

**Breaking up
is hard to do:
the future of
UK financial
regulation?**

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1 Introduction

The broad shape of the new UK regulatory architecture proposed by the Coalition Government is now clear. There will be a new macro-prudential regulator, the Financial Policy Committee, within the Bank of England; a new prudential regulator – the Prudential Regulation Authority (PRA) – established as a subsidiary of the Bank to supervise banks, insurers and other systemically significant investment firms; and a conduct regulator and markets regulator – provisionally named the Consumer Protection and Markets Authority (CPMA) – to focus on consumer protection and market regulation.

The Treasury issued a Consultation Paper on the proposals in July 2010¹, and published the responses in November 2010². In that response, it stated that whilst there was support for the proposed restructuring, five common areas of concern emerged:

- the importance of accountability and transparency for the three new bodies: the FPC, the PRA and the CPMA
- the need for the regulatory authorities' core statutory objectives to be balanced and supplemented by other factors
- the importance of effective coordination between the new bodies
- the need for a strong, coherent markets regulation function within the CPMA, to include the UK Listing Authority
- the importance of the European and international regulatory agenda both in the transitional phase and beyond

The purpose of this paper is to discuss some of the key issues that need to be considered in devising the legislative mandate, powers and functions for these new bodies. What principles should guide the restructuring? What should be the objectives and remit of the new authorities and how should the objectives be enshrined in legislation? What legislative powers and tools will they require to fulfil those objectives? And how should they be held accountable?

2 Principles to guide the restructuring

The Government's conviction is that a split will enable the new regulatory agencies to be more specialised and focussed and, presumably more effective. The evidence for this is unclear. However, the political decision has now been taken and debate must turn to how best to devise and implement the new structure. In this process, it is easy to become bogged down in details very quickly. Who should have what powers; where precisely should the precise jurisdictional boundaries be drawn; and so on. These details are clearly important, and some are discussed further in this paper. However it is worth considering what broader principles or objectives that should guide policy makers through the detailed maze. In our view, six key principles should guide the reforms and restructuring:

- **Ensuring that the new regulators have a clear and strong voice in Europe.** As the EU moves to be the monopoly provider of regulatory rules in EU financial markets, and seeks to develop a common set of supervisory practices for all regulators to adopt, it is imperative that the remits, powers and objectives of the new UK regulators align with the new European Supervisory Authorities to ensure that the UK's views are expressed clearly and authoritatively at the European level.
- **Ensuring that there is clarity of purpose as to what each regulator, and the regulatory system as a whole, can do and what it can, and cannot be expected to deliver.** In its early days, the FSA issued a paper explaining that it would adopt a 'nonzero failure' approach. That approach has had to be modified in the crisis, and arguably sits uneasily with a 'financial stability' objective. In a recent speech, Hector Sants made it clear that the PRA would not be a 'zero failure' regulator, but that any bank failures should be resolved in an orderly manner. However, he indicated that both the CPMA's and PRA's risk tolerance would reduce.³ A clear articulation of what the three regulators are expected to achieve, separately, together and with the Treasury, would help to clarify the purposes, responsibilities and expectations for each organisation. It would also help to inform policy decisions as to legal powers, functions and processes that should be utilised by those regulators.
- **Ensuring that there is clarity as to the jurisdiction of each regulatory authority** – the scope of the new authorities' remits risks being defined in part by the regulatory objectives they are pursuing, and in part by the type of institutions and activities being performed, producing a complex list of who is regulated by which authority and for what activity based on an unclear and uncertain rationale. In these circumstances, it is imperative that the responsibilities of each body are clearly delineated in order to avoid turf wars or even litigation over the scope of the jurisdiction of each body.
- **Ensuring that there is adequate coordination between the new authorities.** By moving microprudential supervision to the Bank the new structure is intended to improve coordination between macro and micro-prudential supervision. However, there is a very real risk that the problems of coordination will not be removed, but simply displaced. Whilst we can expect that there will be greater coordination in prudential supervision, there is a very real risk that there will be far less coordination between prudential supervision, market oversight and conduct of business regulation. The creation of new coordination problems could have a damaging effect on the regulators' ability to achieve their objectives and impose needless costs on the industry. In particular, coordination will be particularly important in a number of key areas: licensing decisions; policy making and standard setting in areas of common interest, such as operational risk management; the approved persons regime; remuneration policies; regulation of systems and controls (especially in relation to operational risk); oversight of market infrastructure; information gathering/regular reporting and supervisory activities; and investigation and enforcement.
- **Ensuring adequate independence of the Bank of England and CPMA from Treasury in matters not concerning the use of public finances, balanced by appropriate accountability arrangements.** It is important that the new authorities are independent from the Government but that they have clear responsibilities for which they are accountable. In particular, the Bank of England will have unprecedented powers to determine monetary policy and ensure financial stability. There are potential conflicts of interest between the two objectives and it is imperative that the Bank exercises its powers through the Monetary Policy Committee (MPC), FPC and PRA

