard to the importance of taking action intended to minimise the extent to which it is possible for regulated business to be used for a purpose connected with financial crime. More detail on the FCA's functions in this area is set out in Box 4.C.

Box 4.C: Financial crime

The FCA will be responsible for dealing with financial crime within the regulatory framework. It will be the competent authority specified for the purposes of the money laundering regulations and cognate legislation (and will also retain the FSA's powers of criminal prosecution for market abuse, as discussed below).

The FCA will also be the body that maintains the key links with the other actors in this area, including the Police, the Serious Fraud Office (SFO), the Serious Organised Crime Agency (SOCA), the National Fraud Authority (NFA) and in future the Economic Crime Agency (ECA) and National Crime Agency (NCA). The Government remains firmly committed to establishing the ECA; the Home Office is in the process of developing proposals on the ECA and will consult on them in the spring.

The FCA will also be the body operating FIN-NET, the cross-government fraud and financial crime network set up following and as a result of the collapse of BCCI and currently operated by the FSA alongside some of the bodies listed above. The PRA will also be a member of FIN-NET.

The PRA, while having no formal role in countering financial crime, will, as part of its core supervisory work, be alert to risk arising to its objectives from firms being used for or themselves engaging in criminal activity. It will need to work closely with the FCA to ensure that both authorities are well-informed and able to take action where necessary at the earliest opportunity.

Governance and accountability

4.35 The FCA will be established by adopting the legal corporate entity of the FSA, and will operate as an independent, non-departmental body, financed by fees paid by the financial services industry. The Government believes that this presents the most practical solution for ensuring efficient implementation, minimising disruption for affected staff and securing value for money.

4.36 As outlined in the July consultation document, the FCA will be governed by a Board with a majority of non-executives, appointed by the Treasury. A proportionate number of non-executives will be appointed jointly by the Treasury and the Department for Business, Innovation and Skills (BIS) to ensure that appropriate expertise in consumer and business issues is available to the board.

4.37 The legislation will require the FCA to have a board, Chairman, and Chief Executive. The Chief Executive of the FCA will be an ex-officio member of the PRA board and will also sit on the FPC. Future appointments to the post of Chief Executive will be made by the Treasury.

4.38 Respondents to the previous consultation were broadly supportive of the governance and accountability measures proposed in the July consultation, and particularly welcomed the proposal to subject the FCA to audit by the NAO. The Government will therefore provide for these measures in the new Bill.

4.39 Respondents also welcomed the Government's proposal that the FCA should retain the Practitioner and Consumer Panels, and put the Smaller Businesses Practitioner Panel on a statutory footing. They also suggested a separate markets panel be established. The Government will therefore legislate for Practitioner, Smaller Business Practitioner, Markets and Consumer Panels for the FCA.

4.40 Under the current structure, the FSA is required to maintain arrangements for the investigation of complaints, including a requirement for external investigation if the complainant is dissatisfied with the results of the FSA's internal investigation. The FCA will be required to have a complaints procedure, replicating the existing provisions of FSMA. As set out in chapter 3, the FCA and PRA will maintain separate arrangements for dealing with complaints.

4.41 In line with the Government's transparency agenda, the FCA will be fully subject to the Freedom of Information Act 2000 (FOIA). However, as with the PRA, some additional safeguards will be put in place to ensure that information can flow freely between the Bank and the FCA without undermining the limitations on the application of FOIA to the Bank of England. This is discussed in more detail in Chapter 2.

4.42 Respondents did, however, note that they would like to see even more engagement from the FCA. There were calls for more to be done around the transparency of the FCA, how decisions are made, and how these are communicated to firms and the public. The Government has reflected these concerns by highlighting greater transparency as an essential aspect of how the regulator itself behaves, both by enshrining it in the regulatory principles and by embedding it in the supervisory approach, where the FCA will have new powers of disclosure. In addition, the Government expects the FCA to engage more directly with consumers.

4.43 In addition, respondents also called for greater accountability to Parliament where things have gone wrong. As described in Chapter 3, the Government recognises that, where there has been a significant regulatory failure, it is appropriate that there should be a substantive analysis of what went wrong, and what lessons can be learned. It is also appropriate for Parliament and the public to be able to see this report and, where necessary, hold the regulator to account. Such a report would address the regulator's action and decision making and consider what lessons can be learned by firms and regulators. The Government is therefore setting out in legislation a new requirement on the FCA to make a report to the Treasury where there is a regulatory failure. The legislation will set out a trigger for when a report must be produced, and the regulator will be responsible for determining when the trigger has been met.

4.44 However, the Government recognises that it may be hard to define objectively in legislation a trigger based on a failure of conduct regulation. The Treasury and the FCA may disagree over whether a report has been triggered under this provision. The Treasury will therefore have a backstop power to be able to direct the FCA to produce a report where it considers that a report should have been triggered but the regulator failed to do so, and it will also have a power to direct production of a report when that would be in the public interest. Reports may include the disclosure of confidential information where this is justified in the public interest. The Treasury will subsequently lay this report before Parliament.

Box 4.D: Consultation question

12 What are your views on the Government's proposed arrangements for governance and accountability of the FCA?

Scope

4.45 As outlined in the July consultation document, the FCA will have responsibility for the conduct of business regulation of all financial institutions – approximately 27,000 firms – including those that are regulated prudentially by the PRA and those passporting in to the UK. This will include the conduct of firms when engaging with retail customers, and conduct between wholesale markets participants. In addition to its direct focus on retail products and services – and the Government is currently consulting on whether this focus should be expanded by transferring consumer credit regulation from the OFT – this broad scope will allow the FCA to take an integrated approach to conduct regulation, recognising the links that exist between wholesale markets and the products and services sold to retail customers.

4.46 The FCA will be responsible for regulating wholesale market conduct, covering the behaviour of market participants in the activity of trading or dealing on markets, and the behaviour of 'wholesale' firms both internally (for example, their governance, culture and controls) and in their dealings with customers and clients. The scope of markets regulation within the FCA will also include:

- enhancing the integrity of markets, protecting the interests of investors, and facilitating efficiency in the provision of services in line with the FCA's objectives;
- the regulation of issuers of securities subject to the listing regime operated by the UK Listing Authority; and
- oversight over providers of market trading infrastructure such as recognised investment exchanges (RIEs), which will continue to be regulated under Part XVIII of FSMA, and authorised persons operating multilateral trading facilities and other trading facilities.

4.47 Finally, the FCA will be the prudential regulator for the approximately 18,500 firms that will not fall within scope of PRA regulation and are not passporting in to the UK – including, for example, personal investment firms, investment management firms, authorised professional firms, providers of market trading infrastructure, non-bank mortgage lenders, and mortgage or insurance intermediaries.

4.48 Thus, the significant majority of UK firms will be solely regulated by the FCA for both prudential and conduct purposes. The remainder will be dual-regulated – by the PRA for prudential purposes and by the FCA for conduct issues. Coordination between the FCA's and PRA's supervisory and regulatory work, and how they will seek to minimise the regulatory burden, is set out in Chapter 5. But the FCA will itself also be responsible for ensuring that the coordination of prudential and conduct regulation is effective for the firms it solely regulates.

Box 4.E: Prudential regulation in the FCA

The FCA will be responsible for the prudential regulation of around 18,500 regulated UK firms that do not fall within the scope of PRA regulation. These firms will cover a wide spectrum of activities, ranging from small intermediaries to complex investment firms, major providers of market trading infrastructure and non-bank mortgage lenders. As a rule these firms will not individually pose a threat to financial stability, but some may, individually or alongside peers, play a significant role in particular markets or sectors.

Given the FCA's strategic and operational objectives, its prudential regulation will focus less on acting to avoid the failure of firms and more on preventing consumer detriment. In the event of failure, the FCA's main objective will be to ensure that customers are not disadvantaged and that risks to confidence in the UK's financial system are minimised.

For the great majority of firms, this will mean that the FCA will require them to demonstrate financial soundness by meeting a minimum capital requirement which should be sufficient to achieve an orderly wind-down. Prudential supervision of these firms will be mainly through baseline monitoring of returns and responding to alerts.

The FCA will, however, pursue more proactive and intensive prudential supervision for a very small population of 'prudentially significant' firms, where the FCA considers that the firm's failure could individually undermine any of the FCA's objectives. More detail will be given in the forthcoming FSA publication on the FCA's operating model.

A new approach to conduct regulation

4.49 The FCA will have a fundamentally different approach to that of the FSA in the way it intervenes to mitigate risk financial services. The FCA will have a lower risk appetite for issues affecting a whole sector, sub-sector or type of product – it will be less prepared to see detriment actually occur, instead seeking to act in a more preventative manner. This will entail, for example, proactively intervening earlier in a product's life cycle, with greater scrutiny of firms' product design and product governance complementing the traditional focus on sales and marketing, and the disclosure of information.

4.50 The FCA will also draw on wider sources of intelligence in identifying risk, including information provided by the FOS. This will be supported by the new provisions formalising the cooperation between the FOS and the FCA, as described in Chapter 6, which will enable the FCA to use the FOS more explicitly as a source of intelligence and require it to consider and act, if appropriate, on issues the FOS brings to its attention.

4.51 A more proactive, interventionist approach, will also imply a greater use of judgement, with the regulator using its expertise to judge where consumer detriment is most likely to occur, and intervene, on a forward-looking basis, accordingly. However, this approach does not mean that the FCA will pursue a zero-failure regime. This would imply that the regulator was seeking to eliminate all risks, effectively removing from retail customers any responsibility for their own decisions. The costs of such a regime would be likely to destroy the markets it sought to regulate. As noted by the TSC, this would not be a desirable outcome: "financial markets are primarily about the management and pricing of risk, not its removal".[4]

[4] *Financial Regulation: a preliminary consideration of the Government's proposals,* Treasury Select Committee, February 2011, page 4

Supervision of retail financial services

4.52 The FSA will in due course publish more information about the FCA's operating model and what is set out below may well evolve further. Nevertheless, it is expected that firms will notice a marked difference in supervisory approach, as the FCA places conduct, and more specifically the prevention of consumer detriment, at the heart of its operating model.

4.53 Building on the FSA's consumer protection strategy, the FCA will undertake comprehensive risk analysis and research to identify earlier the sources and nature of risks to retail customers. It will have a greater willingness to look widely for sources of intelligence, including to consumers themselves, about emerging risks (and will work closely with the FOS, as noted above).

4.54 While detriment can arise from misconduct in a single firm, significant detriment for retail customers is more often likely to arise from issues that affect a whole sector, subsector or type of product. Issues-based supervision will, therefore, play a major role in the FCA's approach, informing the way it will carry out supervisory scrutiny of firms. Where supervision identifies issues across a sector or group of firms, action can be taken by using existing regulatory tools, or the new product-banning or competition powers set out below.

4.55 Where issues-based supervision identifies problems in individual firms, the mechanisms will be in place to ensure that appropriate supervisory action is taken, including referral for enforcement action where appropriate. Credible deterrence will be a key aspect of the FCA's approach, and this is set out in more detail below.

4.56 Although issues based supervision will be the key pillar of the FCA's approach, supervisory contact on an individual firm basis will continue. All firms will be subject to a periodic review of their governance, culture and controls. For the vast majority of firms the main day-to-day contact with the FCA will be through a contact centre, as is the case in the FSA now for small firms, reflecting the size of the regulated firm population and in line with the need to use its resources efficiently. A small number of firms which pose a significant risk to the FCA's objective, because of, for example, the type of activities they carry out, their share of the market or the profile of their customers, will have a dedicated supervisor.

Intervention

4.57 In recent years a catalogue of product failures has resulted in unacceptable levels of retail customer detriment and shaken confidence in financial services. As noted earlier, the focus on monitoring the sales process and relying on the disclosure of information has not proven to be effective in preventing consumer detriment and protecting consumers.

4.58 The Government therefore believes that a more proactive, interventionist approach is essential to more effective retail conduct regulation, so that actual or potential risk is acted upon before it crystallises in significant detriment. A large number of consultation respondents were in favour of the FCA taking a more interventionist approach.

4.59 The Government recognises the concerns, expressed by other respondents, that earlier regulatory intervention in the product lifecycle could lead to less choice for retail customers and increase uncertainty for industry. However, the Government believes that an effective proactive intervention strategy will actually ease the regulatory burden and benefit both consumers and providers in the long-term. Issues will be addressed at an earlier stage, before they have widespread impact requiring lengthy investigations, costly legal proceedings and redress payments. Reputational damage to firms will also be reduced.

New product intervention powers

4.60 Where it has identified an issue with a particular product, the FCA will be able to take action using existing regulatory powers. For example, the FCA will be able to make rules to place requirements on products or product features; mandate minimum product standards; or restrict the sale of a product to a certain class of consumers. In many (or even most) cases, such action will be sufficient, particularly when combined with a lower risk tolerance.

4.61 However, the Government believes that as a credible conduct regulator, the FCA needs to have the tools to take even more decisive action, particularly in support of retail customers.

4.62 The Government believes that where the FCA identifies a serious problem with a product or product feature, it should be able to take timely and decisive action to ban it, if necessary. For example, the FCA should be able to intervene to block an imminent product launch or to stop an existing product from achieving volume sales to prevent retail customers from being harmed, rather than waiting to intervene until there is clear evidence of widespread consumer detriment.

4.63 The Government will therefore legislate to enable the FCA to make temporary product intervention rules for a period of up to 12 months with immediate effect, where it considers it expedient to meets its operational objectives. This will mitigate risks of consumer detriment arising or worsening during the time it takes for the FCA to introduce permanent rules.

4.64 The Government recognises, however, that it is important to strike an appropriate balance between enabling the FCA to act quickly to protect consumers, and providing an appropriate degree of certainty for firms. The Government considers that it will only appropriate for the FCA to undertake product banning in certain circumstances and in response to specific market failures. The Government will therefore legislate to require the FCA to publish and consult on a set of principles governing the circumstances under which it will use this new product intervention power. Importantly, these principles will also give greater clarity and certainty to industry about the FCA's expectations in relation to product design and product governance, and will codify the need for proportionate application of such a power to reflect that it is unlikely to be appropriate in relation to professional or wholesale customers.

4.65 The Government will also legislate to enable the FCA to make provision on the unenforceability of contracts made in breach of its product intervention rules, temporary or permanent. This will allow the FCA to make rules stipulating, for example, that any contract made in breach of a specific product ban will be void and the consumer will be entitled to recover any payment made under it.

4.66 The Government recognises that FCA action to ban a product could have potential consequences of concern to the PRA. The coordination mechanisms applying across the range of regulatory activity (described in more detail in Chapter 5) will therefore operate in relation to this power.

4.67 While representing an important new regulatory tool, it is important to note that neither the product-banning power, nor the FCA's more proactive and interventionist approach to regulation more generally, represents a move towards widespread product pre-approval. This would be very resource intensive, increasing the cost of regulation, and therefore potentially restricting access to more innovative or risky products. It would also represent an unacceptable transfer of responsibility for appropriate conduct of business from firms' senior management to the regulator.

4.68 Finally, while the proactive and preventative approach discussed above will be primarily focused on retail products and services, it will also involve greater consideration of risks and issues across the financial value chain, including how they are transmitted between wholesale and retail markets. It is important to remember that, in many wholesale markets, retail consumers have as much of an interest in the quality of wholesale conduct regulation as institutional investors or corporate clients, given that this is where their savings and pensions are ultimately invested. Dealing with these interactions and linkages will be part of the FCA's role as an integrated conduct regulator.

Box 4.F: Consultation question

13 What are your views on the proposed new FCA product intervention power?

Enforcement and redress

4.69 Even with a new focus on preventing consumer detriment, a greater willingness to intervene earlier and an enhanced regulatory toolkit, the FCA will not be able to prevent all consumer detriment. The new approach therefore needs to be supported by a strong set of powers to deal with situations where risk has crystallised and detriment has arisen, and a willingness to use them.

4.70 The FCA will be responsible for enforcing both its conduct and prudential rules. In its enforcement function, the FCA will carry forward the FSA's strategy of credible deterrence and a willingness to impose high fines, in order to encourage better conduct across the industry. With the shift to more issues based supervision, it is likely that the proportion of enforcement cases arising from the regulator's thematic work will increase, but as noted above the FCA will still take enforcement action against regulatory breaches identified during the course of firm-specific work.

4.71 The FCA will also have a greater willingness to use redress to secure better outcomes for retail customers who have not been treated fairly. The Government has commenced the FSMA s.404 powers to enable the regulator to require firms to review their past business where it appears that compliance failings have resulted in consumer loss, and for firms to pay compensation for this loss.

4.72 The FCA's actions in this area will be supported by new provisions formalising cooperation between the FOS and the FCA, as described in Chapter 6, which will ensure that the two bodies are duty-bound to work together, particularly where issues identified potentially have wider implications.

Transparency and disclosure as a regulatory tool

4.73 The Government believes that greater regulatory transparency and disclosure will be an important tool for the FCA.

4.74 Respondents to the July consultation stated that the FCA should be open in disclosing its views on market developments (e.g. trends in products or services) and what it observes by way of firm behaviour, both good and bad. The Government agrees that, building on work already initiated by the FSA (for example on firms' complaints handling) disclosure has the potential to be a powerful tool. Effective use of disclosure will enable the FCA to look beyond rule-book compliance and enforcement to more innovative ways to encourage good practice across the industry. Disclosure also enables the regulator to communicate with consumers about what it sees and what remedial action it is taking, thereby enforcing market discipline.

4.75 As signalled in the regulatory principles, the Government therefore expects the FCA to have a regulatory culture based on a presumption of transparency, so that it makes greater use of existing powers to make disclosures itself, or require disclosures by firms. The Government will reinforce this presumption of transparency by legislating to give the FCA new powers of disclosure in certain cases where it believes such powers could make a real difference to the regulator's ability to achieve its strategic and operational objectives. The Government however notes that the FCA, along with the PRA will be subject to restrictions (in accordance with the requirements imposed under European law) on the circumstances in which it may disclose confidential information.

4.76 However, the Government also recognises the importance of an open and honest relationship between firms and FCA supervisors, based on the appropriate treatment of confidential information. Untimely disclosure can have unintended consequences. The Government will therefore ensure that these new powers contain the necessary safeguards to ensure that an appropriate balance is struck between the interest of consumers and regulated firms.

4.77 The FCA's approach on transparency and disclosure will be complemented by a clarification of the FOS's ability to publish determinations, as described in Chapter 6. This should contribute to better overall consumer outcomes and greater confidence, while preserving the respective roles of the two bodies.

New power to direct firms to withdraw misleading financial promotions

4.78 Misleading advertisements can be a key source of detriment for retail customers of financial services, for example by failing to give an accurate description of the risks or costs associated with a product. Advertisements can often have an immediate impact, and so swift regulatory intervention is often necessary to prevent consumers from being harmed.

4.79 Regulating financial promotions is therefore an important part of the FSA's retail conduct work, and its general approach will be carried forward to the new regime. Nevertheless, the Government believes that there is significant scope to do more, particularly to make firms' conduct and the regulator's actions in this area more visible to the public.

4.80 A shortcoming of the current regime is that the FSA is not able to publish the fact that it has asked a firm to withdraw a misleading promotion, unless this action is the result of a formal decision or supervision notice.

4.81 While the FSA does a lot of work to enforce its financial promotions rules, this is not always evident to consumers, who do not know what action the regulator takes – often as a result of their tip-offs. Many consultation respondents cited this lack of transparency as an area of frustration, and argued that there was a missed opportunity here to impose greater market discipline around activities that the FSA considers 'bad practice'.

4.82 The Government agrees with stakeholders that greater visibility of the regulator's actions and decisions in relation to misleading financial promotions will increase confidence in the FCA's ability to protect consumers and increase regulatory accountability, and that greater transparency around misleading promotions will engender better practice across the industry by making firms' misconduct more visible.