independently from the Treasury in a manner which is clear and as transparent as possible, with clear lines of accountability for the decisions of each body.

- **Ensuring that the system is dynamic and capable of coping with rapid change.** The FSA has been an integrated regulator with a wide remit which is defined on the basis of the nature of investment products and services being provided. As noted above, creating two new regulators will mean that issues are likely to arise as to the boundary between each new regulator. Financial markets evolve rapidly and so there needs to be some mechanism to ensure that the structure can adapt quickly to respond to financial innovation and to other changes in the markets. It may not always be the case that the normal process of using delegated legislation to effect a change can happen sufficiently quickly. In particular we know from the crisis that institutions that do not look systemic *ex ante* can become so during the crisis. It is therefore particularly important that there is the capacity to extend the PRA's or CPMA's jurisdiction on an emergency basis without having to engage in protracted procedures, perhaps, in this respect, following the model of the US Financial Stability Oversight Council.

In addition both will have to take into a range of factors: (paras 3.5-6; 4.78)

- the objectives of other regulatory authorities, to which each must have regard in carrying out its own functions in order to support effective coordination
- principles of good regulation
- other considerations in order to ensure that its pursuit of its primary objective is also balanced against, or pursued in accordance with, important matters which relate to the public interest

However the Consultation Paper emphasises that for neither agency should these include considerations of global competitiveness or innovation in financial services. It argues that 'There is a strong argument that one of the reasons for regulatory failure leading up to the crisis was excessive concern for competitiveness leading to a generalised acceptance of a 'light-touch' orthodoxy, and that lack of sufficient consideration or understanding of the impact of complex new financial transactions and products was facilitated by the view that financial innovation should be supported at all costs'.⁷ With respect to the 'public interest' considerations, the Consultation Paper suggests that the PRA should take account of potential wider economic impact of its policies or regulatory decisions, and effects on consumer and business lending (para 3.11). The CPMA should have to have regard to:

- the potential impact of policies or regulatory decisions on financial stability
- potential impact on consumer and business lending
- promoting public understanding of the financial system
- the need to maintain diversity in the financial services sector (for example, by removing barriers to entry where possible, and ensuring that its rules do not disadvantage mutually owned financial institutions)
- promoting financial inclusion where possible, by encouraging access to suitable products and services

In its feedback to the consultation responses, the Treasury indicated that the majority of respondents supported the proposal that each authority should have a single core objective supplemented by a number of other factors to which the regulators have to 'have regard to'. Responses to the Consultation Paper suggested that both the PRA and CPMA should be required to have regard to innovation and competitiveness, and in addition the CPMA should be required to have regard to competition, diversity, financial

3 Objectives and remits. Who should do what, and what should each do?

Objectives

The statutory objectives that regulators are given can ensure that they do not 'drift' from the main purposes for which they were set up. The Treasury's Consultation Paper proposes that the PRA 'will have a primary objective to promote the stable and prudent operation of the financial system through the effective regulation of financial firms, in a way which minimises the disruption caused by any firms which do fail'.⁴ It argues that this objective will support the PRA in taking a 'credible and appropriately intrusive approach to regulation and supervision'.

The CPMA's primary objective is proposed to be 'ensuring confidence in financial services and markets, with particular focus on protecting consumers and ensuring market integrity'.⁵ The Treasury argues that this objective 'will allow the CPMA to adopt a focused and specialised approach to all aspects of conduct regulation'.⁶

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inclusion and a 'proportionate' approach to regulation. The Treasury indicated in its response that it will require the authorities to have regard to each others' statutory objectives and, for the CPMA and PRA, a common set of principles of good regulation. However it left the question of what additional factors should be included, if any.⁸

The key questions, therefore are whether the primary objectives of each body are sufficiently clear, and what additional considerations the authorities should be required to 'have regard to', if any.

With respect to the PRA's proposed objective, is it really sufficient to say that the PRA has an objective of delivering "effective regulation" in order to minimise disruption caused by any failure? Is the primary objective to reduce contagion, to avoid failures, or to have orderly resolution in the event of failure? What is effective regulation and is the "sound and prudent operation of the financial system" to be the legal basis for PRA intervention in the affairs of a bank (as financial stability is now a ground for the FSA's own initiative variation of permission ("OIVOP") power)?

This raises the much bigger question: what do we want from the prudential regulator? Is it primarily there to protect the interests of taxpayers and/or consumers? Or is the primary objective to control the systemic risks associated with failure? The answers to these questions have potentially important implications for the nature of the regulator's objectives and powers. For example, if the working assumption is that the taxpayer implicitly guarantees the liabilities of banks and the role of the prudential regulator is protect taxpayers' interests, then this might lead to a strong and essentially commercial focus on scrutinising and challenging risk taking and risk management in these institutions, and an interventionist stance which relies heavily on regulators' judgements about individual institutions and is less concerned about creating a level playing field. If, conversely, the working assumption is that taxpayers should never again have to bail out banks and the objective of the regulatory regime is to ensure adequate investor compensation and the containment of systemic/contagion risks associated with the failure of any financial institution, this might lead to a very different style and focus of supervision and regulatory intervention – and perhaps still leaves some role for genuine competition. There is the risk, however, that in this case the presence of an orderly resolution regime could act as a moral hazard for regulators, making them less concerned to prevent failures in the first place.

Examples from other prudential regulation authorities illustrate the very different answers that can be given to these questions. In Australia, which has a system similar to the 'twin peaks' structure proposed for the UK (but does not involve the central bank in supervision), the objectives of the Australian Prudential Regulation Authority (APRA) are 'to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality.'⁹

In Canada, which also has a separate prudential regulator for financial institutions, the Office of the Superintendent of Financial Institutions (OSFI) is required to supervise institutions to 'determine whether they are in sound financial condition' and are compliant and 'to monitor and evaluate system-wide or sectoral issues that may impact institutions negatively'. It has a very clear mandate to be interventionist, however. It is required by statute to 'promptly advise institutions in the event that there are material deficiencies and take, or require management, boards or plans to take, necessary corrective action expeditiously' and to 'advance and administer a regulatory framework that promotes the adoption of policies and procedures designed to control and manage risk.'¹⁰

Arguably the statutory mandate to intervene when there are material deficiencies and to ensure that institutions control and manage risk gives a far clearer message about OSFI's role than the requirement to have 'effective regulation' of financial firms.

Given the dominance that EU regulation will have over financial regulation, and by implication the new UK authorities, it is worth also considering what objectives the new European Supervisory Authorities will have. As the UK bodies will be subject to their rules and technical guidance in a number of respects, these objectives will in effect 'flow through' to them. The objectives of each of the three new authorities, the European Banking Authority (EBA), European Securities and Markets Authority (ESMA) and European Insurance and Occupational Pensions Authority (EIOPA) are the same, differing only in that which relates to their specific task.^{11 12} The objective of all the authorities shall be 'to protect the public interest by contributing to the short, medium and long-term stability and effectiveness of the financial system, for the Union economy, its citizens and businesses', and to pay attention to systemic risks. In particular each shall contribute to:

- improving the functioning of the internal market, including in particular a sound, effective and consistent level of regulation and supervision

- ensuring the integrity, transparency, efficiency and orderly functioning of financial markets
- strengthening international supervisory coordination
- preventing regulatory arbitrage and promoting equal conditions of competition
- enhancing customer protection

There is a strong theme running through that the role of the authorities is to focus on financial risks. The task specific objectives of each are to ensure that there is appropriate regulation and supervision of credit and other risks (EBA); investment and other risks (ESMA) and the taking of risks related to insurance, reinsurance and occupational pensions activities (EIOPA).