4.83 The Government will therefore legislate to give the FCA a new power to direct a firm to withdraw or amend misleading financial promotions with immediate effect, and to publish the fact that it has done so. Under this new power, when the FCA considers that there has been, or is likely to be, a breach of its financial promotions rules:

- the FCA will notify the firm of its decision, directing the firm to withdraw its promotion (or approval) with immediate effect;
- after receiving the notice, the firm will have a short period of time to make representations to the FCA (during which time the financial promotion must remain out of circulation);
- after considering the firm's representations, the FCA's senior executive or committee will decide whether to confirm its direction;
- the FCA will give written notice to the firm of its final decision, and will have a duty to publish details of this notice, where appropriate; and

- the firm will have the right to appeal to the Upper Tribunal, during which time the promotion will stay out of circulation.

4.84 If a firm refuses to comply with a notice issued under this power, or repeatedly fails to comply with the financial promotions rules, the FCA will have recourse to its usual supervisory or enforcement options.

Early publication of enforcement action

4.85 As noted above, a strong enforcement function and a credible deterrence strategy will be a key pillar of the FCA's regulatory approach. Many consultation respondents called for a power (but not a duty) enabling the new regulators to disclose the fact that a warning notice (which signals the start of formal enforcement proceedings) has been issued.

4.86 The Government believes that greater transparency as to what enforcement action is currently underway would increase the impact of the regulators' enforcement work by highlighting potential issues to consumers at an early stage and signalling to firms what behaviours the regulator considers to be unacceptable and is an important feature of a transparent and effective regulatory system.

4.87 The Government will therefore legislate to allow for publication of the fact that a warning notice has been issued, and of a summary of the notice (including, for example, the grounds on which action is being taken). This new power will apply to both the PRA and FCA.

4.88 In practice, most enforcement action is taken with respect to conduct regulation, and the Government therefore expects the FCA to make greater use of enforcement powers than the PRA – not least because it will continue the credible deterrence strategy. The Government believes that publication of the fact that the FCA is proposing to take enforcement action against a firm or individual will increase the visibility of the actions it is taking to protect consumers' interests, while at the same time giving firms greater insight in to the actions taken and their eventual outcome. This will enhance consumer and industry confidence in the new regulatory system, and enable consumers to make more informed decisions.

4.89 The expectation is that the regulator will publish the fact that a warning notice has been issued, unless doing so would not be compatible with its operational or strategic objectives. However, the Government recognises the need for appropriate safeguards for this new power, given that the publication of information of this nature could cause reputational damage to firms or individuals where enforcement action is later discontinued. This new power will therefore include a safeguard to ensure that that there is procedural fairness for affected firms and individuals:

- while the expectation is that the regulator will disclose the existence of a warning notice, the regulator will have discretion rather than a duty to publish the fact that a notice has been issued or information about the notice;
- we would expect the authority to consider the impact of disclosure of information about a warning notice on the person subject to the warning notice (or indeed its own objectives) in considering whether to disclose information; and
- where the regulator decides to take no further action after it has made public the fact that enforcement has commenced, it will be required to publish the fact that it has issued a 'notice of discontinuance'.

Box 4.G: Consultation question

14 The Government would welcome specific comments on:

- the proposed approach to the FCA using transparency and disclosure as a regulatory tool;
- the proposed new power in relation to financial promotions; and
- the proposed new power in relation to warning notices.

New role and powers in competition

4.90 As discussed above, the Government agrees with consultation respondents and the TSC that the FCA should have a stronger role in competition than the FSA has had to date. This stronger role is clearly reflected in the FCA's remit and objectives. To enable the FCA to play a credible and effective role in competition, it is also important to ensure it has appropriate tools at its disposal. Effective interaction with the general competition regime will also be important.

Regulatory tools and competition

4.91 The FCA's new operational objective in relation to efficiency and choice, combined with the competition elaboration to its remit, will enable it to use its existing regulatory tools more clearly in pursuit of promoting competition. This will include, for example, the ability to make rules that will have beneficial competition outcomes.

4.92 Recent experience in the Payment Protection Insurance (PPI) market provides an example of a case in which such a competition mandate would have been useful in enabling the FSA to address competition issues in financial services in a more efficient and targeted way. Although a super-complaint was first launched by the Citizens Advice Bureau in September 2005, a package of remedies was not implemented until 2010. This followed an OFT market study, consultation and referral, and a further market investigation by the Competition Commission.

4.93 A key element of the Competition Commission's remedies was separating the sale of PPI from the sale of loans. This was mainly driven by competition concerns in this market caused by the "point-of-sale advantage" enjoyed by the provider of credit - that is, the benefit which certain lenders who offer PPI combined with their underlying credit products enjoy from having sole access to customers at the time that they are buying their credit. An explicit competition mandate such as that proposed for the FCA would have allowed the FSA to use its regulatory tools to take targeted action to intervene more swiftly in the market for the purposes of dealing with this, and other, competition concerns identified.

FCA powers in relation to competition law

4.94 In order to support its new objective and strengthen the work carried out by the FCA in this area, the Government believes that it is worth considering whether the FCA should also have additional new powers in relation to general competition law. In some cases it will be appropriate for the FCA to use specific regulatory powers to address a problem, but in others it may be better for the FCA to use general competition powers.

4.95 This, and how such general competition law powers would relate to specific regulatory tools, will need to be considered in the context of wider reforms to the UK competition framework. BIS will shortly launch a consultation considering the options for strengthening the competition regime and merging the Competition Commission and the competition and markets investigation functions of the Office of Fair Trading (OFT). This will include options for improving the use and coordination of 'concurrent' competition powers between the OFT and other sectoral regulators.

4.96 In this context, the Government is considering a range of options for FCA powers in relation to existing competition law and intends to bring forward more detailed proposals informed by BIS's review of concurrency. The options that the Government will consider include:

- a limited form of concurrency, for example powers to keep competition in the financial services market under review and where appropriate make a market investigation reference (MIR) to the Competition Commission. With MIR powers, the FCA could assess whether it was more appropriate to use its regulatory powers or to consider a MIR to address a specific issue. It would allow the FCA to agree legally binding commitments with the industry rather than making a referral, which could also speed up the process of taking action. If MIR powers were given to the FCA, it may also be appropriate for the FCA to have concurrent duties to respond to super-complaints launched by designated consumer bodies; or
- as an alternative to MIR powers, an appropriate body (for example, the FCA's Consumer Panel) could be given the ability to trigger the super-complaint process. When a super-complaint is made to the OFT (or sector regulators with concurrent obligations), this triggers a duty to publish a response within 90 days, stating what action, if any, it proposes to take in response to the complaint and giving the reasons behind its decision. This process is intended to be a fast-track system to ensure there is transparency about complaints about market failure which harms consumers.

4.97 Several sectoral regulators in markets which are concurrently regulated have powers (concurrent with the OFT) to enforce the Competition Act 1998 prohibitions on cartels and abuse of dominance. Given that the FCA will not be an economic regulator and in light of key differences between financial services and other sectors, however, the Government does not propose to provide the FCA with such powers.

4.98 Given the increased role of the FCA in competition matters, it will be important to put the relationship between the FCA and the competition authorities on a stronger footing. The detail of such arrangements or provisions will depend on which (if any) of the above options are pursued. The Government will come forward with more detail as the wider review of the competition regime is progressed.

Box 4.H: Consultation question

15 Which, if any, of the additional new powers in relation to general competition law outlined above would be appropriate for the FCA? Are there any other powers the Government should consider?

Wholesale and markets regulation

4.99 The preceding section has discussed a number of significant new proposals, presenting them primarily in the context of retail conduct regulation. These proposals include more proactive supervision and enforcement, new powers to intervene in specific product decisions, the use of transparency and disclosure, and new competition responsibilities.

4.100 Many of the proposals described above will also be directly relevant to wholesale conduct regulation. For example, much of the FSA's current work on wholesale conduct is already undertaken on an issues basis, and the FCA will continue to build on this experience in developing its wholesale conduct function. The use of disclosure and the new focus on competition will also be highly relevant to wholesale conduct issues.

4.101 At the same time, the Government recognises that greater intervention will generally be less appropriate for market participants at the sophisticated or professional end of the spectrum, who do not suffer from the same information asymmetries as retail customers, and for whom the *caveat emptor* principle is a fundamental part of doing business. In line with the proportionality regulatory principle, the Government therefore expects the FCA to take a proportionate and tailored approach to conduct regulation. The use of product intervention powers, in particular, may be less generally relevant in wholesale conduct regulation, depending on who is the target audience for the product or to whom it is made available.

4.102 However, making a sharp *a priori* distinction between retail and wholesale conduct regulation is neither straightforward, nor necessarily helpful. Indeed, the potential synergies from bringing retail and wholesale conduct together – particularly when products sold to retail customers are based upon instruments traded on wholesale markets – is one of the drivers behind the creation of the FCA as an integrated conduct regulator. But there are many circumstances in which wholesale activities do not contain an immediate retail dimension, and the approach to regulation will need to vary accordingly.

4.103 For example, a bank may be trading in interest rate swaps on behalf of corporate clients managing risk in relation to their overseas business. And it may also be trading in interest rate swaps as a way of managing interest rate risk arising from capped rate mortgages it is itself selling to retail customers. In the first instance, the FCA's regulatory approach would be likely to be based primarily on its interest in ensuring the efficiency of such trading and the integrity of the markets in which the trading takes place. In the second instance, the FCA might take a very different approach, viewing the activity from the perspective of the impact that it might have on the bank's mortgage customers.

4.104 As noted earlier in this chapter, the flexibility of the FCA's statutory objectives and remit, combined with the regulatory principle of proportionality, will enable the FCA to vary its approach to the regulation of wholesale activities appropriately. Given the contribution made by wholesale markets, not only to the position of London as a global financial centre, but also their importance to the economy as the mechanism by which capital is raised and risk managed, it will be vital to ensure that their regulation continues to be effective and proportionate.

4.105 The FCA's approach will include:

- continuing work to monitor the conduct of market participants and their dealings with one another and the impact on market efficiency and integrity. This will include consideration of level playing field issues, reflecting the FCA's new mandate of securing better outcomes and promoting greater competition; and
- the FSA's focus on the integrity of markets will be given new focus through the FCA's integrity objective, meaning that there will continue to be a strong focus on tackling market abuse and enforcing requirements under the listing regime.

4.106 The FCA will also be responsible for the regulatory oversight over client assets. Confidence in the protection of client assets was hit significantly during the financial crisis. The Treasury and the FSA have been working together to rebuild confidence and trust in the UK's client asset regulatory regime. The protection of client assets will remain a regulatory priority under the FCA as a core part of its programme. The new regulator will continue the intensive and intrusive approach adopted by the FSA's specialist Client Asset Unit to identify and mitigate risks.

4.107 As well as conduct regulation of wholesale activities, there are a number of specialised market regulation functions which the FCA will carry out. As discussed in the introduction to this chapter, the Government's general approach to these functions will be to transfer them largely intact and unchanged from the FSA to the FCA. The Government's approach to markets regulation also recognises the increasingly significant role played by European institutions, and particularly ESMA, in determining not only the form but also the substance of regulation in the markets sphere.

Enforcement

4.108 The FCA will be responsible for exercising the civil and criminal powers the FSA currently has under Part VIII of FSMA for tackling market abuse. The Government does not propose to make any substantive changes to these powers. As set out in the July consultation, the Government considered whether the FSA's criminal enforcement powers in relation to market conduct should be transferred to a new Economic Crime Agency (ECA), as part of wider improvements for tackling economic crime. The Government has decided that the FSA's powers of criminal enforcement will be transferred to the FCA to ensure that it can take a suitably robust and flexible approach to combating market abuse.

4.109 The Government remains committed to the ECA as a powerful new authority; the Home Office will be bringing forward detailed proposals for consultation in the spring.

Listing and the UKLA

4.110 As set out in the Government's consultation response document, published in November 2010, the Government has decided that the UK Listing Authority (UKLA) should remain part of the FCA. This decision has been welcomed by the TSC. The UKLA will play a key role within the new integrated conduct authority, focusing on primary market activity.

4.111 The main change to the listing regime and other primary market regulation will be to bring it under the general legislative framework of the FCA (rather than being solely contained in a discrete part of the statute), including by extending the application of the objectives and regulatory principles to the general functions under Part VI.[5]

4.112 Otherwise, Part VI will remain largely substantially unchanged. The regulatory reform Bill will, however, be used to make some minor technical improvements to Part VI. These will include:

- allowing the UKLA to discontinue or suspend a listing at the request of an issuer without following the warning notice and decision notice procedure – these procedures are onerous and unnecessary when the UKLA is agreeing to a request made by the issuer;
- extending the UKLA's powers to impose sanctions on sponsors for breaches of UKLA rules and requirements imposed on sponsors, to include the ability to impose financial penalties and to suspend a person's approval as a sponsor or restrict their activities, subject to the normal enforcement and appeal mechanisms in FSMA. Sponsors play a crucial role in listing which is important for protecting investors and maintaining the reputation of London's international markets;
- extending the limitation period for taking action for breaches of the listing rules from two years to three years – this ensures consistency with other similar FSMA provisions;
- allowing the UKLA to require a listed issuer to have a skilled person prepare a report on a matter in respect of which the UKLA could require information to be supplied

[5] This will be achieved by extending the application of the FCA's objectives and omitting Schedules 7 and 8 to FSMA which respectively apply and amend the application of various provisions in FSMA and confer powers on the Treasury to transfer the functions under Part VI to another body.

– this is an intermediate power between requesting information and launching a full external investigation and would enable the UKLA, therefore, to have certain matters investigated in a less onerous way for issuers;

- giving the UKLA the power to make rules for, and impose sanctions on, primary information providers (PIPs), organisations which channel news from issuers to the UKLA and announce information to the market. At present, the UKLA approves PIPs and sets conditions for them on a non-statutory basis. The proper flow of information is vital for maintaining market integrity and the reputation of London's international markets; and

- removing the provisions which allow the UKLA functions to be transferred to another authority – these are now redundant – and amending other provisions so that the UKLA functions are fully integrated with those of the wider FCA.

Recognised investment exchanges

4.113 The FCA will be solely responsible for the conduct and prudential regulation of recognised investment exchanges (RIEs) and operators of multilateral trading facilities (MTFs). MTFs, as authorised persons, will be regulated by the FCA in the normal way. They are not considered further in this section.

4.114 Following the consultation on this issue in the July consultation document, the Government has decided to retain the Part XVIII regime for recognised bodies, pending the outcome of the European Commission's review of the Markets in Financial Instruments Directive (MiFID). This review was launched towards the end of last year and it is likely that legislative measures (such as EU regulations or directives) needed to implement any resulting reforms would take effect about the same time as the regulatory reform Bill.

4.115 The Government proposes, therefore, that any substantive measures requiring UK legislation will not be included in the regulatory reform Bill, but will be implemented using section 2 of the European Communities Act 1972.

4.116 Nevertheless, the Government proposes to use the regulatory reform Bill to make a small number of technical improvements to Part XVIII. These include:

- simplifying the procedure for issuing directions and allowing the FCA to impose penalties on an RIE – other changes to enforcement powers may be made as part of ensuring that the FCA has the powers needed to enforce requirements imposed under European law;

- extending the information gathering powers; and

- removing the special competition regime in Chapter 2 and Chapter 3 of FSMA – in practical terms, this regime has been largely overtaken by a new procedure brought in under the Investment Exchanges and Clearing Houses Act 2006 allowing the FSA to prevent the introduction of excessive requirements in RIE rules. The competition authorities (OFT and Competition Commission) have sufficient powers to investigate competition concerns under their own legislation while EU law also applies to prohibit anti-competitive practices in RIE rules.

European representation

4.117 The FCA will hold the UK's seat on ESMA, and one of its most important functions will be to work within this body to ensure that European markets regulation – which is becoming increasingly detailed, across an expanding range of issues – effectively meets the needs of the City of London as Europe's leading financial centre.

4.118 It will be important, therefore, to ensure that the FCA has the credibility to represent the UK in relation to all matters covered by ESMA, including those for which other authorities are responsible in the UK – such as the Financial Reporting Council (accounting standards), and the Bank of England, which will be responsible for regulating systemic infrastructure (clearing houses and settlement systems), as described in Chapter 2. The Bank and FCA will ensure that there is effective coordination, particularly with respect to the FCA's role in representing the UK in ESMA in dealing with issues relating to clearing houses and settlement systems. The necessary coordination will be achieved through a memorandum of understanding which will cover the engagement of the Bank and FCA on systemic infrastructure issues which have an ESMA or conduct element.

Box 4.I: Consultation question

16 The Government would welcomes specific comments on:

- the proposals for RIEs and Part XVIII of FSMA; and
- the proposals in relation to listing and primary market regulation.

5 Regulatory processes and coordination

5.1 The Government's reforms will make financial regulation more effective in a number of ways:

- by creating, in the Financial Policy Committee (FPC), a new high-level body focusing entirely on macro-prudential and systemic issues: a focus that is clearly lacking in the current framework;
- by separating the regulation of significant micro-prudential risk from conduct of business issues, and locating this function – to be carried out by the new Prudential Regulation Authority (PRA) – alongside the new macro-prudential regulator, within the Bank of England group; and
- by ensuring that conduct and consumer protection issues receive the focus and expertise they need through the establishment of a dedicated, integrated conduct regulator in the form of the Financial Conduct Authority (FCA).

5.2 The previous three chapters have described these new regulatory institutions in terms of their fundamental purpose and approach, setting out detail on their objectives, regulatory and supervisory philosophies, and governance and accountability mechanisms. Much more detail on the philosophy and operating models for each authority – particularly on the operational matters which will be of significant interest to firms and were commented on in responses to the July consultation – will be published by the FSA and the Bank of England later in the spring, when the FSA launches its new operational model to foreshadow the PRA/FCA functional split.

5.3 In addition to the operational work being taken forward by the Bank and the FSA, the Government also recognises the crucial role of the legislative framework in providing the new regulators with appropriate tools and powers. As discussed in previous chapters, the Government's general approach to this issue has been to take the approach of the Financial Services and Markets Act 2000 (FSMA) as a starting point, and adapt it as necessary.

5.4 The Government also recognises that the process of creating a system of specialised prudential and conduct regulation will also mean that new legislative provisions will be needed to create coordination mechanisms ensuring that regulatory processes will operate effectively and efficiently. This chapter deals with this issue in detail.

Effective, efficient and well-coordinated regulatory processes

5.5 The majority of respondents to the July consultation supported the Government's proposal for improving the regulatory system through greater focus and specialisation. However, they also emphasised the importance of coordination between the new regulators.

5.6 The PRA and FCA will both have the remit and powers necessary to deliver their strategic and operational objectives. The overall purpose of coordination between the PRA and FCA must be to support the regulators in delivering their statutory objectives in an effective and timely manner, recognising that the PRA and FCA will be equal in status. The regulatory processes and coordination mechanisms outlined in this chapter are therefore underpinned by high level principles, which are intended to ensure that this overall objective can be delivered:

- there must be complete clarity around the ability of each regulator to take decisions within its areas of focus and expertise. This is vital not only to ensure the effectiveness of the regulatory authorities, but also to ensure that they are accountable for their decisions;
- the arrangements must enable the PRA and FCA to manage any conflicts that arise;
- regulatory 'underlap' (the risk that important issues and activities are neglected as they do not fall into either authority's jurisdiction) must be avoided, and regulatory overlap or duplication managed in a proportionate way;
- from the perspective of firms, coordination must result in regulatory and supervisory engagement that are cost-effective and mitigate the risk of duplication. Firms should not receive conflicting views from regulators;
- the arrangements should be sufficiently clear and flexible to allow for decisions to be taken in unforeseen or urgent circumstances; and
- neither regulator should be required to second-guess the other's statutory objectives but should be required to consult and take account of the other regulator's view and reconcile conflict with these as far as is consistent with its own statutory objectives.

5.7 The rest of this chapter sets out how these principles will be reflected in the legislation. The first section describes the general requirements on the PRA and FCA to ensure that they are working together effectively, building on the proposals set out in the July 2010 consultation document. The subsequent section sets out specific proposals for coordinating particular regulatory processes.