These alternative examples raise a number of questions. Should the objectives of the PRA and CMA be more risk-focused? Should they be afforded a clearer mandate to intervene in financial institutions where those risks are not being managed appropriately? What degree of overlap, if any, there should be between the PRA and CMA's objectives? It would not necessarily be appropriate for the PRA and CMA to have the same objectives, as it is their objectives which distinguish them and define their respective remits, not the types of financial institutions or activities per se. However, market confidence and financial stability go hand in hand – financial stability can be radically affected when there is a loss of market confidence, and market confidence is clearly damaged when there is financial instability, in each case creating a vicious cycle of instability.

Should both regulators therefore have the objectives of enhancing market confidence and financial stability, but with the PRA required to attain this through ensuring the soundness of financial institutions, and the CMA required to attain this through ensuring consumer protection and market integrity?

Further, the Treasury proposes that each should 'have regard' to the objectives of the other. This is clearly necessary but the question is whether it is sufficient to ensure coordination and, more particularly, to enable the PRA and CMA to exercise their powers jointly (discussed below), or whether some degree of shared objectives would give such activities a clearer legal base. Any doubts over the purposes for which the regulators can exercise their powers is likely to provide fertile ground for litigation, which whilst good for lawyers is rarely good for effective regulation. Moreover, in crisis management situations, it is important

to ensure that their objectives are complementary, not pulling them in different directions. What of the list of factors to which the regulators should 'have regard'? Arguably the remits of the two new regulators are unnecessarily parochial – there is no mention of the need to have regard to the decisions of the international committees of regulators, for example. Given that the UK is a member of these committees, which are active standard setters and increasingly peer reviewers, this seems an odd and unnecessary omission.

However, there is a need for care in devising a list of 'have regard to's' for it can quickly become an overly long 'wish list' which reflects particular policy concerns or special pleading at the time of enactment which may then pass, but which the regulator is left lumbered with as part of its mandate. The factors regulators have to 'have regards to' can also in practice require trade-offs between objectives or factors, giving the regulator no clear sense of direction. They can also have unintended and deleterious effects. For example, the statutory requirement for the FSA to take into account senior management responsibilities arguably caused them to adopt a 'light touch' approach to business judgement decisions (see the Turner report).¹³ In contrast, OSFI is given a very different message by their mandate as to how much leeway they should give to the senior management of banks on their watch. Moreover, whilst it is difficult to argue against any requirement that regulation should be proportionate, should this requirement really be couched in terms that the regulator should be under an obligation to consider the industry's competitive position internationally? Should not regulators act independently in the pursuit of their objectives? Surely they are there to regulate, not to be a champion either of industry or, arguably, of the consumer? Nonetheless, should they not be explicitly required to have regard to the need to promote fair and open competition within the financial services market? All of that said, what does fair and open competition mean in a global market that is arguably distorted by the existence of implicit state guarantees of the liabilities of systemically important financial institutions?

Remits and jurisdiction

Whether or not the FSA should be broken up is not up for debate. That decision was made prior to the election, indeed just as Labour's decision to create the FSA was made pre-election and with no public consultation.

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The current consultation process focuses on how that decision should be implemented. The Consultation Paper is clear that prudential regulation of 'financial firms' (undefined) should be the responsibility of the PRA, and that conduct of business regulation and consumer protection should go to the CPMA. However, there are a significant number of institutions and activities which fall between those two stools. Since publication of the Consultation Paper in July 2010, a number of further key decisions have been taken, notably to keep responsibilities for listing with the CPMA.

The ambivalence as to the CPMA's role at the time the Consultation Paper was written in July perhaps accounts for its lack of emphasis on market regulation. However, market regulation extends beyond primary listing, and remains a matter the significance and implications of which are under-recognised in either the Consultation Paper or Summary of Responses. This is clearly a matter which needs to be addressed.

In addition, there is little if no recognition in the Consultation Paper that markets can have systemic consequences. This reflects the traditional regulatory approach to markets, first that the primary focus is on equity markets, second that the main concern is transparency, integrity and efficient price formation. Whilst globally there is a recognition of the need to improve the transparency and resilience of the OTC derivatives market, this is not reflected in the current debates on the role of the CPMA. Neither, indeed, are the issues of the changing structure of equity market trading, the continuing opacity of the bond markets, or the future role of the OTC markets, notwithstanding the role of the latter two in the crisis. The systemic implications of these markets need to be recognised as a matter of priority, and the jurisdictions of the CPMA and the PRA need to reflect this policy concern and confer on each sufficient powers to respond appropriately and in a coordinated manner.