General duties of coordination between the PRA and FCA

5.8 The Government believes that the key to delivering effective coordination is to allow the PRA and FCA flexibility about how they engage with each other, rather than specifying onerous and bureaucratic processes in statute. The general duties of coordination build on the measures that were outlined in the July consultation document. They include:

- a statutory duty to coordinate the exercise of their functions;
- an obligation to prepare a Memorandum of Understanding (MoU);
- cross-membership of boards; and
- specific mechanisms to reduce the risk of regulatory actions threatening financial stability or the disorderly failure of a firm.

Statutory duty to coordinate

5.9 Consultation respondents stressed that coordination arrangements should seek to avoid duplicate or uncoordinated requests by the PRA and FCA that could lead to significant additional regulatory burden on dual-regulated firms. The Government agrees that this would be an undesirable outcome. The Government will set out clearly in primary legislation the legal responsibilities of each regulator. Where appropriate, this will include allocating specific responsibility for particular processes and regulatory decisions relating to dual-regulated firms or groups.

5.10 Additionally, the July consultation document proposed a number of mechanisms for ensuring effective coordination, including a requirement for the PRA and FCA to 'have regard' to each other's objectives. After further consideration, the Government believes that a broad requirement to have regard formulated in this way would not offer sufficient clarity as to how the impact on the other regulator's objectives would be identified and addressed. Neither regulator should be required to second-guess the views of the other; to do so would require each to consider matters which fall outside their own expertise or remit and could weaken the PRA and FCA's focus on delivering their own objectives.

5.11 Instead, the Government proposes that there should be a more positive and precisely specified legal duty on the PRA and FCA to coordinate their activities. This 'duty to coordinate' will have three main limbs:

- where the PRA is considering action that may materially impact on the FCA's achievement of its objective, it must consult the FCA for its views. Similarly, where the FCA is considering actions that may materially impact the PRA's achievement of its objective, it must consult the PRA;
- the PRA and FCA must consult each other where necessary, in order to take advantage of the other's expertise; and
- both regulators will be subject to a requirement to ensure that processes involving both regulators are managed congruently and efficiently. This would include, for example, taking steps to coordinate or combine supervisory activities to reduce unnecessary burdens on dual-regulated firms.

5.12 The duty to coordinate will be supported by a requirement in legislation that the PRA and FCA should agree and publish a Memorandum of Understanding (MoU) setting out how they will deliver the duty.

Memorandum of Understanding (MoU)

5.13 The legislation will set out a non-exhaustive list of matters that must be included in the MoU. The Government proposes that this should include the key areas where the regulators will need to coordinate in order to deliver effective regulatory processes, including:

- the role of each regulator, and how their roles are distinct;
- how the regulators will consult each other where they have a statutory obligation to do so;
- how the regulators will consult each other to avoid hindering each other's strategic objective;
- how the regulators will coordinate their interaction with firms where appropriate, including the gathering and sharing of information, to avoid unnecessary regulatory burden, in accordance with the regulatory principles; and
- how the regulators will coordinate their engagement with international and European regulatory bodies.

5.14 The legislation will specify that the MoU should be reviewed annually and that the Treasury should lay the MoU before Parliament whenever changes are made.

5.15 The Government's view is that these measures – a duty to coordinate and an obligation to produce an MoU – will put the PRA and FCA under a suitable statutory duty to arrange their regulatory activities in an efficient and non-duplicative way. These measures will also provide a mechanism to deliver this duty in a way that is transparent and supports accountability. The arrangements will be flexible enough to ensure that the processes and mechanisms can evolve over time, and will complement the specific requirements to coordinate regulatory processes, which are set out in more detail below.

Cross membership of boards

5.16 The July 2010 consultation document proposed that the Chief Executive of the FCA would sit on the board of the PRA and the Chief Executive of the PRA would sit on the board of the FCA. This proposal was broadly supported by consultation respondents, who recognised that the purpose is effective strategic coordination between the two regulatory authorities. The Government will therefore legislate for CEO cross membership on boards.

5.17 However respondents were concerned that this could blur the lines between the two bodies, leading to an erosion of their independence. The Government accepts that this would be an unsatisfactory outcome, and has considered limiting the involvement of each CEO – for example, by restricting their involvement in regulatory decisions. It is nevertheless likely that the CEOs will be able to make a substantial contribution by participating in the deliberations of the other's board, and the Government does not wish to stand in the way of this. To preserve the demarcation between the two bodies, however, this should not extend to voting on firm-specific decisions.

Box 5.A: Consultation question

17 What are your views on the mechanisms and processes proposed to support effective coordination between the PRA and the FCA?

Managing the risk of disorderly firm failure or threat to financial stability

5.18 The PRA and FCA will be distinct and dedicated 'centres of excellence', focused on delivering their own objectives. However, as discussed above, there are areas where the regulators will need to consult each other where they believe that their actions may impact materially on the other's achievement of its objective, and they must take account of these views.

5.19 The FCA will have a clear remit to act to promote confidence in the financial system by, for example, securing an appropriate degree of protection for consumers and protecting the integrity of the financial system. This will include the ability to impose requirements on a regulated firm, or in more serious cases to cancel a firm's permission, to address conduct failures (for example, for egregious and persistent conduct breaches or knowing involvement in financial crime activities) if that is the best way of meeting one or more of its operational objectives, even if the PRA's view is that the firm is prudentially sound.

5.20 Where a firm is dual-regulated, the objectives of the PRA and FCA will be closely aligned around the need to ensure that a firm does not fail in a disorderly way and that a threat to the stability of the financial system as a whole is minimised – as disorderly failure or instability would be harmful both to the PRA's strategic objective and the FCA's strategic objective.

5.21 For dual-regulated firms, it is the PRA that will have the expertise to judge whether a regulatory intervention is likely to lead to a firm or firms failing in a disorderly way. The PRA will also be able to consult other parts of the Bank group, including the FPC, to assess whether the action could lead to wider financial instability.

5.22 The Government expects that in most cases the PRA and FCA will be able to agree actions (joint and separate) aimed at protecting financial stability and confidence in the financial system, for example:

- delaying the FCA's action for a period of time, while the regulators (and possibly the management of the firm) take action to mitigate the risks of disorderly failure;

- where applicable, coordinating the imposition of the penalty with steps under the firm's recovery and resolution plan (RRP) – including making preparations for resolution using the special resolution regime (SRR) – or under the proactive intervention framework (PIF);

5.23 In practice, the Government expects that the FCA would take the advice of the PRA, as the regulator with greater expertise in prudential matters, in its assessment of whether an action poses an unacceptable risk of disorderly failure or impact on other firms. In taking this advice and determining its correct supervisory strategy, the FCA should nonetheless also aim to minimise consumer detriment.

5.24 However, where the PRA and FCA cannot agree an appropriate course of action, the Government considers that it is necessary to enable the PRA to prevent the FCA from taking actions where it considers that they are likely to lead to the disorderly failure of a firm or wider financial instability (on which the PRA may consult the FPC). This recognises the fact that the PRA will be best placed to make this assessment and thereby avoid outcomes that would be harmful to both regulators' objectives.

5.25 This will be a limited power. It could not be used to prevent the FCA from bringing about the closure of a firm, if that closure would be orderly. As noted by the TSC in their recent report,[1] it is also important that there should be transparency around use of the power. Therefore, the legislation will require:

- that the notification of the veto must be laid before Parliament, subject to considerations of public interest, including considerations of financial stability and confidentiality; and
- the PRA must report on the use of the power in its annual report, subject to the same considerations.

5.26 The Government believes that this is the right balance, allowing the PRA and FCA to act independently in pursuit of their objectives, while ensuring that the PRA is able to intervene where firms could fail in a disorderly manner with possible systemic stability consequences.

Box 5.B: Consultation question

18 What are your views on the Government's proposal that the PRA should be able to veto an FCA taking actions that would be likely to lead to the disorderly failure of a firm or wider financial instability?

Specific regulatory processes

5.27 The remainder of this chapter details how the roles of the authorities will be specified for those regulatory processes for which specific provision will be made in legislation. The principles mentioned above have been placed at the centre of these coordinating processes to ensure that each authority can remain focused without becoming excessively burdened with legislative processes.

5.28 This document does not set out the detailed day-to-day arrangements required to underpin the legislative requirements proposed – this will be for the authorities to do themselves – but answers a number of concerns raised in the responses to the previous consultation in relation to cooperation and coordination, in particular for group supervision. The Bank and FSA will publish papers on the PRA and FCA prior to the commencement of the legal powers, giving more detail

[1] *Financial Regulation: a preliminary consideration of the Government's proposals,* Treasury Select Committee, February 2011, page 47

on how the split of responsibilities will work in practice and building on the legislative proposals that are set out here.

5.29 The processes described below are those in which the FCA and PRA will both have jurisdiction over firms (with reference to their distinct conduct and prudential objectives). It should also be noted that the majority of regulated firms (by number) will be entirely regulated by the FCA, so will not be subject to any PRA oversight. Where these firms are not in groups with PRA firms, the coordination mechanisms described below will not be relevant.

Authorisation and variations to permissions

5.30 Authorisation is the process by which firms are granted the regulator's approval to conduct specific financial services activities set out in the Regulated Activities Order made by the Treasury under FSMA. For most firms, this is currently achieved by applying to the FSA for permission (under Part IV of FSMA) to conduct a regulated activity – although it is also possible to acquire authorisation in other ways, for example as a result of passporting in from another EEA state (see below).

5.31 Authorisation will continue to play a vital role in setting out clear expectations and standards for firms wishing to conduct regulated activities. For the PRA, the authorisation process should enable it to assess whether the firm will be capable of managing its business prudently and to evaluate the soundness of an applicant's proposed business model. The PRA will consider not just the regulated activity for which a particular application has been made, but also any risks to the applicant's financial soundness arising from the effect of the requested activity on other elements of its operations. As such, the PRA's prudential approval will extend to activities of a PRA firm that would not by themselves cause the firm to be PRA regulated.

5.32 For the FCA, authorisation will be an important means of ensuring that all new entrants to the financial services market meet the necessary conduct and consumer protection requirements (for example scrutinising firms' proposed products and distribution strategies to assess whether these are appropriate to the target market, and whether they create any mis-selling risk). Both elements of this process – prudential- and conduct-related – will be essential to ensure that each regulator can fulfil its objectives.

5.33 It is also important that the authorisation process is both practical and efficient for applicants. As part of their duties to have regard to the regulatory principles, the Government expects the PRA and FCA to work together to ensure that the authorisation process does not present inappropriate disincentives for firms wishing to enter the financial sector.

5.34 The Government proposes that for firms regulated solely by the FCA, the authorisation process should be operated by the FCA in much the same way as the FSA currently operates the Part IV process under FSMA. For dual-regulated firms – those firms which are regulated by both the PRA and the FCA, the Government's view is that the PRA and FCA must both give their consent to a firm's application in order for permission to be given. Two ways to achieve this outcome are described below.

5.35 To support this approach, the Government intends to give the FCA and PRA powers to designate sole or lead jurisdiction for one authority under each of the threshold conditions, providing clarity over each authority's considerations when determining whether individual firms should enter or exit the financial sector.

Lead proposal

5.36 The Government proposes to introduce a new stage in the authorisation process before permission under Part IV is given – the giving of 'prudential' and 'conduct' approvals. To obtain permission, an applicant would have to apply for, and be granted, both prudential and conduct approval. For those firms and regulated activities solely within the FCA's jurisdiction, the FCA would provide both approvals. For activities regulated by both authorities (such as deposit-taking), the FCA and PRA would each be required to give approval for the respective conduct and prudential requirements before the applicant could receive permission to undertake the activity in question.

5.37 If either authority declined to give its approval to an application, the applicant would not receive permission to conduct the regulated activity. However, the applicant would receive a decision notice setting out the reasons for why either or both of the authorities refused to give approval. This will provide a clear route for the applicant to appeal against an authority's decision, if it wishes.

An alternative approach

5.38 The arrangements outlined above provide for a process in which each authority considers an application for permission separately, with the final permission granted only when each authority has given its approval to the application. However, the Government considers that there may be advantages to considering whether one authority should be charged with processing each application, seeking the consent of the other authority on the areas where they have expertise prior to granting permission. As with the lead proposal outlined above, if one authority withheld its consent, the application would fall.

5.39 There are two ways that responsibility for processing and providing consent for applications could be divided between the authorities – either the FCA (as the regulator with scope covering all firms) could be responsible for processing applications (seeking the consent of the PRA), or the authority with prudential responsibility for the activity at the centre of the application could take on this responsibility. Both authorities would have the power to request further information from applicants as part of the application process, and would be able to interact directly with applicants.

5.40 Under either variant of this alternative approach, both authorities could withdraw or vary permission from the firms that they regulate (following consultation with their counterpart), but the PRA's veto over FCA decisions would still apply. Similarly, the authority responsible for the application process would also process any applications for variation of permission, but its counterpart would need to give its agreement to any variation of permission to undertake an activity over which it had jurisdiction.

Variation and removal of permission

5.41 Once a firm has been authorised, it may become desirable to vary or withdraw its permission. This may be at the request of the firm, a failure to conduct the regulated activity over the preceding 12 months, or a need to impose a condition or withdraw its permission altogether if the firm does not continue to meet its threshold conditions.

5.42 Currently the FSA administers changes to permission through two processes. The FSA uses the Own Initiative Variation of Permission (OIVoP) procedure if it wishes to vary a firm's permission without its consent. If a firm wishes to apply to vary its permission, they can apply for a Voluntary Variation of Permission (VVoP). The FSA's decisions in this area are subject to a range of procedural constraints set out in legislation, including the requirement for the FSA to give the firm adequate written warning of their decision (except in cases of urgency), and the opportunity for the subject of the decision to make representations to the FSA.

5.43 As with the authorisation process, the Government's view is that both regulatory authorities should be able to impose requirements that affect the nature of a firm's permission, in accordance with their strategic and operational objectives.

5.44 Therefore, the Government proposes to replicate the effect of the current conditions powers (the OIVoP and VVoP powers) so that the powers available to the FSA are available to both the PRA and the FCA. Each regulator would be able to remove a firm's permission to conduct a regulated activity if the institution no longer met one or more of the threshold conditions that the regulator was responsible for assessing. However, the removal of a key permission could well make a firm's business model unviable, bringing about its failure. To ensure that the regulators can take the steps that may be needed to mitigate the risk that this failure may be disorderly (and therefore impact on the soundness of other regulated firms or financial stability more widely), the PRA's veto (described above) will apply to the FCA's actions in this area in relation to dual-regulated firms. This ensures that the PRA would be able to exercise its expertise in matters connected with soundness of firms and financial stability, with a clear determining voice in discussions about the ongoing solvency of individual firms and measures to mitigate their disorderly failure.

Box 5.C: Consultation questions

19 What are your views on the proposed models for the authorisation process – which do you prefer, and why?

20 What are your views on the proposals on variation and removal of permissions?

Approved persons

5.45 Individuals that exert significant influence over an authorised firm by virtue of their position, or who carry on customer-facing functions are required to obtain approval from the FSA that they are fit and proper to undertake these 'controlled functions'. The process is important to the FSA's financial stability or consumer protection objectives and since the financial crisis the FSA has deepened and intensified its approved persons regime and clearance process.

5.46 Given the risks that inadequate management can pose to the soundness of regulated firms and to their customers, the new regulatory authorities will continue to conduct prior scrutiny of individuals undertaking controlled functions. This scrutiny will need to be both coordinated and effective.

5.47 For firms regulated only by the FCA, the FCA will have full power to designate controlled functions (subject to conditions similar to those currently set out in FSMA) and to approve individuals to undertake those functions.

5.48 For firms regulated by both the FCA and the PRA, the Government proposes that lead responsibility for controlled functions will be split between the PRA and the FCA in line with their objectives. Both authorities will have the power to specify new controlled functions and to approve or prohibit any individuals from carrying on these functions or regulated activities. The PRA would lead on designation (subject to relevant conditions) and approvals of all controlled functions connected to the prudential soundness of a regulated firm (e.g. Significant Influence Functions such as the Chief Executive Officer) consulting the FCA where it has an interest in a particular function, but having the final say on the approval decision. Similarly, the FCA would lead on all functions concerned with a firm's interface with customers (e.g. client assets, anti-money laundering), consulting the PRA where it has an interest.

5.49 However, regardless of which authority led on an application for approval, both authorities will have the power to ban an approved person working in a dual-regulated firm.

Box 5.D: Consultation question

21 What are your views on the Government's proposals for the approved persons regime under the new regulatory architecture?

Passporting

5.50 Under the single market directives[2], financial services firms authorised by their home regulator in EEA area states are able to carry out financial services in the UK, through establishing branches, without having to obtain separate authorisation from the FSA. This ability to 'passport' means that FSA powers in relation to the UK branches of these firms are largely limited to regulation of conduct of business issues, as the home state regulator retains responsibility for prudential requirements and compliance with prudential standards. However, the exception to this is liquidity where the host state prudential regulator will be responsible for the setting of liquidity standards within the UK, and will supervise this in cooperation with the home state regulator.

5.51 Moreover, as a general matter the PRA will consider the impact of cross-border firms on UK financial stability while they are carrying out business within the UK, and will take action where required, including referring issues back to home state regulators and other international bodies as appropriate. When combined with the passporting regime, this means that the PRA will work closely with the home state regulators of those firms which have branches in the UK to ensure the financial stability of the UK system, even where its own powers are limited in respect of prudential issues.

5.52 The FCA will have regulatory responsibility in relation to conduct of business matters for all branches within the UK and so will also have responsibility for the passporting process and administrative oversight of firms which have passported into the UK. It will therefore receive all notifications from overseas regulatory authorities.

5.53 Where a UK-authorised firm is passporting financial services out of the UK through a branch, the relevant prudential authority will be responsible for issues relating to financial soundness. The FCA will be responsible for all conduct issues, where relevant.

Box 5.E: Consultation question

22 What are your views on the Government's proposals on passporting?

Mutual organisations

5.54 The Government is clear that neither regulatory authority should seek to promote or favour one type of ownership model over another, and that consumers should not be advantaged or disadvantaged because of the ownership model of their provider. The same consumer protection, conduct and prudential standards must be applied to every regulated firm, regardless of their ownership model.

5.55 In order to ensure that a 'level playing field' operates across the financial system, the Government will modify the consultation requirements for both the PRA and FCA so that they must provide not only an analysis of the costs which will arise from a proposed rule, but also an analysis of the extent to which those costs (and benefits) affect mutually-owned institutions differently to other ownership models; this analysis will be undertaken alongside the usual cost-benefit analysis. This will serve to build up an impartial evidence base so as to assist the regulators, the public and Government in understanding whether the legislative framework continues to treat diverse financial business models appropriately.

5.56 The Government is also considering the location and suitability of the functions and powers which are currently allocated to the FSA as registrar of mutual societies (including

[2] Listed in Schedule 3 of FSMA as: the Banking Consolidation Directive, the Insurance Directives, the Reinsurance Directive, the Markets in Financial Instruments Directive, the Insurance Mediation Directive, the UCITS Directive.

building societies, friendly societies, credit unions and industrial and provident societies). As a number of the powers currently allocated to the registrar are prudential in nature (for example, the ability to direct a transfer of engagements), it may be appropriate for these powers to be allocated to the prudential regulator rather than the registrar. Furthermore, it may be desirable to transfer responsibility for registration of industrial and provident societies outside of the financial regulatory perimeter. In particular, there may be a case for transferring registration of those societies which do not do financial services business, to avoid the misleading impression that these firms would be subject to conduct and prudential scrutiny on the same basis as firms conducting regulated activities. Options could include transferring these responsibilities to an alternative regulator or for the Government to work with the mutuals sector to establish a sector-led body which would be responsible for registration. The Government would welcome respondents' views on these issues, including respondents' views about other bodies – in the form of other regulators or alternatively sector-led entities – who could take on responsibilities for registration of non-financial mutuals.

5.57 In considering the appropriate location of the registrar functions for different types of mutual, the Government will have particular regard to minimising the burdens that may be placed on mutuals should it be appropriate to divide registration and regulation functions.

5.58 The Government also intends to make a small number of minor amendments to legislation affecting building societies, including allowing building societies to grant floating charges in favour of payment and settlement systems, and widening the range of mutually owned institutions to which the FSA can direct that a building society transfers its business without a full member vote if the regulator considers a merger expedient in order to protect the investments of shareholders or depositors.

Box 5.F: Consultation question

23 What are your views on the Government's proposals on the treatment of mutual organisations in the new regulatory architecture?

Ongoing supervisory processes

Rule-making

5.59 Both the PRA and the FCA will have the statutory power to make rules that apply to regulated firms within their jurisdiction. When dealing with dual-regulated firms, the PRA and FCA may both make rules applying to the same functions within individual firms (e.g. their systems and controls). It is important, therefore, that the PRA and FCA consult each other prior to making such rules, to ensure a consistent and coordinated approach.

5.60 Both authorities will only be able to make rules in pursuance of their objective – for example, the PRA could not make rules primarily aimed at consumer protection or market conduct, and the FCA may not make prudential rules applying to dual-regulated firms. As such, the authorities' distinct objectives should reduce the risk of overlap.

5.61 Where the authorities disagree about the way to proceed following consultation, they may consult the FPC if the disagreement relates to the authorities' assessment of the impact of a rule on financial stability. The FPC can then make recommendations to the authorities, on a 'comply or explain' basis if it wishes. While the FPC's advice may offer a conclusive view on the appropriate resolution to a disagreement (leading to a recommendation with which both authorities would subsequently comply), in any event the PRA will also be able to veto a rule proposed by the FCA if it considers that it would risk the disorderly failure of a dual-regulated firm or affect financial stability more widely.

Rule waivers

5.62 At times it is necessary for rules to be either waived or modified in relation to a certain firm or group of firms. A rule can currently be waived at the request of the firm itself or if the FSA thinks it is inappropriate or unduly burdensome for the firm(s) affected to have to comply with that rule – for example, to allow firms to use capital models more appropriate to their business where those deviate from international standard models.

5.63 Each authority will also be able to consent to the modification or disapplication of the rules that it makes. When this is in relation to a firm which is regulated by the PRA or a member of a group which includes a dual-regulated firm, each authority must consult the other prior to issuing a direction approving the amendment.

5.64 If the rule modification or waiver only affects firms which are prudentially regulated by the FCA, the FCA will still be required to consult the PRA if it considers that the proposed action could threaten financial stability. As set out above, the PRA will be able to veto any proposed FCA action to prevent the disorderly failure of a dual-regulated firm or on grounds of financial stability. This will also extend to an ability to veto rule waivers or modifications on a firm-by-firm basis where necessary.

Box 5.G: Consultation question

24 What are your views on the process and powers proposed for making and waiving rules?

Supervision of financial groups

5.65 When carrying out supervision of an individual firm, effective supervision will also take into account the relationship, and interaction, between the firm and the rest of its group, whether authorised or not. In this way, regulators will gain an understanding and be able to assess and mitigate how risks interact within a group, and how they might aggregate to cause instability to regulated firms within the group. This type of supervision is primarily concerned with prudential risk, including any prudential spill-overs resulting from conduct risk (for example, the risk that a conduct liability might be so significant as to threaten the stability of the firm).

5.66 Various EU Directives,[3] informed in part by the Basel Concordat, require the 'consolidated supervision[4]' of firms carrying out specified activities within a group. For example, the Banking Consolidation Directive requires that supervision of all banks and investment firms within a group be consolidated. These Directives also set out which regulator should be the consolidated supervisor of a group – e.g. for banking and insurance groups, and investment banking groups for which the PRA has been designated as prudential supervisor, this will predominantly be the PRA. However, these Directives are not intended to result in exhaustive or exclusive consolidation of firms in the group. Some firms within the group may not be included in consolidation at all, whereas other firms may be covered more than once as part of different consolidated units within the group.

5.67 Where 'solo' prudential supervision of firms within the consolidation group is split across the PRA and the FCA, the regulators will coordinate their activities appropriately to carry out effective consolidated supervision, consulting each other as appropriate, as required by the general duty to coordinate. As a backstop, the Government is proposing that the authority

[3] Banking Consolidation Directive, Capital Requirements Directive, Insurance Groups Directive, Financial Conglomerates Directive

[4] Under the Insurance Groups Directive, this is referred to as 'group supervision', although the same concept is meant, and this is therefore included within the definition of 'consolidated supervision' within this document.

responsible for consolidated supervision should have a power of direction over the other authority, should that be necessary.

5.68 This power of direction will be subject to a number of conditions and limitations.

- first, the consolidated supervisor will only be able to use the power of direction where necessary to ensure effective consolidated supervision; and
- second, because of the significant complexity of many financial groups, which frequently include a large number of regulated and unregulated firms, there is a risk that the use of such a power could have unintended consequences. Therefore, the power of direction will only be available where a consolidation group exists under EU law. In this way, the consolidated supervisor will only be able to use the power of direction in relation to an authorised entity.

5.69 The power of direction will be subject to certain additional procedural safeguards. It will be necessary for an authority to consult with its counterpart prior to issuing a direction and for further consultation to take place where there are procedural requirements to do so. Once the firm has responded, this response will be relayed to the relevant authority who will then issue the direction formally or amend it. A copy of all directions will be provided to those firms which are affected by them and all directions will be published, subject to a public interest requirement, i.e. withholding disclosure where deemed necessary in the public interest.

5.70 The PRA veto in relation to financial stability or disorderly firm failure will apply to directions given by the FCA to the PRA. While it is necessary to ensure that it is possible to carry out effective consolidated supervision, and in certain cases the consolidated supervisor will be the FCA, the Government is of the opinion that preserving a stable financial system is essential. Given that the trigger for the use of the PRA veto will be set at a higher bar than the trigger for the use of the power of direction, this is consistent with the PRA's veto power over other FCA actions which could cause financial instability.

5.71 Although consolidated supervision is required by EU law, the limits placed around the inclusion of entities within these groups mean that it may also be appropriate to carry out supervision on a wider basis: 'group supervision'. This is intended to provide a more complete picture of the group as a whole. Group supervision enables the regulators to take a view of risks across the group as a whole, or across all relevant financial firms within the group (regardless of whether they are covered by EU consolidation requirements).

5.72 As a matter of practice, the FSA currently tends to carry out consolidated supervision with reference to the wider group, effectively subsuming consolidated supervision into its supervision of the group as a whole. The proposed approach to regulation of groups will continue to provide this discretion if the new regulatory authorities wished to continue this practice. The decision on which regulator leads on group supervision will be for the authorities to determine on a case-by-case basis, subject to the general provisions on coordination described above,[5] but the power of direction will not apply if there is no consolidation group present within the group under EU law.

Unregulated holding companies

5.73 Where there is a parent undertaking within the regulatory group structure, which is itself not regulated, but controls and exerts influence over an authorised person, it is proposed the supervisor will have a power of direction over that entity in certain circumstances. This will ensure the regulatory framework for the supervision of financial groups is applied as intended so

[5] In many cases the regulator leading on group supervision will also be responsible for consolidated supervision as the entities within the group are all also members of the consolidation group, for Directive purposes.

that the same level of oversight and supervisory powers can be applied irrespective of the legal structure of the group.

5.74 Where the regulatory authority considers it is desirable for the purposes of fulfilling its statutory objective, it will be able to use this power of direction over the UK unregulated entity that exerts control or influence over the authorised person.

5.75 Before applying the power of direction the regulatory authority must consider the tools it has available against the authorised person in the first instance, and only then apply the power of direction where those tools available at the level of the authorised person would not be effective.

5.76 The power of direction will be subject to certain safeguards, comparable to those available currently to authorised persons who are subject to similar powers, namely:

- a requirement to consult the affected firms, whether regulated or not;
- a right of appeal to the Upper Tribunal; and
- a notice warning of the potential application of a power of direction.

5.77 Where there is mutual interest in the affected firms (i.e. the firm is dual-regulated or part of a group which contains a dual-regulated firm), the PRA or FCA will be required to consult with its counterpart prior to issuing a direction. A statement of practice will also be issued by the regulatory authorities as to how this power will be exercised.

Box 5.H: Consultation question

25 The Government would welcome specific comments on

- proposals to support effective group supervision by the new authorities – including the new power of direction; and
- proposals to introduce a new power of direction over unregulated parent entities in certain circumstances?

Change of control

5.78 Where an individual or a firm wishes to acquire or increase their holding in a regulated firm above certain thresholds, they must first notify the regulatory authority which has the power to object to the acquisition. Consistent with EU law, the authority can only object to an application on the basis of the criteria specified in section 186 of FSMA, or if an incomplete set of information is provided with the application. Notification requirements also apply where a person wishes to reduce or divest their holdings.

5.79 As the criteria which the regulatory authority has to assess the application against are primarily of a prudential nature, including the financial soundness of both the person wanting to acquire the holding and whether the regulated firm will be able to continue to meet regulatory requirements post acquisition, the relevant prudential supervisor of the firm in which the holding is being acquired will consider change of control applications, i.e. for dual-regulated firms the PRA will consider applications, while the FCA will consider all others.

5.80 As both authorities will have a general interest in change of control applications where the firm is dual-regulated or part of a group in which a dual-regulated firm sits, in these circumstances the lead authority will be under a statutory duty to consult its counterpart authority, and overseas regulators where necessary. For a dual-regulated firm, if the FCA objects to an application on grounds of the risks of money laundering or terrorist financing, then these objections will mean that the application will be refused, or approved subject to certain requirements. This is because anti-money laundering is primarily a conduct-focused issue, as current rules focus on the relationship between the firm and its customers and counterparties, and so the PRA will need to defer to the FCA's greater expertise in this area. For a firm which is prudentially regulated on a solo basis by the FCA but is also in a group with a dual-regulated entity, if the PRA objects to an application on grounds of the post-acquisition entity's ability to meet its prudential requirements, or the regulator's ability to supervise the group containing the post-acquisition entity, the application will be refused. Where, for example, in the case of a group reorganisation, a transaction involves the change of control of several regulated firms, if the PRA approves a change of control in relation to a firm which is dual-regulated, the FCA will be expected to have regard to the PRA's prudential assessment before making its own decision in relation to any of the FCA firms for whom approval is required.

5.81 The PRA and the FCA will also have the power to impose conditions in respect of an application, as is currently the case, although these conditions are subject to certain restraints[6].

Part VII transfers

5.82 The process currently detailed in Part VII of FSMA sets out a framework to enable the transfer of insurance and banking business. Under the current Part VII mechanism, the courts are ultimately responsible for approving or rejecting an application for a business transfer, while the FSA has the right to make representations to the court and is responsible for approving the relevant necessary documentation. In practice, the regulator will be aware of the transfer prior to the application being made to the courts as firms will hold preliminary discussions with the regulator. It is compulsory to use this process for transferring insurance business and optional for banking business. It is the Government's view that these arrangements work well, so the Government does not propose altering the substance of the current framework.

5.83 It is clear that both authorities will have an interest in relation to a transfer of business. Although it is primarily a prudential process and there is a need to ensure that the resulting entity (after the transfer has taken place) is financially sound, sufficient consideration needs to be given to how the transfer may affect customers of the firms. As such, while the PRA will be primarily responsible for the process, the FCA has an interest and so will need to satisfy itself that the transfer will not adversely affect, as a minimum, the customers of the firms involved in the transfer.

5.84 Although both authorities will have an interest in the outcome of a Part VII transfer and both will be able to make representations to the court during the transfer process, the transfer process only applies to firms which are prudentially regulated by the PRA (banks and insurers), and is principally concerned with prudential matters. Therefore, the PRA will have responsibility for specific regulatory duties connected with Part VII applications, although the ultimate decision of whether to approve a business transfer or not will remain with the courts. The PRA will be responsible for:

- issuing solvency certificates and other notifications, such as to overseas regulators;
- approving press notices and the form and content of information provided to policyholders; and
- approving the independent expert to produce a scheme report for an insurance transfer, as well as the form which the report will take.

5.85 As the second and third of the responsibilities detailed above involve consideration of policyholder impact and detriment, the PRA will be required to consult with the FCA on these

[6] 1) The Authority may impose conditions on its approval of an acquisition; 2) The Authority may only impose conditions where, if it did not impose those conditions, it would propose to object to the acquisition; 3) The Authority may not impose conditions requiring a particular level of holding to be acquired; 4) The Authority may vary or cancel the conditions.

issues. To support this, both the PRA and FCA will be able to apply to the court for an independent actuary's report to be carried out after the transfer has been approved by the court, as is currently the case within section 113 of FSMA. This report will provide important analysis on possible policyholder detriment, enabling the PRA and FCA to prepare their supervisory strategies accordingly.

Box 5.I: Consultation questions

26 What are your views on proposals for the new authorities' powers and coordination requirements attached to change of control applications and Part VII transfers?

Other processes

Insolvency

5.86 Insolvency proceedings are overseen by the courts and triggered by firms themselves (a voluntary winding up), the regulatory authority or by a third party. It is important that the authority – or authorities – responsible for supervising the firm are informed about proceedings brought by either a third party or the other regulatory authority so that they can exercise their right to receive information from the insolvency practitioners or from the petitioner.

5.87 Subject to the constraints described below, both authorities will be able to initiate insolvency proceedings against an authorised firm (administration, winding up, bankruptcy) and to make representations in court during insolvency proceedings. Each authority must notify the other if it is planning on participating in insolvency proceedings, or applying to commence insolvency proceedings against a dual-regulated firm.

5.88 Where either authority wishes to bring insolvency proceedings against a bank or building society, it must apply for a bank (or building society) insolvency order, as set out in the Banking Act 2009. As discussed in Chapter 2, in doing this either authority would have to gain the prior consent of the Bank of England.

5.89 Where the FCA is proposing to begin insolvency proceedings against a dual-regulated firm that is not a bank or building society, it will be required to obtain the PRA's consent. Where the firm is not dual-regulated itself but is in a group with a firm which is prudentially regulated by the PRA, the FCA will have to consult the PRA prior to applying for insolvency proceedings to begin. In this way, the PRA will be aware of the FCA's proposed actions and will be able to prepare for possible consequences.

5.90 The PRA's veto over FCA decisions that may risk disorderly failure of a firm or wider financial stability will operate over proposed insolvency action by the FCA.

Life insurers

5.91 To ensure continuity of policyholder protection, the FSA is currently required to agree to any voluntary winding up of a life insurer. Although the original aim of this provision was to protect policyholders, there are clear prudential, and possible financial stability, implications associated with the winding up of a life insurer. The Government will consider the most appropriate division of responsibilities between the PRA and the FCA in this area, in the context of its wider work to ensure that insurance firms are recognised appropriately within the regulatory framework.

Box 5.J: Consultation question

27 What are your views on the Government's proposals for the new regulatory authorities' powers and roles in insolvency proceedings?

Actuaries and auditors

5.92 Currently, there are a number of legislative provisions relating to the disclosure and flow of information between actuaries and auditors of regulated firms and the FSA – which enable the FSA to benefit from the expert opinions of these professions. These arrangements will remain in place for both the FCA and the PRA. As the TSC notes in its recommendations, it is important for both authorities to work closely with the audit and actuarial professions, and to be able to take full advantage of the information, expertise and insight which they offer in relation to authorised persons.

5.93 Both the FCA and the PRA could have an interest in information which could be provided by actuaries and auditors acting on behalf of authorised persons. It may be useful for each authority to be able to rely on external validation or an external viewpoint for some of the practices of the regulated firms – for example to enable the FCA to benefit from external analysis of investment practices within investment firms.

5.94 As such, the rule-making powers in relation to actuaries and auditors will be given to both authorities. However, as the PRA is the prudential authority and actuarial and audit work is often likely to focus on the financial soundness of regulated firms, the PRA will be responsible for rules that cannot be easily classified as conduct or prudential. Each authority will enact, monitor and enforce its own rules, and where these impact on firms regulated by both authorities there will be a duty to consult both the other regulatory authority and the impacted firms themselves.

5.95 If an actuary or auditor fails to comply with a duty imposed on them under FSMA, the regulatory authority can disqualify them from acting on behalf of an authorised person, or a class of authorised person. Both the PRA and the FCA will have this power. However, as it has become common practice to appoint a firm of actuaries or auditors, as opposed to a designated individual, it will be made clear that the regulatory authorities will have the power to disqualify any individual professional they deem to have failed to comply with the duties under FSMA, irrespective of whether they were appointed as an individual or were representing their firm.

5.96 The PRA's veto will apply to any FCA action in relation to auditors and actuaries, although it is highly unlikely that it would be needed in this area.

5.97 These provisions will also apply to the relevant professionals acting for the members of Lloyd's of London who, although not authorised persons themselves, are regulated as part of the market.

Fees and Levies

5.98 For the regulatory authorities to be able to function effectively and efficiently, it is important that they are able to raise appropriate funding to cover their own costs. Fees are currently collected by the FSA in relation to its regulatory activities, following appropriate consultation with industry. However, it may be the case that certain sectors are subject to special project fees, such as those which the insurance sector was subject to in order to cover the costs of the implementation of Solvency II, or those costs involved in Part VII transfers.

5.99 Within the new regulatory structure, it will be essential for the PRA and the FCA to use their resources efficiently in order to keep their costs down. As is currently the case, allocation of fees will also need to be considered thoroughly, and will be especially important for those smaller firms which will be subject to regulation by both authorities, and so will have to pay two sets of fees. Therefore, there is a need for effective coordination between the two authorities. Each authority will have to abide by the principle of proportionality in setting its fee structure, and will need to be able to demonstrate how consideration has been given to the impact that it may have on relevant sectors of the financial services industry.

5.100 The Government is proposing that the current arrangements for the collection of fees are replicated within the new regulatory structure. Each authority will have the power to charge fees to those authorised persons which it regulates, and this will remain subject to a consultation requirement with industry and the counterpart authority.

5.101 The FSA is currently responsible for raising levies to fund the associated bodies: the Financial Services Compensation Scheme (FSCS), the Consumer Financial Education Body (CFEB) and the Financial Ombudsman Service (FOS). Also, in its role as the registrar of mutuals, the FSA charges an annual fee to maintain the mutuals register.

5.102 Due to the inherent linkages to consumer protection, the FCA will be responsible for raising the levy in relation to CFEB and the FOS, as well as being responsible for the levy for the registration of mutuals, depending on the location of the registration function. However, the OFT regime already imposes FOS levies on consumer credit firms and the OFT will have powers from April 2011 to levy consumer credit licensees or applicants to meet a proportion of CFEB's costs. If the responsibility for consumer credit is transferred to the FCA, the FCA would be the one body responsible for collecting these fees. In relation to the FSCS, both authorities will have the power to make rules (albeit only in relation to the sub-schemes for which they have responsibility) and therefore raise levies.

5.103 It is expected, however, that while the PRA will levy its own fees, a non-statutory arrangement will be put in place for the collection of fees through one organisation, similar to that which currently exists in relation to the collection of the FSCS levy by the FSA.

Box 5.K: Consultation question

28 What are your views on the Government's proposals for the new authorities' powers in respect of fees and levies?

6 Compensation, dispute resolution and financial education

6.1 The Financial Services Compensation Scheme (FSCS), the Financial Ombudsman Service (FOS) and the Consumer Financial Education Body (CFEB) provide important functions that underpin consumer and market confidence in financial services, and which thereby help to secure better consumer outcomes. The FOS and the FSCS help to protect consumers when things go wrong, by giving consumers access to independent adjudication where a dispute arises with a provider and offering compensation or pay-out if a firm goes into default. The CFEB, soon to be called the Money Advice Service, performs a more preventative function and aims to help rebalance the information asymmetries consumers face when making financial decisions and dealing with providers. This chapter sets out how the Government intends to reflect the roles of the FSCS, FOS and CFEB in support of the new arrangements for financial regulation.

6.2 The Government remains committed to a model in which the bodies responsible for compensation, dispute resolution and financial education are operationally independent of the regulators. Each of these bodies should continue to have a single focused objective or function which ensures their actions and decisions are unbiased and, rightly, are not directly influenced by wider regulatory considerations. This enables these bodies to provide the right outcomes for consumers.

6.3 However, the Government also recognises that the objectives of both regulators – the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) – will interact with those of the FSCS, FOS and CFEB. As set out in Chapter 3, the PRA has a remit to contribute to the promotion of the stability of the UK financial system; this will include minimising the adverse impacts, should a PRA-regulated firm fail. It will rely on the FSCS paying out to consumers quickly to help it deliver this objective.