4 Powers of new agencies

The range of powers

Having a clear set of objectives is necessary but not sufficient to ensure effective regulation. It is imperative that all the new authorities have adequate appropriate powers to pursue those objectives. These powers do not need to be

the same: the FPC has a very different role from the CPMA and PRA and so needs a very particular set of powers. The roles of the CPMA and the PRA are more similar but if the objectives and focus of each regulator are to be very different this may have implications for the legal powers, functions and processes that are needed to achieve those differing objectives.

Both the PRA and CPMA need strong powers to carry out core regulatory functions of licensing, standard setting, monitoring and enforcement in order to modify behaviour and manage risks. There are strong arguments for ensuring that each has powers comparable to those of the FSA; the crisis did not suggest that the FSA's failings were due to deficiencies in its powers. In particular, there are good arguments for retaining the current 'double perimeter' of authorisation and permission, and ensuring that the PRA and the CPMA each have powers to exercise these powers and formulate rules in pursuit of all their objectives (including, for the CPMA, clear authority to modify common law in some instances),¹⁴ guidance, write rules of evidential status, issue waivers and have powers to vary the terms of the authorisation or permission unilaterally. In addition, each needs strong information gathering and investigation powers, powers to appoint third parties to conduct investigations and to report, and strong enforcement powers. Further, there are good arguments for retaining the power for the CPMA to designate certain rules as having a private right of action attached. This latter right is appropriate for conduct of business rules, but we would suggest not for the prudential rules of the PRA.

More difficult issues arise with respect to the powers of the FPC. The FPC is to have two types of powers: system management powers, ie, to issue directions and recommendations to other bodies involved in the regulatory regime – the PRA, CPMA and MPC, and direct powers to act to preserve financial stability. With respect to its system management powers, the FPC is to be given powers, *inter alia*, to issue directions to the PRA and the CPMA to take specific actions where this is necessary to ensure financial stability. This is clearly a necessary power if the objective of ensuring that there is a coordinated approach to financial stability, led by the FPC, which can effectively 'join up' macro and micro-prudential supervision. Moreover, as the chief executives of the PRA and the CPMA are to be members of the FPC they will have a voice in how and when this power is exercised.

With respect to its direct powers to take action, there are two issues in particular which need addressing. First, it is not clear from the Consultation Paper whether it is the FPC or the PRA which will have the role of 'triggering' the special resolution regime processes set out in the Banking Act 2009. Arguably, if the same rationale is to be retained, it should be the PRA. This, however, may sit uneasily with the FPC's powers to give directions; it is not clear who is the main decision maker, and where the key veto points are.

The second issue concerns what the powers of the FPC should be to manage macro-prudential supervision and how they should be conferred. These powers are novel, or at least putting them in a statute is novel. Arguably many of the strategies set out in the Consultation Paper for managing macro-prudential risk have already been used by the FSA or the Bank in managing the crisis. However, what the suite of tools should be to manage macro-prudential risk is currently a matter of intense debate amongst central bankers and other banking supervisors at the international, EU and national level. The Consultation Paper sets out those which are most frequently referred to at present, notably counter-cyclical capital requirements, variable risk weights, leverage limits, forward looking loss provisioning, collateral requirements and (though perhaps less fashionably), quantitative credit controls and reserve requirements. Interestingly it does not mention quantitative easing, which has been the Bank's predominant strategy to stabilise the financial system once it became clear that the limits of monetary policy had been reached, nor the purchase of commercial paper – also used in the crisis to stabilise the financial system, nor the role of the Bank in providing liquidity, changing its own collateral requirements, or adapting the operation of its discount window – traditionally seen as an instrument of monetary policy but used as a mechanism to stabilise banks during the crisis. In each case, the omission raises an interesting question as to the relationship between monetary policy and financial stability, a question of much broader implications which the Bank will have to resolve. For these purposes, however, it prompts the question as to whether it is always possible, or indeed desirable, to identify in advance what is a monetary tool and what is a financial stability tool.

In setting out in statute what macro-prudential tools the FPC can use to stabilise the financial system, there are three very real dangers. First, that the list is regarded as exhaustive. Given our current state of knowledge of how best to manage financial stability, the list of tools is at best

a list of best guesses – we are at a very early stage in the debate and it may well be that other tools may be identified as the debate moves on which are considered to be more appropriate. Second, that the list is regarded as enumerating the powers not just of the FPC but of the Bank as a whole to act to preserve financial stability, as it is not clear from the Consultation Paper whether the Bank will retain its financial stability objective or whether this will be given just to the FPC. However the list, at least as set out in the Consultation Paper, does not include actions which the Bank took during the crisis – raising the question of whether the Bank would continue to have an implied power to adopt those strategies, or whether that would be overridden as they are not set out in statute. Third, that the list is too slow to change, meaning the Bank /FPC has insufficient powers at the time it most needs them – in a crisis. If it can only be changed by statutory instrument, the process is either too slow to be useful, or if expedited in an emergency, operates in a way which makes a mockery of any systems of Parliamentary accountability which are meant to accompany it.¹⁵

We know there will be another crisis but we do not know which form it will take. Following one of the key design principles we proposed at the outset, viz that the system created in the restructuring should be capable of responding quickly to changing situations, we propose that rather than set out a particular list of macro-prudential tools in statute or by way of statutory instrument, the FPC be given a general power to take actions to ensure financial stability, coupled with a requirement that the FPC engage in a process of consultation to develop and publish a code of practice setting out how those powers will be used. It can adjust the policies set out in the code after further consultation if it so wishes, but it is bound only on a 'comply or explain' basis. In other words it is not bound to use only those tools or policies in a crisis situation if others would be more appropriate in the circumstances. This legislative strategy has been used in the Banking Act 2009 with regards to the powers conferred under the special resolution regime. There are strong arguments for saying it should be used again with respect to the FPC's powers to navigate the uncharted waters of macro-prudential supervision.

Exercising powers – need for coordination: in day to day times and in crisis times

It is clearly critical that there is adequate coordination between the FPC, PRA, CPMA, Treasury and the Bank

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during times of crisis. Our main focus here, however, is on peace time conditions – coordination in the day to day business of regulation and supervision. Ensuring this day to day coordination in the exercise of the powers of the PRA and CPMA will be essential to ensure effective regulation. However, whilst the need for coordination is noted in the Consultation Paper, the need for it is arguably insufficiently recognised. There is an assumption running through the Consultation Paper that within a firm the ‘prudential’ aspects of its business are clearly delineated from the ‘conduct’ aspects, for example the proposal that the CPMA is to make provisions on internal controls for Conduct of Business rules, the PRA on internal controls for capital rules. However, in many firms the risk and compliance functions are merged. In practice, there is an enormous overlap between prudential and conduct regulation. For example, managing compliance with conduct requirements has significant overlap with operational risk management which is of increasing importance to prudential regulation; effective credit risk management and “responsible lending” are intimately connected. There are real dangers of inconsistencies emerging in the internal control and risk management standards required by the two different regulators leading to costly and confusing requirements for firms with no proven beneficial impacts. Moreover, there will need to be mechanisms for resolving potential conflicts between the objectives of prudential regulation (or even wider economic policy) and consumer protection considerations. How, for example, will the FPC, the PRA and the CPMA resolve the potentially conflicting objectives of increase lending to support economic recovery, prudent credit risk management, responsible lending and financial inclusion?

We would suggest that there are strong arguments for allowing, or perhaps requiring, the CPMA and PRA to exercise their powers jointly with respect to the same financial institution where this is necessary to ensure coordination and reduce the scope for regulatory arbitrage. There is a particular need for consistency and coordination in the following areas where both regulators are regulating the same financial institution (or in some instances where they are part of the same group) with respect to the following:

- decisions on authorisation and permission
- the exercise of OIVOP powers
- regulation of all matters related to internal management and corporate governance, including:
 - the design and operation of an approved persons regime or its equivalent

- provisions on systems and controls
- provisions on remuneration

In addition, there should be joint supervision of the implementation of those provisions within financial institutions which both regulate. It is also imperative that each has powers, and is required to, share information and to cooperate in any investigation and enforcement action where appropriate.