6.4 Furthermore, as set out in Chapter 4, the FCA will have a remit to enhance confidence in the UK financial system, including for retail consumers. Effective arrangements for resolving disputes and paying compensation when things go wrong are key to ensuring consumers have confidence in the financial system. Financial education and money advice will also help to underpin confidence: consumers will be able to engage confidently with financial services if they have a better understanding of their financial needs and the products which are suitable for them. The FSCS, FOS and CFEB will, in fulfilling their specific functions, help to contribute to good consumer outcomes and provide further support to the FCA in fulfilling its objectives. The FOS and CFEB will also help to support the FCA's preventative regulatory philosophy, described in Chapter 4, under which it will aim to deal with risks before they crystallise and cause widespread consumer detriment: through their direct engagement with consumers, they will support the FCA by helping to identify the causes of potential consumer detriment early.

6.5 Within this framework of operational independence, the Government proposes to take two different approaches to the independent bodies associated with the regulators:

- in view of the important role that the FSCS plays in both compensating consumers and promoting financial stability through effective resolution, the FCA and PRA will jointly take on the FSA's powers and responsibilities in relation to the FSCS; and

- given the direct read-across to its market confidence objective, the FCA will solely take on the FSA's existing functions in relation to both the FOS and CFEB.

6.6 While it is right for these independent bodies to retain discretion and operational independence, it is equally important that there are formal and effective mechanisms in place to ensure that they work effectively with the regulators so that consumer protection is maximised. This chapter sets out how the Government intends to ensure effective coordination.

6.7 Accountability goes hand in hand with independence and this chapter also sets out the Government's proposals to strengthen the accountability and transparency of these bodies, as it is proposing to do elsewhere in the reform programme.

Financial Services Compensation Scheme

6.8 Compensation plays an important role in supporting consumer confidence in any financial regulatory framework. In the UK system, the FSCS also has a specific and important part to play in financial stability by supporting the swift and orderly resolution of failed firms. Given that the FSCS will play a key role in supporting the objectives of both the PRA and FCA, it is important that both regulators should have direct input to the scheme.

Operating model and rule-making

6.9 The Government believes that it is vital that the FSCS remains a single organisation to administer compensation so that consumers have a single, accessible point of contact for compensation matters. The vast majority of respondents to the July consultation supported this principle.

6.10 The Government consulted in July on two alternative operating models for the FSCS: one approach would be for both the PRA and FCA to have rule-making powers in relation to the FSCS; the other would be for the FCA to make all of the compensation scheme rules. Consultation responses were split on this issue: some agreed that both regulators should have rule-making powers as the FSCS supports the objectives of both regulators, and some also felt this approach could mean that the cross-subsidy would no longer apply; others felt that a model in which the FCA set all rules for the FSCS would ensure consistency in rule-making and help to minimise costs.

6.11 The Government proposes that each regulator will have distinct rule-making powers over the FSCS:

- the PRA will have responsibility for making compensation and fees (both levies and funding) rules on deposits and insurance provision; and
- the FCA will have responsibility for making compensation and fees rules relating to all other types of financial activity covered by the compensation scheme.

6.12 The PRA will be required to consult the FCA as appropriate in making rules, as the FCA will also have a role in the conduct regulation of deposit-takers and insurers. The FCA will be required to consult the PRA where relevant, for example when making rules relating to compensation in investment business.

Coordination

6.13 Well-functioning coordination mechanisms between the FCA and PRA will be vital to ensure that they fulfil their functions and responsibilities in relation to the FSCS, and that the FSCS can operate effectively. As described in Chapter 5, the PRA and the FCA will be under a general statutory duty to coordinate and this duty will be binding on the regulators' compensation rule-making and oversight of the FSCS. To strengthen this, the Government will include coordination in relation to the FSCS in the indicative list of elements covered by the MoU between the PRA and the FCA described in Chapter 5.

6.14 It is also important that there are formal mechanisms in place to ensure that the FSCS works effectively with both of the regulators. Under the current arrangements, the FSCS has agreed and published an MoU with the FSA on a voluntary basis. The Government intends to put this good practice on a statutory footing and require the FSCS to put in place MoUs with the FCA and PRA to strengthen transparency and accountability.

Governance

6.15 Given that the FCA and PRA both have rule-making powers for the compensation scheme, the Government proposes that both regulators should be jointly responsible for oversight and associated functions in relation to the FSCS.

6.16 The FCA and the PRA will therefore be jointly responsible for all appointments to the FSCS board, with the Treasury retaining its right of approval over the appointment of the Chair. FSCS board members will, as now, be appointed on terms which secure their independence.

Box 6.A: Consultation question

29 What are your views on the proposed operating model, coordination arrangements and governance for the FSCS?

Financial Ombudsman Service

6.17 Access to swift and impartial resolution of disputes between firms and consumers is an important element of the Government's vision for enhanced consumer protection in financial services. Therefore, as outlined in the July consultation, the Government intends for the FOS to remain an operationally independent alternative dispute resolution service and for the FCA to take on the FSA's existing functions in relation to the FOS.

6.18 The workload of the FOS has increased significantly since it was established: originally set up to handle around 30,000 complaints per year, it now receives over 160,000 complaints annually. In part, this increase has arisen from the growth of industry-wide issues which have lead to mass claims. These issues have presented particular challenges for the regulator and the ombudsman scheme and the Government is determined to address these. The Government intends to strike the right balance between the role of the regulator in preventing or intervening early in such issues and the role of FOS in resolving individual cases. It will do this in a number of ways, outlined below.

6.19 First, the statutory function and responsibilities of the ombudsman scheme are, and should remain, quite distinct from those of the regulator. This distinction should become clearer as a result of the FCA's greater focus on improving firms' retail conduct and the action it will take to tackle potential causes of consumer detriment before their effects become widespread. The FCA will have tools at its disposal to act early and decisively, including the newly updated section 404 power, which gives the regulator powers to require firms to establish and operate consumer redress schemes. This will help to ensure that the FOS is able to focus on its function to deal with individual disputes on a case by case basis.

6.20 Second, the Government believes that the roles of the ombudsman service and the regulator can also be made clearer by strengthening the mechanisms which specify how they should work together, in the context of their respective remits, to help promote consumer outcomes. To put in place a formal mechanism by which the FOS will be able to support the

FCA in its preventative and issues-based approach to regulation, the Government will require the FOS to pass to the FCA any information which could be important in helping to promote better consumer outcomes. The Government will also put a requirement on the FCA to have regard to information it receives from the FOS in fulfilling its objectives.

6.21 Third, the Government will also strengthen and formalise the coordination and cooperation mechanisms between the FOS and the FCA. The Government will introduce a statutory obligation for the FOS and the FCA to publish and maintain an MoU, building on the voluntary MoU already in place between the FOS and the FSA. The MoU will deal with how the FOS and the FCA will work together, especially on issues where individual FOS cases could have wider implications.

6.22 The Government will consider whether there are further measures which could help to make the respective roles of the regulator and the ombudsman scheme clear and distinct.

Transparency

6.23 The Government intends to clarify the FOS's ability to publish information in accordance with its statutory function. The Government wants to clarify that, like other ombudsmen schemes, the FOS is able to publish its determinations in a proactive and coordinated way. The Government will make provision to allow the FOS to publish determinations if it considers it appropriate to do so. The FOS will be expected to produce and consult on the principles it would apply to the publication of determinations.

Box 6.B: Consultation questions

30 What are your views on the proposals relating to the FOS, particularly in relation to transparency?

Consumer Financial Education Body

6.24 The CFEB plays an important role in addressing the information asymmetries between the financial services industry and consumers. Through initiatives like the Money Advice Service, it can help consumers understand their financial needs, plan ahead and make good financial decisions. This will underpin the FCA's work to promote good consumer outcomes. Therefore, as outlined in the July consultation, the Government intends that the FCA will take on the FSA's existing functions in relation to the CFEB.

6.25 As proposed for the FSCS and FOS, the Government intends to require the CFEB and the FCA to put in place a statutory MoU governing how they work together, building on the voluntary MoU the CFEB and the FSA published last year.

Accountability of the FSCS, FOS and CFEB

6.26 As also noted above, accountability is an important part of the reform programme as a whole and the Government intends to strengthen this where appropriate.

6.27 The FSCS and the FOS voluntarily publish an annual plan alongside their budget in addition to the statutory requirement to produce an annual report. As an annual plan is a useful and important mechanism to demonstrate how these bodies plan to apportion their resources in the coming year, the Government proposes to make this voluntary arrangement statutory and require the FSCS and FOS to publish an annual plan and consult on it as appropriate. The CFEB is already required to publish an annual plan and report under provisions introduced by the Financial Services Act 2010.

6.28 The Government will place in statute provision for the FSCS, the FOS and the CFEB to be audited by the National Audit Office (NAO). The NAO will have similar powers in relation to the FSCS, FOS and CFEB as it has in relation to public bodies and, as set out in previous chapters, to the PRA and FCA. This will provide assurance that these bodies are required to carry out their functions in an efficient and economic way. In the case of the CFEB, this provision will replace the power the FSA currently has to instigate an independent 'value for money' review of the CFEB.

Box 6.C: Consultation question

31 What are your views on the proposed arrangements for strengthened accountability for the FSCS, FOS and CFEB?

7 European and international issues

7.1 The global nature of financial markets means the recent crisis has prompted far-reaching reform internationally, with the G20 leading much of the international crisis management and policy response. The UK authorities have played a leadership role in the G20 as they have in the other key global bodies including the Financial Stability Board (FSB), International Monetary Fund (IMF) and the Basel Committee on Banking Supervision (BCBS), as well as in the European Union.

7.2 Repairing and reforming global financial markets, so that they are open, efficient, fair, stable and competitive is imperative if they are to provide the valuable services needed to support sustainable growth in the global economy. National authorities have come together with international bodies to pursue a wide ranging reform agenda including measures to strengthen the global banking system, improving resolution tools – including their operation across borders – and enhancing institutional structures and supervision. Among the most significant reforms are the agreements reached in the BCBS in September 2010 to enhance capital and liquidity standards (as set out in Chapter 2). These are essential to strengthening global financial stability, and their consistent application is crucial to support international financial markets and minimize the risks of regulatory arbitrage.

7.3 While much has already been agreed and achieved, there is still a significant agenda to pursue including an extensive legislative programme being taken forward in the European Union. Though many of the EU reforms are strongly rooted in lessons learnt from the recent crisis, and focused on delivering the G20 priorities, as individual legislative proposals come forward it is critical to ensure that these are evidence based, proportionate and able to address systemic risks to financial stability. Reforms must also reinforce the single market and deliver a level-playing field across Member States, which is central to supporting EU competitiveness in global financial markets.

7.4 As the UK's own institutional arrangements evolve, the authorities will continue to take a leadership role in EU and international reforms, working both with one another and the wider stakeholder community to deliver sound reform, which complements changes proposed to the UK framework. The remainder of this chapter explains how this will be achieved.

The European system: ESAs and ESRB

7.5 A clear lesson from the crisis is the need for greater international coordination and cross-border cooperation. The Government recognises that it is imperative to get the regulatory framework right for the future strength and stability of the UK, European, and global economy.

7.6 As part of the EU's work to deliver better and more coordinated standards of regulation and effective EU-wide enforcement, especially in cross-border situations, all Member States recently agreed upon a new supervisory architecture for the financial system. The new architecture establishes four new European bodies: three new micro-supervisory authorities to oversee banking, insurance and securities markets – the European Supervisory Authorities (ESAs) – and a body responsible for macro-prudential oversight – the European Systemic Risk Board (ESRB). Box 7.A provides a breakdown of the core tasks of the ESAs and the ESRB. These new authorities became operational on 1 January 2011.

Box 7.A: Core tasks of the ESAs and the ESRB

Three new ESAs were established on 1 January 2011: the European Banking Authority (EBA) in London, the European Securities and Markets Authority (ESMA) in Paris, and the European Insurance and Occupational Pensions Authority (EIOPA) in Frankfurt. The ESAs will play a key central role. In particular, they:

- have strong technical standard-setting powers and ensure that these standards are properly adhered to, through their role in enforcing Union law and though a responsibility to undertake peer review;
- set the single rulebook that national supervisors will then have to enforce
- will ensure that supervisors are complying with and enforcing the rulebook, and take binding actions against those that do not enforce the rulebook;
- can settle cross-border disputes between supervisors in a binding manner; and
- ensure greater supervisory quality by setting high quality guidance, undertaking peer review and facilitating cooperation.

The ESRB is responsible for the macro-prudential oversight of the financial system within the Union in order to contribute to the prevention or mitigation of systemic risks. The ESRB's core tasks are as follows:

- to collect and analyse information relevant to achieving their objectives;
- when significant risks are identified, the ESRB shall provide warnings of potential systemic risks and, where appropriate, issue recommendations for remedial action, including, where appropriate, for legislative initiatives;
- to enhance the awareness of risks and to prioritise such risks, the ESRB, in close cooperation with the ESAs, shall develop a common set of quantitative and qualitative indicators (risk dashboard) to identify and measure systemic risk, and elaborate a colour-coded system corresponding to situations of different risk levels;
- monitor the follow-up to warnings and recommendations; and
- decide on a case-by-case basis whether a warning or recommendation should be made public

7.7 The new architecture is intended to ensure a stable and single European Union financial market for financial services, linking national supervisors within a strong Union network. While facilitating better coordination of supervision, day-to-day supervision of financial institutions will remain at the national level, ensuring that national governments retain their frontline responsibility to protect national tax payers' interest and that regulators retain their frontline responsibility to regulate.

7.8 The new European framework has the potential to improve significantly the quality and consistency of supervision, ensure more effective rulemaking and enforcement, and better identify risks in the financial system. The new architecture will improve cross-border supervision, provide mechanisms to ensure supervisors are complying with their legal obligations, and ensure national supervisors are of a high quality.

Representation and coordination in the EU

7.9 The Government has placed renewed emphasis on international engagement and this will remain an ongoing priority. Consistent with this emphasis, the Government expects the UK's regulatory agencies to put significant time and effort into ensuring that the UK's voice is heard at the European level and that the decisions taken by the new authorities are appropriate. The TSC, in its recent report on financial regulation, also underlined the need for the UK authorities to treat engagement in European negotiations as a high priority.

7.10 The UK regulatory authorities will be well placed to influence and take part in the technical work of the ESAs, for example the development of binding technical standards, and the production of guidance and advice. The Treasury is responsible for official- and political-level negotiation, with other Member States, of European directives and regulations. Much of the detailed provision, however, will be in secondary technical standards, rules and guidance, which is the responsibility of the competent authorities in the ESAs. Therefore, a principle of continual reciprocal engagement between the Treasury and the authorities will be crucial as negotiation of legislative provisions moves from political to technical levels.

7.11 Each Member State has one voting seat on the three new ESAs, as well as the ability to bring a limited number of additional non-voting members. As set out in the Government's July consultation document, *A new approach to financial regulation: judgement, focus and stability*, the new Prudential Regulation Authority (PRA) will hold the UK's voting seat on the EBA[1] and EIOPA. The Government's priority is to ensure that there is a strong and credible voice to promote the UK's interests in these new institutions, and ensure effective cooperation with European counterparts on the regulation of large, cross-border financial firms.

7.12 The Government also recognises the importance of ensuring that the arrangements for wholesale markets regulation allow the UK authorities to play a full part in engaging with ESMA. To ensure that the right outcomes are delivered for London and the UK, the Financial Conduct Authority (FCA) will represent the UK's interests on ESMA.

7.13 However, each ESA covers both prudential and conduct of business issues and there will be substantial areas of the ESAs' work which are not the primary responsibility of the institution that holds the voting seat. When this occurs, effective domestic coordination and cooperation between the regulatory authorities will ensure the UK's views are best represented. For example, where ESMA discusses issues that fall within the scope of the PRA domestically, the FCA should invite PRA to the meeting as an observer and take account of the PRA's views in any vote.

7.14 The legislation sets out that in Member States where more than one authority is responsible for supervision, those authorities shall agree on a common representative.[2] While the voting members act independently and objectively in the sole interest of the Union as a whole, this means that both the PRA and FCA will need to ensure that they jointly represent each other's expertise and that of all UK competent authorities. They will need to therefore ensure the responsibilities and expertise of the Pensions Regulator (tPR), the Gibraltar Financial Services Committee, the Bank of England (in relation to the regulation of systemic financial infrastructure) and other relevant UK parties will be adequately respected. The final section of this chapter considers how this coordination will work in practice and what mechanisms (legislative or otherwise) may be needed to support it.

[1] In the EBA, the competent authority may bring a non-voting representative from the National Central Bank, if the authority is not a central bank – therefore a representative of the Bank of England may also attend in a non-voting capacity.

[2] Article 40.5, EBA, ESMA and EIOPA legislation. When an item to be discussed by the Board of Supervisors does not fall within the competence of the national authority being represented, that member may bring a non-voting representative.

Box 7.B: Key EU policy issues in 2011

To strengthen the single market in financial services, to enhance financial stability across the Member States, and in many cases to provide vehicles to implement agreements made in other international forums, an extensive legislative programme is underway in the EU. The UK authorities are engaging throughout the legislative processes, pressing to make sure measures are coherent, evidence based, proportionate and focused on reducing systemic risk while making markets work well, contributing to EU and global growth. The EU actively seeks views from a wide range of stakeholders as it develops its proposals. Given the important role the UK plays as a financial centre in the EU, many stakeholders with an interest in UK domestic reforms also have relevant expertise and knowledge and can contribute evidence and views to these processes, both via the UK authorities and directly with EU policy makers as policies develop. The UK authorities encourage strong engagement.

During 2011, among some of the most important issues being taken forward in the EU will be:

- reform of the regulatory regime covering investment services and financial markets via the review of the Markets in Financial Instruments Directive (MiFID). A wide ranging European Commission consultation on this has just closed.[3] The scope of these reforms is significant, and will impact thousands of firms across the EU, including in the UK. The proposals draw on the successes of the MiFID since its inception – where Europe is now the destination of choice for global companies seeking to access deep pools of capital, and competition has brought down trading costs, improved liquidity, and resulted in better protection for investors. However, as is to be expected with such wide ranging coverage, some proposals require further analysis and evidence, and stakeholder input will be key to getting the reforms right;
- alongside the MiFID review, the G20 commitment that all standardised Over the Counter (OTC) derivatives contracts should be traded on exchanges, or on electronic trading platforms where appropriate, and cleared through central counterparties will be largely delivered at the EU level via the European Markets Infrastructure Regulation, usually known as EMIR. Legislative proposals are under discussion, and while the UK supports many of the measures, further refinements will be needed as the proposals are finalised;
- implementing the newly agreed Basel standards on capital through the Capital Requirements Directive (CRD) IV, on which proposals will come forward later this year. The consistent implementation of these standards globally is vital to strengthen financial stability and minimise risks of regulatory arbitrage and the UK Authorities will be encouraging the EU to show global leadership in its delivery strategy through CRD IV;
- work to ensure that Member States have appropriate crisis management regimes for their banks, including minimum resolution toolkits to reduce the cost of bank failure and ensure creditors bear the losses, not the taxpayer. As mentioned in Chapter 2, the Commission is currently running a consultation[4] which contains many useful proposals to deliver a common legislative framework for Member States to respond to crises, and credible tools and powers to intervene quickly to avert or manage the failure of a bank. The UK's special resolution regime provides

[3] http://ec.europa.eu/internal_market/consultations/docs/2010/mifid/consultation_paper_en.pdf (consultation closed, 2 February 2011).

[4] http://ec.europa.eu/internal_market/bank/crisis_management/index_en.htm

the UK authorities with the resolution tools that the Commission is keen to extend to all Member States. The Commission is also proposing measures to improve coordination in the event of a cross border failure in Europe. Responses to the consultation are due by 3 March; and

- other policy issues which will be taken forward in coming months include Solvency II, markets abuse, and a retail agenda incorporating deposit guarantee schemes, investor protection and packaged retail investment products (PRIPS). The UK authorities strongly encourage stakeholder input on these and other policy issues.