However, there are real issues in how the agencies can and will exercise overlapping powers. It is anticipated that the agencies will essentially work this out through memoranda of understanding and operating protocols. As a practical strategy that is no doubt sensible. However, the legislative framework will be critical. If each has independent powers, a different set of objectives, of factors to ‘have regard to’, and indeed different legislative messages as to how they should regulate (discussed further below), then achieving common use of those powers will be difficult and may even be susceptible to legal challenge on the basis of unlawful delegation. It will be important to ensure that there is clear statutory authority for joint decision making where that is desirable.

Enforcement – particular issues

There are particular issues relating to enforcement that will need to be addressed. We discuss below the question of the appropriate supervisory and enforcement ‘culture’ that the PRA and CPMA should adopt. The focus here is on the powers and processes that should be used. With respect to the procedures involved to take formal enforcement action, there is a sense that regulators may have tired of due process, see for example the changes in the Financial Services Act 2010 to enable the FSA to publicise contested decision notices. Will there be an attempt to further “streamline” enforcement processes, of either the CPMA or the PRA, to enable regulators to deliver public enforcement action more speedily? For example, will the statutory right to make representations to a decision maker separate from the investigation team be re-examined? Will the FSA’s Regulatory Decisions Committee process survive in either or both regulators? Or are we moving to a more US style of enforcement whereby regulators can simply file a complaint which they then publicise even though it may be hotly contested? If so, it should not be assumed that such moves will lead to speedier settlements – the dynamic is not the same as in the US where the spectre of class action lawsuits

and the availability of no-admission no denial settlements are big drivers for settlement. Further, bringing publicity to an earlier stage of the process might result in more fully contested cases as the reputational damage will already have been done. Moreover, rights to make representations and have matters considered by those independent from the investigation team can help regulators make better decisions.

Particular issues also arise as to when formal enforcement or other regulatory actions should be taken. The Consultation Paper proposes that legislation should stipulate trigger points for action by the PRA. However, the experience of OSFI and APRA is that a better approach is for the regulator to determine when to take action, not to have this prescribed in legislation. Both OSFI and APRA 'key in' a particular set of supervisory responses to the risk assessment as a matter of published supervisory practice. In APRA's case it is their Supervisory Oversight and Response System (SOARS) which is linked to its risk assessment framework and sets the supervisory actions to be taken with respect to firms posing specified risks.¹⁶ In OSFI's case these are set out in its Guides to Intervention, also linked to the risk assessment framework.¹⁷ Both regulators have found that having a clear but tailored and flexible strategy is better than having hard line 'trigger points' written in legislation. The experience of the financial crisis provides further support for such an approach. By their nature, crises can take unexpected forms. There is a real danger that if there is a crisis without the legislative 'trigger points' having clearly been triggered that the regulator will be inhibited, indeed prevented, from acting.

Powers and regulatory culture – ways in which powers are used

One of the stated aims of the Consultation Paper is that the legislation enacted will promote a more 'informed and judgemental approach' to regulation by the PRA.¹⁸ To that end, the Treasury will consider 'whether any modifications or alternatives to FSMA are required to accomplish the objective of judgement-led prudential regulation'.¹⁹ However, the Treasury does not have the same expectation for CPMA. The thread running through the Consultation Paper is that prudential regulation is a matter of skill and judgement, but that conduct of business regulation is more a matter of ensuring compliance with rules.

Can legislation determine or at least influence regulatory culture? What should that culture be, however it is created?

In portraying the PRA as the regulator that needs to exercise skill and judgement and the CPMA as the regulator that needs to focus on ensuring compliance with a set of rules, does the Consultation Paper recognise the key differences in supervisory approach that are required for each to achieve its objectives, or is there a risk of creating an inaccurate caricature, which if somehow enshrined in legislation will have a damaging effect on the way both agencies perform their functions?