7.15 There will be two UK seats on the General Board of the ESRB; a seat for the Governor of the national central bank as the voting member and a seat for a non-voting representative from the competent national supervisory authority. The Governor of the Bank of England is currently vice-Chair of the ESRB. For the non-voting seat, the representative will rotate according to the item discussed, unless national authorities have agreed a common representative. Therefore, we expect the PRA to rotate its position with other competent authorities such as the FCA.

International representation and coordination

7.16 Beyond Europe, the UK is represented in a large number of international financial regulatory bodies through seats currently held by the Treasury, Bank and FSA. The UK will ensure that influence in these bodies remains strong, both during and following transition to the new regulatory architecture.

7.17 Of particular importance are the FSB and BCBS. The FSB coordinates the work of national financial authorities and international standard-setting bodies at the international level. Its mandate includes assessing vulnerabilities affecting the financial system, advising and monitoring best practice in meeting regulatory standards. It also collaborates on the joint FSB-IMF Early Warning Exercise, which monitors future risks to economic and financial stability at the global level. The BCBS sets international capital and liquidity standards. For both the BCBS and the FSB, the primary responsibility for UK representation currently falls to the Bank of England and FSA. The Bank also holds a seat on the Board of Directors of the Bank for International Settlements, which hosts the BCBS.

7.18 UK authorities also hold seats on a number of important technical standard-setting bodies, for example International Organization of Securities Commissions (IOSCO), which sets standards for securities regulation, and the International Association of Insurance Supervisors, which sets international standards for insurance regulation. There are cases where overlap might require coordination. For example, IOSCO’s responsibilities in setting rules of conduct might imply that the FCA should retain the seat currently held by the FSA. However, the Bank is responsible for regulating central counterparty (CCP) clearing houses while the PRA will be responsible for the regulatory capital regime around exposures to CCPs; IOSCO agreements may impact significantly on each of these.

7.19 In many cases, there may be no change to seats on international bodies currently held by the Bank, while seats currently held by the FSA are expected to be transferred to equivalent roles in the PRA. Given the technical nature of many of these bodies, the FSA and Bank are best placed to decide how seat transitions might best be managed.

Ensuring coordination in the EU and internationally

7.20 As set out above, in most international bodies each country has a limited number of voting seats – usually one or perhaps two – with the authority holding the voting seat expected to put forward the overall position and interests of the country it represents. This means that whichever authority is in the lead – whether the Treasury when negotiating EU legislation, the Bank of England in BCBS and FSB or the PRA and FCA in the ESAs – they will need to consult other interested domestic authorities and take their views into account when communicating the UK's position.

7.21 Effective international coordination is central to securing financial stability, and managing global risks, going far beyond simply ensuring that the relevant competent authority has the opportunity to feed in their views. In order for the UK to successfully influence and steer the development of international policy on financial regulation, all the UK authorities – including the Treasury and the Bank of England – must work together to ensure that, while respecting the objectives of the individual authorities where possible, international negotiating positions represent a single, consistent, agreed UK position. The TSC has also highlighted the importance of clear and effective international coordination and the key role of the Government in supporting this.

7.22 There are three different types of international coordination:

- coordination between the PRA and FCA, particularly in EU bodies, on prudential and conduct aspects of the same firms and activities (for example, conduct matters related to banking and insurance in EBA and EIOPA);
- coordination between the PRA or FCA and other domestic competent authorities, such as tPR and the Financial Reporting Council (FRC) , where responsibility for matters discussed in international forums lies outside of the PRA and FCA; and
- wider coordination to agree a single, consistent UK negotiating position on significant aspects of financial regulation.

Coordination between the PRA and FCA

7.23 As set out above, the EU's structure for financial regulation is organised around activities and does not map exactly onto the UK's regulatory structure. For example, the ESAs cover both prudential and conduct of business issues and there will be areas of the ESAs' work which are not the primary responsibility of the institution in the voting seat.

7.24 The PRA and FCA will work closely together to ensure that the other regulator is kept fully informed of any matters due to be discussed in EU bodies that fall into their sphere of responsibility. This should mean, for example, that if a conduct-related issue is discussed in the EBA, the PRA should seek the FCA's views in advance, invite the FCA to attend the meeting as a non-voting observer and take the FCA's views into account in any vote.

7.25 Between the PRA and the FCA, the coordination mechanisms proposed in Chapter 5 – a duty to coordinate which requires them to seek the other's views and expertise on matters that relate to the other's objective and an MoU which will set out how the regulators will coordinate their engagement with foreign regulatory bodies) – will ensure that the PRA and FCA effectively cooperate with each other to coordinate their interaction in international bodies.

Coordination between the PRA or FCA and other domestic authorities

7.26 As mentioned previously, there are some discrete areas where domestic responsibility does not lie with the PRA or FCA. Examples include tPR, which is responsible for the regulation of work-based pension schemes, and the Bank of England, which will be responsible for the regulation of key systemic infrastructure such as recognised payment and settlement systems and clearing houses, and the Department for Business, Innovation and Skills and FRC who are responsible for corporate governance, accounting and audit. To ensure that cooperation is embedded, the PRA and FCA will need to discuss and agree cooperation arrangements and design a cooperation process with other relevant UK competent authorities, to ensure that their views are adequately represented.

7.27 Where another competent UK authority has an interest in matters discussed in an international body such as the ESAs the Government expects the PRA and FCA, where relevant, to agree coordination mechanisms on a bilateral basis with these authorities. For example, the FSA is already in the process of establishing a MoU with tPR which is expected to set out how they will coordinate their interaction around pensions matters that are considered by EIOPA. This should represent a useful precedent for similar arrangements between the PRA and FCA with other relevant authorities in the future.

Ensuring a consistent and coordinated UK position in international discussions

7.28 Finally, in order to ensure effective coordination in international negotiations ensuring that relevant views are captured and taken into account on specific issues is only the first step. In order for the UK to continue to play a lead role in the ongoing development and implementation of internationally-agreed changes to financial regulation, the authorities will need to maintain a single, coherent and consistent overall strategy. This will be vital in ensuring that the UK's interests are protected, and that individual proposals are consistent, evidence-based, proportionate and fit for purpose.

7.29 It will be particularly important to hold a consistent, agreed UK position where there is more than one UK representative at an international meeting and where different levels of a single policy and legislative process involve different UK representatives. An example of the challenges involved is the setting of capital requirements for banks, where the overall policy is set initially by the BCBS (in which the Bank and PRA will have a role), with the Treasury leading for the UK on the Directive at EU level and the detailed implementation left to the ESAs, where the PRA and FCA represent the UK.

7.30 The Government therefore proposes to legislate to require the establishment of a statutory MoU between the Treasury, the Bank of England, the PRA and the FCA on overall international coordination within the UK's system for financial regulation. The legislation will set out a non-exhaustive list of the key areas that the MoU should cover, including:

- the process for discussing and agreeing strategic objectives to inform a single UK approach to significant changes in financial regulation;
- who represents the UK in each international body and forum;
- how the authorities will coordinate their engagement in international bodies;
- how each authority would consult the others in advance of relevant issues being discussed in international forums; and
- how the authorities would seek the views of other interested parties, including financial sector participants.

Box 7.C: Consultation question

32 What are your views on the proposed arrangements for international coordination outlined above?

8 Next steps

8.1 This consultation document marks an important step in the development of policy implementing the Government's commitment to reform the framework for financial regulation in the UK. This chapter sets out the next steps in the reform programme, and covers both the legislative process and the FSA's plans to move to 'shadow' operation of the PRA and the CPMA.

8.2 The Government is committed to putting the new regulatory architecture in place by the end of 2012. The Government believes that this remains an appropriate and achievable target. It is important that stakeholders, including regulated firms, can have confidence in the timetable for implementation and are assured that disruption will be kept to a minimum.

8.3 The Treasury Select Committee's (TSC) report notes that there is a risk that the quality of the legislation could be compromised if the Government pursues this timetable too rigidly. The Government is aware of this risk but, as the TSC notes, the financial services industry "should not have to deal with regulation in a state of flux",[1] and the Government is therefore determined to keep up the momentum to meet the planned timetable and minimise uncertainty and disruption for the financial services industry and other interested parties.

8.4 The Government is wholly committed to getting the policy and legislation right. Openness and transparency throughout the policy development process is key to achieving this, and a strategic commitment of the coalition Government. The Government has set out in its policy thinking on financial regulation reform at key stages in the process, in an initial consultation document published in July 2010, in a summary of consultation responses in November and now in this paper. It has invited stakeholders to share expertise and provide comments to improve these proposals, both through formal consultations such as this, and through informal consultation mechanisms including meetings and workshops. This is the right way to ensure that the final policy proposals are robust. Further details on how stakeholders are invited to engage with the proposals set out in this document are outlined below.

8.5 The Government will continue to adopt this open and consultative approach as the reform programme moves into its legislative stages. The Government will publish a White Paper in the spring, including a draft Bill for Parliamentary pre-legislative scrutiny (PLS). PLS is a valuable and transparent way of improving the quality of legislation before it is formally introduced to Parliament, as the TSC notes in its report on financial regulation. The Government welcomes the TSC's support for PLS. The publication of the White Paper and a draft Bill for PLS will be a further opportunity for stakeholders and parliamentarians to engage with the details of the Government's proposals for financial regulation reform.

8.6 The exact format of PLS will be a matter for Parliament, but the Government believes that PLS should last for a full twelve Parliamentary sitting weeks to ensure that there is ample time for thorough scrutiny of the draft legislation. The Government also believes that it would be helpful for a joint scrutiny committee of MPs and Peers to be convened to undertake PLS.

[1] *Financial Regulation: a preliminary consideration of the Government's proposals*, Treasury Select Committee, February 2011, page 3

8.7 The Government expects that the Bill will be introduced in mid-2011 and will receive Royal Assent in mid-2012, although the timetabling of PLS and legislation is a matter for Parliament.

Transitional arrangements

8.8 The Government is committed to ensuring as far as possible a smooth transition to the new regulatory architecture, to minimise disruption for stakeholders.

Financial Services Authority

8.9 The FSA is on track to make the transition to the new regulatory structure at the end of 2012. In April 2011 the FSA will, as planned, replace its current Risk and Supervision business units with a prudential business unit and a consumer and markets business unit. Following that, the focus will be on progressively changing the regulatory processes (insofar as the FSA's current statutory remit allows) so that the FSA can begin to operate distinct prudential and conduct approaches to regulation. Work is underway to complete the more detailed design of the operating models for the PRA and the CPMA. The FSA and the Bank will continue to work closely together as the reform programme progresses.

8.10 This approach should provide an opportunity to 'road test' some key elements of the new supervisory structure before the formal transition at the end of 2012. It is also designed to reduce uncertainty for staff. Inevitably, the transition period will create new challenges for management. However, the move to a risk-based, judgement-led approach by the prudential business unit will mean that lower risk firms are subject to a more appropriate level of supervision. This will release management resources so that supervision of high risk firms continues to be intensive.

8.11 The Government welcomes the appointment of Martin Wheatley as managing director for consumer protection and markets at the FSA and CEO-designate for the FCA. On taking up post from 1 September 2011, he will work with the current FSA executive team to prepare for the transition from the FSA to the new regulatory structure.

Responding to this consultation

8.12 The closing date for responses to this consultation document will be 14 April, as described in more detail in Annex A. Responses will feed into the Government's White Paper and draft Bill, which will be published in the spring.

8.13 The Government will engage proactively with stakeholders on the proposals set out in this consultation, through roundtable meetings, seminars and workshops.

A How to respond

A.1 This paper is available on the Treasury website at www.hm-treasury.gov.uk.

A.2 Responses are requested by 14 April 2011. Please ensure that responses are sent in before the closing date. The Government cannot guarantee that responses received after this date will be considered. The Government will engage directly with relevant stakeholders ahead of the closing date. For further details, please e-mail financial.reform@hmtreasury.gsi.gov.uk

A.3 Responses can be sent by e-mail to: financial.reform@hmtreasury.gsi.gov.uk; or by post to:

Financial Regulation Strategy
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

A.4 When responding, please state whether you are doing so as an individual or on behalf of an organisation.

A.5 Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes (these are primarily the Freedom of Information Act (FOIA), the Data Protection Act 1998 and the Environmental Information Regulations 2004).

A.6 **If you want the information that you provide to be treated as confidential, please mark this clearly in your response**. However, please be aware that under the FOIA, there is a Statutory Code of Practice with which public authorities must comply and which deals, among other things, with obligations of confidence. In view of this, it would be helpful if you could explain why you regard the information you provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances.

A.7 In the case of electronic responses, general confidentiality disclaimers that often appear at the bottom of emails will be disregarded unless an explicit request for confidentiality is made in the body of the response.

Code of practice for written consultation

A.8 This consultation process is being conducted in line with the Government's Code of Practice, available at http://www.bis.gov.uk/files/file47158.pdf

A.9 If you feel that this consultation does not meet the Code, please contact:

Isabel Summers
Transport, regulation and competition
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

B Impact assessment

B.1 This annex contains the impact assessment for the proposed regulatory reforms. It considers two options for reforming the framework of financial regulation by establishing specialist financial regulators: first, the Government's proposals as presented in this document; and second, a variation in which, in addition to the new prudential and conduct of business regulators, a third authority covering markets regulation is established.

B.2 In general, this reform should result in substantial benefits from the reduction in the frequency of severe financial crises.[1] The precise quantification of those benefits is dependent on a number of assumptions, as detailed in the impact assessment. However, it is assumed that the benefits would be essentially the same for both options, and so the difference between them largely depends on their costs. Since the main difference between the two options is the creation of a third specialist regulator, the costs of the 'three regulator' option are reasonably estimated to be higher, given the need for additional overheads.

B.3 The impact assessment considers both transitional and ongoing costs, for public authorities and regulated persons. The Government sought views on the transitional and ongoing costs for all types of regulated person in the previous consultation. However, few respondents addressed this point in their responses and this impact assessment includes purely illustrative estimates of the costs for regulated persons. The Government would therefore welcome comments from all types of firm on the assumptions made for the transitional and ongoing costs for firms.

B.4 The cost estimates for public authorities have been provided by the Bank of England as they relate principally to the creation of the PRA, its integration with the Bank and subsequent operations. There will be a transfer to the Bank and PRA of staff associated with prudential regulation and with the regulation of CCPs and settlement systems: this is likely to account for about a third of the FSA's regulatory staff. The Bank will incur low costs in setting up the FPC.

B.5 The Bank's approach to creating the PRA is based on the expectation that costs of prudential regulation will fall in the medium term following the adoption of the new judgement-based regulatory model, improvements to IT and from taking advantage of regulatory and operational synergies with the Bank of England. But in the short term, the Bank will incur significant costs in acquiring and fitting out premises and installing IT.

B.6 The FSA legal entity will become the FCA and retain the staff and systems not transferring to the PRA. Transitional costs will be significantly smaller, but there is unlikely to be any significant change in ongoing costs.

B.7 The Bank and the FSA will undertake further work to refine the cost estimates. Both the Bank and the FSA are committed to ensuring that the transitional costs are minimised and controlled, and to achieving long-run cost savings to offset the transition costs. As at present, regulators' costs will be recovered in fees or levies paid by regulated persons or by persons engaged in regulatory transactions, apportioned, as they currently are, on the basis of size and other relevant factors.

[1] Recognising, of course, that some of the benefits will be attributable to other measures (such as internationally agreed changes to regulatory requirements) which will be going ahead regardless of these proposed reforms.

Title: **A new approach to financial regulation**	**Impact Assessment (IA)**
Lead department or agency: HM Treasury	**IA No:**
Other departments or agencies:	**Date: 17/02/2011**
	Stage: Consultation
	Source of intervention: Domestic
	Type of measure: Primary legislation
	Contact for enquiries: financial.reform@hmtreasury.gsi.gov.uk

Summary: Intervention and Options

What is the problem under consideration? Why is government intervention necessary?

The tripartite system of financial regulation failed to ensure financial stability - in particular by failing to identify the risk posed by the rapid and unsustainable increase in debt in the economy. This resulted in considerable economic costs in lost output and in substantial deterioration in public finances. The regulatory system cannot be restructured without primary legislation. (This impact assessment does not cover the potential transfer of responsibility for consumer credit from the OFT to the FCA: this was the subject of a separate impact assessment published in December 2010.)

What are the policy objectives and the intended effects?

The objective is to reform the financial services regulatory system to avoid a repeat of the financial crisis. The legislation will create a Financial Policy Committee in the Bank of England to take charge of macro-prudential regulation. The Bank of England will also regulate settlement systems and central counterparty clearing houses. A Bank of England subsidiary - the Prudential Regulation Authority (PRA) - will undertake the prudential regulation of deposit-takers, insurers and certain investment firms using a more judgement-based approach. The FCA will regulate conduct of business generally, market conduct, investment exchanges and listing. The FCA will also be responsible for consumer protection in financial services and for prudential regulation of non-PRA regulated firms.

What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)

The options are: "do nothing" (the base case); the preferred two regulator model of the PRA and FCA (option 1) and a three regulator model (adding a separate markets regulator - option 2). The benefits of the proposed option (net of the benefits of increases in capital and liquidity requirements) should outweigh the costs. The main additional costs are: (1) transitional administrative costs for the Treasury, Bank of England, FSA and the FCA and PRA; (2) ongoing administrative costs for the FCA and PRA (due to the need to duplicate some overheads); (3) transitional compliance costs for regulated firms, mainly for those regulated by the PRA and FCA; and (4) ongoing compliance costs for firms, mainly for firms regulated by the PRA and FCA. Costs cannot be estimated precisely. Costs would be higher in the three regulator model owing to further duplication in regulatory bodies and increased transitional and ongoing compliance costs for regulated firms but the benefits of option 1 and option 2 should be broadly equal.

Will the policy be reviewed? It will not be reviewed. **If applicable, set review date:** Month/Year
What is the basis for this review? Not applicable. **If applicable, set sunset clause date:** Month/Year

Are there arrangements in place that will allow a systematic collection of monitoring information for future policy review?	Not applicable

SELECT SIGNATORY Sign-off For consultation stage Impact Assessments:

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsible Minister: Mark Hoban Date: 16 February 2011

Summary: Analysis and Evidence

Policy Option 1

Description:

Two regulator model (preferred option)

Price Base Year 2011	PV Base Year 2011	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: 1,000	**High:** 10,860	**Best Estimate: 1,000**

COSTS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Cost** (Present Value)
Low	140	2-3	nil	**140**
High	240		25	**400**
Best Estimate	240		25	**400**

Description and scale of key monetised costs by 'main affected groups'

Development and implementation costs (spread over 2-3 years) for existing public authorities and two new regulators; ongoing costs for two new regulators. Transitional and ongoing costs for: firms (deposit-takers, insurers and certain investment firms) subject to prudential and conduct of business (COB) regulation. These are **illustrative** estimates only and it is assumed that firms will not incur significant ongoing costs.

Other key non-monetised costs by 'main affected groups'

There are no significant non-quantifiable costs.

BENEFITS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Benefit** (Present Value)
Low	0		see text	**1,400**
High	0		see text	**11,000**
Best Estimate	0		see text	**1,400**

Description and scale of key monetised benefits by 'main affected groups'

Illustrative benefits only from reduction in frequency of severe financial crises in the UK - a benefit for the UK as a whole rather than for specific groups.

Other key non-monetised benefits by 'main affected groups'

A reduction in frequency of major incidents of consumer detriment in provision of financial services in the UK and benefits for consumers arising from increased competition between financial services firms - benefits for UK consumers, regulated firms and the regulators. These benefits are likely to be significantly smaller than the monetised benefits.

Key assumptions/sensitivities/risks — **Discount rate (%)** 3.5

The key assumptions are those made for benefits calculations and for development, implementation and transitional costs for existing public authorities, new regulators and affected firms. The main risks in relation to costs are that the transitional costs for both public bodies and affected firms could be underestimated and, in relation to ongoing costs, that there could be significant additional compliance costs for firms subject to prudential and COB regulation. The main risk in relation to benefits is that the benefit from the reduction in the frequency of severe financial crises is overestimated; the main overall risk is that the reforms make little or no difference to incidence of financial crises.

Direct impact on business (Equivalent Annual) £m):			**In scope of OIOO?**	**Measure qualifies as**
Costs: N/A	**Benefits:** N/A	**Net:** N/A	No	NA

Enforcement, Implementation and Wider Impacts

What is the geographic coverage of the policy/option?			United Kingdom		
From what date will the policy be implemented?			01/01/2013		
Which organisation(s) will enforce the policy?			Not applicable		
What is the annual change in enforcement cost (£m)?			Not applicable		
Does enforcement comply with Hampton principles?			Yes		
Does implementation go beyond minimum EU requirements?			N/A		
What is the CO_2 equivalent change in greenhouse gas emissions? (Million tonnes CO_2 equivalent)			**Traded:** N/A		**Non-traded:** N/A
Does the proposal have an impact on competition?			No		
What proportion (%) of Total PV costs/benefits is directly attributable to primary legislation, if applicable?			**Costs:** 100		**Benefits:** 100
Distribution of annual cost (%) by organisation size (excl. Transition) (Constant Price)	**Micro**	**< 20**	**Small**	**Medium**	**Large**
Are any of these organisations exempt?	No	No	No	No	No

Specific Impact Tests: Checklist

Does your policy option/proposal have an impact on…?	**Impact**	**Page ref within IA**
Statutory equality duties Statutory Equality Duties Impact Test guidance	No	16
Economic impacts		
Competition Competition Assessment Impact Test guidance	No	16
Small firms Small Firms Impact Test guidance	No	16
Environmental impacts		
Greenhouse gas assessment Greenhouse Gas Assessment Impact Test guidance	No	16
Wider environmental issues Wider Environmental Issues Impact Test guidance	No	16
Social impacts		
Health and well-being Health and Well-being Impact Test guidance	No	16
Human rights Human Rights Impact Test guidance	No	16
Justice system Justice Impact Test guidance	No	16
Rural proofing Rural Proofing Impact Test guidance	No	16
Sustainable development Sustainable Development Impact Test guidance	No	16

Summary: Analysis and Evidence

Policy Option 2

Description:

Three regulator model.

Price Base Year 2011	PV Base Year 2011	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: 800	**High:** 10,650	**Best Estimate: 800**

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	170	2-3	25	**350**
High	290		50	**600**
Best Estimate	290		50	**600**

Description and scale of key monetised costs by 'main affected groups'

Development and implementation costs (spread over 2- 3 years) for existing public authorities and three new regulators; ongoing costs for three new regulators. Transitional and ongoing compliance costs for: (1) firms subject to prudential and conduct of business (COB) regulation; (2) some investment firms subject to COB regulation and market regulation; (3) some firms subject to prudential, COB and market regulation. These are **Illustrative** estimates only.

Other key non-monetised costs by 'main affected groups'

Loss of synergies between wholesale and retail conduct regulation caused by splitting conduct regulation between two regulators - these would directly affect both the regulators and regulated firms, and could have indirect effects on consumers.

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	0		see text	**1,400**
High	0		see text	**11,000**
Best Estimate	0		see text	**1,400**

Description and scale of key monetised benefits by 'main affected groups'

Illustrative benefits only from reduction in frequency of severe financial crises in the UK - a benefit for the UK as a whole rather than for specific groups.

Other key non-monetised benefits by 'main affected groups'

A reduction in frequency of major incidents of consumer detriment in provision of financial services in the UK and benefits for consumers arising from increased competition between financial services firms - benefits for UK consumers, regulated firms and the regulators. These benefits are likely to be significantly smaller than the monetised benefits. There may be benefits for UK wholesale market participants from specialist representation in the European Securities and Markets Authority.

Key assumptions/sensitivities/risks **Discount rate (%)** 3.5

The key assumptions are those made for benefits and for development, implementation and transitional costs for existing public authorities, new regulators and affected firms. The main risks are that the transitional costs for both public bodies and affected firms could be underestimated and, in relation to ongoing costs, that there could be significant additional compliance costs for firms subject to prudential, COB and market regulation. The main risk in relation to benefits is that the benefit from the reduction in the frequency or severity of financial crisers is overestimated; the main overall risk is that the reforms make little or no difference to incidence of financial crises.

Direct impact on business (Equivalent Annual) £m):			In scope of OIOO?	Measure qualifies as
Costs: N/A	**Benefits:** N/A	**Net:** N/A	No	NA

Enforcement, Implementation and Wider Impacts

What is the geographic coverage of the policy/option?	United Kingdom				
From what date will the policy be implemented?	01/01/2013				
Which organisation(s) will enforce the policy?	Not applicable				
What is the annual change in enforcement cost (£m)?	Not applicable				
Does enforcement comply with Hampton principles?	Yes				
Does implementation go beyond minimum EU requirements?	N/A				
What is the CO_2 equivalent change in greenhouse gas emissions? (Million tonnes CO_2 equivalent)	**Traded:** N/A	**Non-traded:** N/A			
Does the proposal have an impact on competition?	No				
What proportion (%) of Total PV costs/benefits is directly attributable to primary legislation, if applicable?	**Costs:** 100	**Benefits:** 100			
Distribution of annual cost (%) by organisation size (excl. Transition) (Constant Price)	**Micro**	**< 20**	**Small**	**Medium**	**Large**
Are any of these organisations exempt?	No	No	No	No	No

Specific Impact Tests: Checklist

Does your policy option/proposal have an impact on…?	Impact	Page ref within IA
Statutory equality duties Statutory Equality Duties Impact Test guidance	No	16
Economic impacts		
Competition Competition Assessment Impact Test guidance	No	16
Small firms Small Firms Impact Test guidance	No	16
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Greenhouse gas assessment Greenhouse Gas Assessment Impact Test guidance	No	16
Wider environmental issues Wider Environmental Issues Impact Test guidance	No	16
Social impacts		
Health and well-being Health and Well-being Impact Test guidance	No	16
Human rights Human Rights Impact Test guidance	No	16
Justice system Justice Impact Test guidance	No	16
Rural proofing Rural Proofing Impact Test guidance	No	16
Sustainable development Sustainable Development Impact Test guidance	No	16

Evidence Base (for summary sheets) – Notes

References

No.	Legislation or publication
	See Treasury website for
1	A new approach to financial regulation: judgement focus and stability - Cm 7874 (July 2010)
2	A new approach to financial regulation: consultation on reforming the consumer credit regime (December 2010)
	See Bank for International Settlements website for
3	An assessment of the long-term economic impact of stronger capital and liquidity requirements (August 2010)
	See Financial Services Authority website for
4	CP 09/23: The assessment and redress of payment protection insurance complaints (September 2009)

Illustrative annual profile of monetised costs* - (£m) constant prices

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Transition costs	100	100	40							
Annual recurring cost			25	25	25	25	25	25	25	25
Total annual costs	100	100	65	25	25	25	25	25	25	25
Transition benefits										
Annual recurring benefits										
Total annual benefits										

*For a discussion of the benefits and the calculation of the NPVs given in the summary table, see discussion below. The benefit in any one year is essentially a small reduction in the probability of a financial crisis occurring in that year multiplied by the very large loss (the present value of the reduction in GDP in that years and several subsequent years) which would result from the financial crisis. But no actual benefit accrues in each year and so no annual recurring benefit figure is included in the table.

Evidence Base (for summary sheets) – Discussion

Introduction

1. This section sets out the assumptions and analysis supporting this consultation stage impact assessment and the further information which is sought from consultees. It should be read in conjunction with the rest of the consultation document. The Government would welcome general comments on the impact assessment.
2. This impact assessment does not cover the possible transfer of responsibility for the regulation of consumer credit from the Office of Fair Trading (OFT) to the FCA. This is the subject of a separate consultation and impact assessment (reference 2). Accordingly, the quantified costs and benefits of that proposal are not included this assessment. The full impact of both reforms can be obtained by adding the corresponding figures of option 1 of the consumer credit impact assessment and option 1 or option 2 of this assessment.
3. The tripartite system of financial regulation failed to ensure financial stability in the UK in 2007 and 2008. As a result there was the longest and deepest recession since the Second World War and a record budget deficit. The policy objective is to reduce the frequency and severity of financial crises.

Overview of costs and benefits

Benefits

4. This impact assessment considers two alternative ways of implementing the Government's regulatory reforms. The key assumption for both options discussed is that creation of specialist financial regulators and the strengthening of the arrangements for coordination between the Prudential Regulatory Authority (PRA) and the Bank of England should result in a reduction in the frequency of severe financial crises in the UK, in addition to any such reduction that could be attributed to other measures (such as internationally agreed changes to regulatory requirements). If that assumption is correct, the benefits of the proposed reforms would be likely to be large but the actual quantification (discussed in detail below) can only be the result of the assumptions made, including those about economic growth and the impact of a single financial crisis. Since the severe financial crises are relatively infrequent (a reasonable assumption would be once every 20-25 years), it would probably not be possible to test the key assumptions for at least 30-40 years and even then, it would be difficult to isolate the effects of past regulatory reforms from other factors.

Costs

5. There will be both transitional costs and ongoing costs. Some regulated firms may incur transitional costs in making arrangements to deal with two regulators rather than one and may also incur ongoing costs in dealing with two regulators on a regular basis. Public authorities (primarily the Bank of England and the FSA) will incur transitional costs in setting up the new regulators. The new regulators' ongoing costs in total may differ from the costs that the FSA would have incurred if the regulatory reforms were not implemented. As at present, regulators' costs will be recovered in fees or levies paid by regulated persons or by persons engaged in regulatory transactions apportioned, as they currently are, on the basis of size and other factors relevant to the type of business activity or concerned.
6. It is assumed that the benefits will be the same in option 1 and option 2. The choice between these options largely depends, therefore, on their costs. Since option 2 involves the creation of a third specialist regulator, focussing on wholesale markets and related issues, the transitional and ongoing costs for public authorities and regulated firms in this option would be likely to be higher.

Costs for public authorities

7. These cost estimates have been provided by the Bank of England as they relate principally to the creation of the PRA, its integration with the Bank and subsequent operations. There will be a transfer to the Bank of staff associated with prudential regulation and with the regulation of CCPs and settlement systems: this is likely to account for about a third of the FSA's regulatory staff. The FSA itself will become the FCA. There are relatively small costs to the Bank in setting up the FPC.
8. The Bank's approach to creating the PRA is founded on a firm expectation that costs of prudential regulation will fall in the medium term. This will flow from the new judgement-based regulatory model, from improved quality of system support (flowing from the extension of Bank's more economical and secure IT framework to the new subsidiary), from eliminating duplication between the PRA and the Bank, and also from tight control of costs.
9. In the short run, however, the transition will involve significant expense to the Bank on premises and IT. Establishment of the PRA as part of the Bank involves substantially more than just splitting the FSA into two parts and putting one part under a Bank governance structure. It is clear that to deliver the objectives of judgment-based regulation, integrated with the Bank's analytical capacity, the PRA will need to be physically located in or very close to the Bank, and given the likely staff numbers involved, a new building will be required. The Bank is also clear that in order to contain costs in the long run it would not wish to share in the existing IT systems at the FSA, which have relatively high running costs. So in order to reach a position in which it can both ensure integration and exercise a proper control over future costs, the Bank will need to invest in the transition.
10. This will involve preparing for and undertaking the transfer to the Bank of relevant FSA staff, most of whom will work in the PRA subsidiary; acquiring and fitting out suitable accommodation close to the Bank; delivery of Bank corporate IT to the PRA subsidiary, with associated networks and data centres; giving PRA access to selected FSA regulatory data and applications pending development of PRA-specific systems; and programme management and business change.

11. The FSA has indicated that much of its regulatory IT estate would be in need of amendment or replacement even in the absence of the changes envisaged by the Government's proposals. New or amended systems for the PRA will therefore be developed as part of 'business as usual', though under the guidance of the PRA Transition Programme Board, a joint Bank/FSA body chaired by Hector Sants. Since both the draft legislation and the new regulatory model are themselves developing, there is at this stage a very wide range of options for future system requirements, and for connectivity to the Bank. Coupled with this is legal uncertainty about the status of some major contracts. So no detailed system design work has yet started.

12. There is also uncertainty about accommodation costs: there is a range of possible premises in the City, and of financial options for acquiring them. And although staff numbers at the point of transfer can be estimated, longer term staff requirements will depend on the evolution of the regulatory model. Underlying these uncertainties are the remaining open questions on the legislation, which may have implications for the size and complexity of the PRA.

13. The FSA legal entity will become the FCA and retain the staff and systems not transferring to the PRA. As with the PRA, there will be significant system development, although this would have been necessary in any event and is not seen as part of the cost of transition. There will however be a cost of restacking the FSA's main site as the PRA staff move out and space becomes available for re-letting; and some HR and training costs. There will also be legal and programme management expenses.

14. The Bank and the FSA are committed to ensuring that the transitional costs are minimised and controlled, and to achieving long-run cost savings to offset the transition costs. There will be further work to refine the cost estimates.

Costs for regulated firms

15. In the previous consultation (reference 1), the Government sought views on the transitional and ongoing costs for all types of regulated person. However, few respondents addressed this point in their responses and the Government has therefore used the assumptions discussed below to provide illustrative cost estimates. The Government would therefore welcome comments from all types of firm on the assumptions made for the transitional and ongoing costs that firms would expect to incur in making changes to their internal systems and processes for option 1 or option 2.

Description of options considered

16. The previous consultation (reference 1) considered the model of creating a Financial Policy Committee and setting up two regulators (PRA and FCA) to replace the Financial Services Authority (FSA). The consultation also sought views on two variants of this model: merging the UK Listing Authority (UKLA) with the Financial Reporting Council (FRC) or retaining the UKLA with the FCA.

17. Most respondents who commented on this issue strongly supported retaining the UKLA as a part of the FCA. But some respondents put forward arguments for other options including establishing a separate markets regulator distinct from the consumer protection and retail conduct functions of the FCA and this option has been considered further. This impact assessment therefore covers:

    Option 0 – "do nothing"

    Option 1 – two regulator model

    Option 2 – three regulator model.

Option 0 – "do nothing"

18. This option is the base case for this impact assessment. As the name implies, in this option the FSA would remain responsible for both the conduct of business regulation and the prudential regulation of all regulated financial services firms, would continue to regulate market conduct and be the UKLA and carry out its other activities as now. The roles and responsibilities of other organisations would also continue as before.

19. "Do nothing" does not mean "no change in the regulatory environment". It only means that the reforms to the regulatory structure discussed in this consultation paper would not be made. Other changes to the regulatory environment – for example, arising from the implementation of changes to EU law or changes to domestic regulatory practice – will continue to happen. These changes will also happen if either option 1 or option 2 is chosen.

Option 1 – two regulator model (preferred option)

20. In this model:

- a **Financial Policy Committee** in the Bank of England will have responsibility for considering the macro-economic and financial issues that may threaten financial stability;
- the **Bank of England** will have responsibility for the regulation of settlement systems and central counterparty clearing houses to sit alongside its existing responsibilities for payment system oversight;
- the **PRA**(a subsidiary of the Bank of England) will have responsibility for the prudential regulation of deposit-takers, insurers and certain investment firms;
- the **FCA** will have responsibility for:
    - supervision (including prudential supervision) of all firms not regulated by the PRA, including most investment firms;
    - consumer protection in financial services (including through a stronger role in competition matters);
    - regulating the provision of consumer credit (see separate consultation);
    - regulating conduct in financial services generally, including in relation to firms authorised and supervised by the PRA;
    - regulating market conduct, including taking action to impose civil penalties for market abuse and pursuing criminal prosecutions;
    - regulating investment exchanges and providers of trading facilities;
    - primary market regulation (including listing).
- the FRC remains a separate body.

Option 2 – three regulator model

21. There are a number of variants of this model depending on (i) whether responsibility for settlement systems and central counterparty clearing houses was transferred to the Bank of England (as in option 2), (ii) whether responsibility for regulating firms mainly active in wholesale markets, or for regulating wholesale conduct (i.e. conduct that was neither market conduct nor conduct in relation to retail consumers) was placed with the separate markets regulator, and (iii) whether responsibility for other bodies such as the Financial Reporting Council was included in the separate markets regulator. For the purpose of this impact assessment, it is assumed that:

- a **Financial Policy Committee** in the Bank of England will have responsibility for considering the macro-economic and financial issues that may threaten financial stability;
- the **Bank of England** will retain responsibility for payment system oversight;
- the **PRA** (a subsidiary of the Bank of England) will have responsibility for the prudential regulation of deposit-takers, insurers and certain investment firms;
- the **FCA** would have responsibility for:
    - supervision (including prudential supervision) of most firms not regulated by the PRA, including most investment firms;
    - consumer protection in financial services (including through a stronger role in competition matters);
    - regulating the provision of consumer credit (see separate consultation);
    - regulating conduct in financial services generally, including in relation to firms authorised and supervised by the PRA.
- the separate markets regulator would have responsibility for:
    - regulating settlement systems and central counterparty clearing houses;
    - regulating market conduct, including taking action to impose civil penalties for market abuse and pursuing criminal prosecutions;

- regulating investment exchanges and providers of trading facilities;
- primary market regulation (including listing);
- the FRC.

Analysis of costs and benefits

Introduction

22. As explained above, the "do nothing" option provides the base case for this impact assessment and it is assumed that other changes to the regulatory environment – changes which would happen irrespective of changes to the regulatory structure - would increase or decrease the costs and benefits of the three options by the same amounts on the same dates. The net present value (NPV) of each option would therefore be increased or decreased by the same amount and the ranking of the options and the differences between their NPVs would not be changed.

23. The costs and benefits of the "do nothing" option are therefore assumed to be zero and the costs and benefits of the other options are measured as differences from the amounts in the "do nothing" option. The costs and benefits of this option are the benefits and costs of the other options and so do not need to be discussed separately. It would, of course, amount to double counting to treat something both as a cost of the "do nothing" option and as a benefit in the other options. A number of minor reforms are discussed in the main consultation document text but are not considered in detail in this impact assessment. It is assumed that they would be taken forward in both option 1 and option 2 but not in the "do nothing" option.

(1) Costs for public authorities

Transitional costs

24. Provisionally, taking account of the accommodation, IT and staff transfer expenses, the full cost to the Bank and the FSA of creating the PRA will be in the region of £75million - £150 million; the wide margin reflects the current uncertainty over the likely scale and cost of the PRA's IT estate and of the acquisition of new premises. The residual cost of creating the FCA (excluding IT development undertaken as 'business as usual') will be in the region of £15 million - £25 million. Further work is needed to establish more precise estimates of the costs but at this stage, the authorities are assuming that the costs of establishing the PRA and transforming the FSA into the FCA would be £90 million and £175 million.

25. Detailed estimates of the costs of establishing a separate market regulator have not been made. But it is clear that this would require additional expenditure to create the new organisation, acquire IT systems and premises etc. in addition to the expenditure required to create the FCA and the PRA. In particular, as the separate market regulator would be a separate legal entity from the FCA, it would, like the PRA need its own accommodation and systems, and staff would have to be transferred. The transitional costs for option 2 would be likely, therefore, to be significantly higher than those incurred in option 1. This impact assessment assumes an additional £20 million to £30 million again mainly spread over 2011 and 2012 but this could be on the low side, taking into account the significant costs that would be likely to be incurred in acquiring new premises and in installing new IT systems.

Ongoing administrative costs

26. The ongoing additional costs of the reforms will be mainly resource costs incurred by the new regulators less the ongoing administrative costs that the FSA would continue to incur in the "do nothing" option.

Changes in supervisory practice etc.

27. The FSA has been taking steps to improve the rigour and credibility of its supervisory effort and the costs of this are reflected in the base case. The PRA is expected to take a more judgement-led style of prudential supervision which is likely to mean more intensive and demanding engagement between the regulator and the firms concerned. The Bank of England considers that these changes in supervisory practice will not result in higher ongoing costs for the PRA because of a more efficient approach to regulation and the ability to adopt more cost-effective IT solutions.

28. The FCA is also likely to make some changes to the operational model of the FSA in order to deliver improvements to consumer protection and market integrity. This reflects its role as a single, integrated conduct regulator with a more proactive approach to regulating conduct in financial services and financial markets and taking on a stronger role in competition matters. These changes will be in addition to changes already made by the FSA towards a more interventionist and pre-emptive approach to retail conduct regulation which are included in the base case.

Loss of economies of scale

29. Some loss of economies of scale due to duplication of fixed costs is inevitable but this is not expected to be significant for the FCA in either option 1 or option 2 as it will remain a relatively large organisation. The PRA is likely to be a smaller organisation but it is expected to be able to share common services and overheads with the Bank of England.

30. The loss of economies of scale would be a more serious issue for a separate market regulator (option1) as this would be a relatively small organisation combining different activities. There would also be a loss of the synergies in combining wholesale and retail conduct regulation which are possible with the FCA while there are unlikely to be sufficient offsetting synergies in links with the FRC which is a specialist regulator in a particular area. A separate market regulator is also likely to have a relatively small permanent base of permanent fee-payers in the financial services area which would be able to cover overheads.

Increased specialisation and efficiency gains

31. Increased specialisation may result in some efficiency gains in option 1. However, these are likely to be limited as the FSA is large enough to ensure that there is a critical mass of expertise in both areas relevant to the FCA and PRA. The FCA should also be large enough to support the specialisation needed for certain activities such as listing, infrastructure regulation and market conduct. There is a risk, however, that a separate market regulator (option 2) would not be large enough to support critical masses of expertise in certain areas (such as listing and other areas currently in the FSA) and this could lead to increases in costs. Advantages arising from enabling the separate market regulator to specialise in representation in the European Securities and Markets Authority (ESMA) (which was an important issue for many respondents to the July consultation) would probably be offset by extra costs in ensuring that the consumer financial services and markets regulators could work closely together in this area.

Other matters

32. There should be no significant additional ongoing costs in respect of functions transferred to the Bank of England or arising from the activities of the Financial Policy Committee (FPC).

Conclusion

33. It is difficult to estimate the overall balance of the factors discussed above. The Bank expects there to be long-run cost savings in the PRA arising from a more efficient approach to regulation and improvements to IT. But it is less likely that such savings could be made in the FCA which will retain a broad set of responsibilities. Overall, therefore, this impact assessment assumes that the FCA's and PRA's combined ongoing running costs should not be materially different (in real terms) in aggregate from the current FSA budget of about £500 million and that the range for additional ongoing costs in <u>option 1</u> would be between £0 and £25 million higher than the base case costs. The ongoing administrative costs of <u>option 2</u> are likely to be higher than those of option 1 but the same range of costs is assumed in this impact assessment.

(2) Costs for regulated firms

Transitional costs

34. <u>The Government has used the assumptions discussed below to provide illustrative estimates of the transitional costs for regulated persons. The Government would therefore welcome input from all types of firm on these assumptions</u>.

35. Most of the approximately 20,000 UK firms regulated under the Financial Services and Markets Act 2000 will be regulated solely by the FCA in option 1 or option 2.

36. These firms may face some transitional costs – for example updating websites and letterheads – but these costs seem unlikely to be important. All firms will need to replace stationery and update websites etc. on a regular basis and they will have had about two years' notice of the proposed change. The additional resources required specifically to take account of the transition from the FSA to FCA are, therefore, assumed to be negligible for the purposes of this assessment.

37. About 1,700 UK firms are likely to prudentially supervised by the PRA while also subject to conduct of business regulation by the FCA ("dual-regulated firms"). These firms are more likely to have to make arrangements to deal with two regulators rather than one, including changes to IT systems and possibly to internal processes and organisation. There are also some groups containing both dual-regulated firms and FCA-only firms which may be affected in a similar way as dual-regulated firms.

38. Many dual-regulated firms will be large banks, insurance companies and investment banks and most groups which contain dual-regulated firms are likely to be large or to contain large firms of these types. These firms or groups seem more likely to incur transitional costs in setting up systems to deal with both regulators, largely a function of the size of the firm.

39. The PRA will also be responsible for prudentially supervising much smaller firms which take deposits or effect and carry out contracts of insurance. Almost all credit unions and some friendly societies and building societies would fall to be considered as small firms; many credit unions would be very small by any standard. Some investment firms regulated by the PRA may also be small firms although it is likely that they will be parts of groups that include a bank or insurance company. The transitional costs for these firms seem likely to be relatively less depending on the circumstances of the individual firm.

40. It is difficult, therefore, to estimate the transitional costs that dual-regulated firms will face. It would be difficult to separate genuinely additional costs from expenditure that would have been incurred anyway. Unlike most regulatory changes which involve firms having to make specific changes to staffing, processes or systems used in their businesses in order to meet precise, identifiable regulatory requirements, the principal effect of the regulatory reforms considered here is that dual-regulated firms will have to deal with two regulators rather than one. The transitional costs for these firms are simply the costs of setting themselves up to be able to do this. These costs are likely to vary considerably depending on their size, individual circumstances and their existing internal organisations, systems and processes.

41. It is not possible, therefore, to produce precise estimates of the transitional costs for dual-regulated firms. However, assuming that 800[1] dual-regulated UK firms would incur additional costs of about £60,000 on average while the remaining 900 dual-regulated UK firms incurred additional costs of about £10,000 on average, transitional costs in <u>option 1</u> would be £57 million. The range of costs is put between £50 million and £60 million. But this is a highly tentative estimate and industry input would be welcome.

42. Transitional costs would be likely to be higher in option 2 than in option 1. (This impact assessment assumes a further £10 million - £20 million.) Many of the larger dual-regulated firms and a large number of FCA-only firms would have to make further systems changes to make arrangements to deal with the separate market regulator. (Only a small number of infrastructure providers would be regulated solely by the separate markets regulator rather than by the FCA and the separate markets regulator.) Depending again on the circumstances of the individual firms concerned and the extent of their involvement in areas overseen by the separate market regulator, the additional costs in option 2 could range from negligible (if the new systems could also be used for the consumer financial services regulator) to those of fully duplicating the additional systems. However, firms would have advance warning of the introduction of the need to make changes to systems etc. and could be expected to plan to minimise the costs of either option.

Do you have any comments on the assumptions made for transitional costs for regulated firms?

Ongoing compliance costs

43. <u>The Government has used the assumptions discussed below to provide illustrative estimates of the ongoing costs for regulated persons. The Government would therefore welcome input from all types of firm on these assumptions</u>.

[1] This assumes most UK banks and building societies, insurance companies and investment banks would have high transition costs,

44. Regulated firms and applicants for authorisation are only like to face significantly higher ongoing compliance costs in option 1 or option 2 if they have to deal with more than one regulator. The majority of FCA-only firms are unlikely, therefore, to face higher ongoing compliance costs in either option 1 or option 2. Some firms may be affected by the possible changes to the FCA operating model but that will depend on a range of factors and need not imply higher costs for firms; this is discussed in more detail in the section on benefits.

45. Dual-regulated firms (and applicants) will have to deal with two regulators and may need to respond to the changes in supervisory practice in the PRA. The impact on larger dual-regulated firms seems likely to be relatively greater than for smaller dual-regulated firms but the amount of the impact would depend to a significant extent on the circumstances of individual firms and its existing internal systems and processes.

46. Ongoing compliance costs would also be likely to be higher in option 2 than in option 1 for those firms that have to deal with a separate markets regulator as well as the PRA or FCA. This would affect the larger dual-regulated firms and FCA-only firms which are active in wholesale financial markets and need to engage with a separate market regulator.

47. It is very difficult to make estimates of the additional ongoing compliance costs that firms or applicants will incur in option 1. These costs seem likely to be most significant for the larger dual-regulated firms and to take the form of increased costs (mainly staff) for relationship management and compliance work. However, firms can be expected to adapt over time to the new regulatory arrangements so these costs can be assumed to diminish as firms adapt. In the long run, therefore, ongoing compliance costs for regulated firms may not be significantly different from base case costs although this can only be a tentative conclusion. This impact assessment therefore assumes that firms will not face additional ongoing compliance costs in option 1.

48. The additional compliance costs in option 2 would probably be higher than the costs in option 1. Many of the larger dual-regulated firms and a significant number of FCA-only firms would have to deal with the separate market regulator as well as the FCA although both the numbers of firms concerned and the resources involved would depend on the precise division of responsibilities between the regulators and the nature of the work. (So some FCA-only regulated firms would become dual-regulated firms while many of the larger dual-regulated firms would become triple-regulated firms.) The additional costs would probably be mainly staff costs for additional compliance work to meet the demands of the additional regulator and might be more likely to be permanent, rather than diminishing in the long run. This can also only be a highly tentative conclusion but this impact assessment assumes that firms will incur additional ongoing compliance costs of £25 million a year in option 2.

Do you have any comments on the assumptions made for ongoing compliance costs for regulated firms?

Benefits

Improvements in prudential regulation

49. In principle, the gross benefits from improvements in prudential regulation of option 1 and option 2 can be estimated by calculating the change in the present value of the total expected welfare losses (represented by the reduction in output i.e. GDP) from financial crises due to the reduction in the frequency and severity of financial crises. This is equivalent to estimating the change in the probability of a a financial crisis occurring in a year multiplied by the very large loss (the present value of the reduction in GDP in that years and several subsequent years) which would result from the financial crisis, and then discounting these annual amounts and summing them.

50. It is then necessary to deduct the amount of any benefits which could be expected to arise in the base case, including (i) the effects of the increased rigour and credibility of the FSA supervisory effort and (ii) the net effect of any changes to relevant regulatory requirements which would happen in any case – such as increases in bank capital and liquidity requirements made to implement the most recent recommendations of the Basel Committee on Banking Supervision to strengthen global capital and liquidity rules.

51. Of course, all such estimates are entirely dependent upon the assumptions made while isolating the net effects of other reforms or measures would be very difficult. The present values of benefits shown in option 1 and option 2 should be regarded as purely illustrative.

52. The Basel Committee on Banking Supervision has published estimates of the annual economic benefits and costs of tighter regulatory standards, including estimates of the effect of higher capital requirements on the probability of systemic banking crises (Reference 3). Their estimates of the annual benefits of reducing the probability of a financial crisis by 1 percentage point (e.g. reducing the incidence of financial crises from 4 per century to 3 per century) range from 0.19 per cent of output per year (assuming that financial crises have no permanent effect on output) to 1.58 per cent of output per year (assuming that financial crises have a large permanent effect on output).

53. The Basel Committee on Banking Supervision also considers that requiring banks to hold increased capital and liquidity will itself lead to significant reductions in the probability of financial crises and to significant net benefits in terms of reductions in output lost. It will always be difficult to assess how much of any benefits should be attributed to changes in capital and liquidity requirements rather than improvements in supervisory practice. The amount of capital and liquidity that a bank holds (and the amount of risk-weighted assets included in the denominator of a capital ratio calculation) can only be estimated on the basis of information from the bank's accounting systems and will depend on the quality of information in those systems. Clearly more intensive supervision could make a more important contribution to improving the stability of a bank if it led to the identification and correction of weaknesses in the bank's information systems. Increasing capital requirements would be more important for a bank which already had good systems.

54. It is impossible therefore to estimate the amount of any benefit that could be attributed to option 1 or option 2 (rather than being included in the base case) but if it is assumed that the proposed regulatory reforms alone reduced the probability of a financial crisis by only 0.1 percentage points, this would generate an annual benefit of between 0.02 per cent and 0.16 per cent of output. On this basis, for **illustrative** purposes, the annual benefit for the UK of the proposed regulatory reforms would be between about £250 million and £2,000 million a year. (This is estimated by assuming UK output (gross value added at basic prices) in 2010 to be about £1,300 billion. The estimates would be higher if GDP at market prices was used.)

55. For the purposes of this impact assessment, it is assumed that these benefits would only accrue from 2014 to 2020, reflecting the 10 year cut-off for impact assessments. In practice, of course, the benefits should endure as long as the new regulatory structure is maintained. (The method of estimating the benefits implicitly assumes they are long-run effects; the effect of the reforms is essentially to increase the time between severe financial crises although the analysis accepts that much of this can be attributed to internationally agreed changes in regulatory requirements (which are in the base case).) On the assumptions made, these benefits should exceed any ongoing costs so the results of this assessment are not biased by working with the 10-year cutoff.

56. The benefits from improvements to prudential regulation are expected to arise mainly from the creation of a specialist prudential regulator (the PRA) as a subsidiary of the Bank of England. This would be largely unaffected by the different allocations of market and other conduct responsibilities in option 1 and option 2. It is assumed therefore that the benefits would be the same for option 1 and option 2.

Improvements in consumer protection

57. The benefits of a more proactive approach in regulating financial services and conduct can be estimated in essentially the same way by calculating the change in the NPV of the expected gains or losses for consumers, regulated firms and others (such as regulators) arising from adopting the new approach to consumer protection and from the FCA having a stronger role in relation to competition. This analysis will also be entirely dependent on the assumptions made.

58. There are potential resource benefits for consumers from a reduction in the frequency or severity of incidents of significant consumer detriment (e.g. major investment misselling cases). Consumers would not have to engage with firms, regulators or bodies such as the Financial Ombudsman Scheme (FOS) in order to obtain redress, or suffer any loss of interest because of the inevitable delay between suffering a loss and receiving compensation. They would also not suffer distress about potentially losing what may be large amounts of money or because of the uncertainty over whether they are able to obtain compensation; distress can be regarded as a resource loss for consumers although it is obviously more difficult to estimate.

59. The resource gains or losses for firms and regulatory bodies could also be large. Firms would not need to use resources to examine claims or complaints from customers or to deal with regulators or the FOS. Regulators, the FOS etc. and, if firms were in default and unable to pay claims, the

Financial Services Compensation Scheme (FSCS) would not need to use resources to process claims. Both firms and regulators etc. can incur these costs whether or not the complaint is justified or compensation is payable. (Compensation paid or losses incurred because a customer is unable to obtain sufficient redress from a firm or from the FSCS (because the claim exceeds the limit in FSCS rules) are transfers rather than resource costs.)

60. There is no doubt that the quantifiable resource gains or losses involved could be large. The cost benefit analysis (CBA) included with an FSA consultation in 2009 on payment protection insurance (PPI) complaints (reference 4) indicates that there had been over 400,000 complaints since January 2005 about PPI while 63,000 cases were submitted to the FOS. The costs for firms and others in dealing with these complaints can differ significantly depending on how they are to be handled. The same FSA CBA assumed administrative costs for firms of £200 per complaint but indicated that this was lower because firms only had to review rejected complaints.

61. It is impossible, therefore, to estimate the amount of any benefit which could be attributable to option 1 or option 2 rather than the base case. However, assuming that numbers of customers affected by any one incident was of the order of 100,000 and that the resource costs were £5,000, the resource costs of any one incident would be £500 million. While the precise answer would depend on the assumed frequency of such incidents and the change in the frequency attributed to an improved operating model, this calculation suggests that benefits could not be of the same order as the benefits from the improvements to prudential regulation discussed above and would almost certainly be substantially lower. No amount has therefore been included in the illustrative benefits of option 1 or option 2.

62. The benefits from the FCA having a stronger role in competition matters are also very difficult to quantify. Most of the effect of the elimination of monopoly rents in the supply of real goods and services (which would include the provision of investment advice but not the provision of financial investments themselves) takes the form of a transfer from suppliers to consumers and so does not involve any resource cost or benefit. The benefits to consumers from the stronger FCA role in competition would therefore be found in any increase in the provision of financial services such as investment advice less the amount of any such benefits that might be expected to arise in the base case. There would also be some benefits in any reduction in resource costs incurred by other bodies such as the Office of Fair Trading. These benefits would be very difficult to estimate but there does not seem any reason for believing that they could be of the same order as the benefits from the improvements to prudential regulation. No amount has therefore been included in the illustrative benefits of option 1 or option 2.

63. The benefits from improvements to consumer protection (including the stronger role in competition matters) would be expected to arise mainly from establishing the FCA as a clear consumer financial services regulator. This would also be largely unaffected by the different allocations of market and other conduct responsibilities in option 1 and option 2. It is assumed therefore that the benefits would be the same for option 1 and option 2.

Assumptions, risks and sensitivities

64. The principal assumptions are those relating to the benefits of avoiding a financial crisis (see above) and about the costs for public authorities and regulated firms.

65. The key assumption is that establishing two specialist financial regulators and the strengthening of the arrangements for coordination between the PRA and the Bank of England should result in a reduction in the frequency of severe financial crises in the UK, in addition to any such reduction that could be attributed to other measures (such as internationally agreed changes to regulatory requirements). Clearly, there is a risk that this assumption is not correct and that the benefits assumed in the impact assessment are overstated.

66. In addition, the amount of the benefits is clearly dependent on the detailed assumptions made (including by the Basel Committee of Banking Supervision in its work). This can be seen in the difference between the high and low estimates of the benefits which reflects different assumptions about whether there are permanent effects on output from a crisis. These estimates will always be very sensitive to changes in economic assumptions (for example, the long-run trend in economic growth).

67. In relation to costs, the main risks are that (1) the transitional costs (i.e. development and implementation costs) for regulatory bodies or firms are materially underestimated (including the risk

that implementation takes longer than anticipated); and (2) the ongoing costs for regulatory bodies and firms are materially underestimated.

68. This impact assessment has assumed that the best estimate of the costs (or benefits) is at the unfavourable ends of the ranges. It is not thought, therefore, that there would be significant risks of costs materially exceeding the estimates. It is unlikely, therefore, that costs could increase by the amount necessary to make option 0 a superior option to option 1 or option 2. Since option 2 involves more duplication than option 1, the additional costs are likely to be larger and therefore a cost underestimate in option 2 is likely to be proportionately larger than a cost underestimate in option 1. The choice between those options is unlikely, therefore, to be affected by any cost underestimate.

Wider impacts

Statutory equality duties

69. The Government has considered the proposed reforms (option 1 and option 2) in relation to its public sector equality duties under the Sex Discrimination Act 1975, the Race Relations Act 1976, the Disability Discrimination Act 1995 and section 75 of the Northern Ireland Act 1998 and has concluded that no relevant issues arise. The Government also considers that the proposed reforms would not be relevant in relation to any additional requirements that take effect from April 2011 under the Equality Act 2010. All UK residents would be affected to a greater or lesser extent by a financial crisis having a severe impact upon the UK economy.

Environmental, social and sustainable development impacts

70. The Government does not anticipate any impact upon greenhouse gases, wider environmental issues, health and well-being, human rights, the justice system, rural proofing and sustainable development. This assumes that the proposed reforms would not change the relationship between certain environmental phenomena and GDP.

Economic impacts

71. Apart from any effect arising from the stronger FCA role in competition matters, the principal effect on competition from financial services regulation is through the effect on barriers to entry into the industry. The Government does not envisage that the proposed reforms to regulatory structure will in themselves change the conditions which applicants have to satisfy to obtain authorisation from a regulator but there may be higher costs in obtaining authorisation for applicants to be dual-regulated firms as both the PRA and FCA will be involved in processing the application. The Government does not expect these costs to be significant and there would in any event be no effect upon the ability of EEA firms to enter the UK market using a ‘passport’ from their home State regulator issued under the relevant EU Directives. The Government does not consider, therefore, that the proposed reforms will have any significant adverse effect on competition.

72. Small firms which take deposits or effect or carry out contracts of insurance, and certain small investment firms will be regulated by the PRA and FCA. The proposed reforms are likely to have some effect on their costs (see above). Most small firms in the financial services industry are not deposit-takers or insurers and will be regulated by the FCA in succession to the FSA. They are not likely to be disproportionately affected by the proposed reforms.

73. Since option 2 is likely to involve higher costs than option 1, the effects on competition or small firms would be greater. There is no reason therefore for wider economic impacts to affect the choice between these options.

Summary and preferred option (with description of implementation plan)

74. The Government’s preferred option is to proceed with option 1.

75. The main implementing measure will be primary legislation which is expected to be enacted in 2012. Secondary legislation and administrative measures (including action by the Bank of England and the FSA) will be needed to complete implementation which is assumed, for the purposes of this impact assessment, to be essentially completed by the end of 2012.

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