On the one hand, it could be argued that prudential regulation is different from market regulation or conduct of business regulation, particularly if the objective of prudential regulation is to protect the financial interests of the state. If the primary goal of the prudential regulator is to protect taxpayers from having to pay out on the implicit guarantee, is the taxpayer not entitled to see greater power and responsibility vesting in the prudential regulator to make bespoke, judgemental decisions about how comfortable it is with the senior management, business model, risk taking and risk management within every systemically significant firm? Is there not an argument that rule making is a blunt tool for this purpose (witness, for example, the increasing use of the waiver power under FSMA to give supervisors very broad discretion and flexibility over precisely what is expected of regulated firms). Is there an argument that prudential regulation of larger institutions should be more about deep due diligence and ongoing assurance processes – utilising regulatory approval/scrutiny/intervention rather than the traditional concept of compliance with legal rules? If that is what the Treasury is aiming for, what role should enforcement and disciplinary proceedings play?

Conversely, is the 'level playing field' a more significant issue in conduct and market regulation – because of the requirement for greater predictability and the need to encourage competition between providers? That is not to say that the rules must always be detailed, prescriptive rules of conduct – they may be rules requiring certain risk management approaches to be adopted, for example. But there need to be rules and principles capable of general application, breaches of which lead to public enforcement actions and tough sanctions.

On the other hand, with respect to the role of rules in prudential regulation, it could be argued that prudential regulation cannot and does not operate on the basis of measures which are completely bespoke and tailored to the individual firm. There are, and there need to be, rules

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on what constitutes capital, for example; what the baseline capital ratios should be; what risks need to have capital held against them; benchmarks for risk weighted assets, and so on. That is not to say that these are not and do not need to be adjusted on an individual basis – such targeted adjustment is arguably at the heart of prudential supervision, and one of its unique features. But capital adequacy regulation is not ‘rule free’. The PRA will have to conform to European directives on capital requirements, and so will have a set of rules, often very detailed rules, it has to implement. Market and conduct regulation, on the other hand, is also characterised by rules, often detailed, but here too there is a strong role for principles of market integrity, transparency, product suitability and so on, and indeed with respect to risk management systems and controls, whose application and implementation has to be adjusted to fit particular circumstances.

When it comes to ensuring compliance, then it may be true that in prudential supervision the role of public enforcement action and sanctions in many cases has to be different from that in market and conduct regulation. ‘Real time’ transparency as to what actions financial institutions are required to take to ensure their financial stability may in certain cases cause a loss of market confidence, jeopardising the financial stability that the PRA is meant to be safeguarding. Nonetheless, there is an increasing expectation that banks will publish their Tier 1 capital levels, for example, suggesting that the traditional norms of secrecy in banking supervision are being altered. It may also be possible to publicise actions after the event, once the risks that disclosure will create market instability have passed. Further, where banks do not respond to regulators’ requests, for example to hold more capital against operational or liquidity etc risk, or change its business model, or not issue loans of more than a certain loan to value ratio, then the regulator has to be prepared to take action (albeit that this could take the form of intervention to require the maintenance of capital rather than the imposition of penalties). The suite of sanctions that it possesses needs to be different in a number of ways than that of a conduct and markets regulator. There needs always to be the possibility that the bank will be put into the special resolution regime, for example. However, there does need to be a clear set of sanctions of increasing severity that can be imposed, and a clear resolve on the part of the regulator to use them.

In the case of conduct and markets regulation, whilst it is the case again that there needs to be strong enforcement

action, it is not necessarily the case that the only way to ensure compliance with the rules is through taking publicised enforcement action when they are breached. There can also be a role for the type of deep due diligence and ongoing assurance processes – utilising regulatory approval/scrutiny/intervention rather than the traditional concept of compliance with legal rules – as there is in prudential regulation. For example, the FSA’s Treating Customers Fairly approach and Retail Distribution Review both illustrate how the FSA found it more effective to ensure consumer protection by adopting reforms that go to the core of business structures, processes and cultures rather than rely on traditional ‘command and control’ strategies: detailed rules backed by legal sanctions. In regulating markets, having the judgement and powers to know when to put in place circuit breakers to manage market volatility, for example, also requires a set of skills (and powers) which are far from that of simply ensuring compliance with detailed rules.

However, whilst legislation can hinder regulators by providing them with inadequate or inappropriate powers, can it create, or at least influence, a regulator’s operating culture? Is the ‘political’ licence of the regulator not as important, or indeed more important, than its legal licence? The political climate has to support the regulators’ approach if the latter is to survive. In his report and evidence to the Treasury Select Committee, Lord Turner emphasised the importance of the prevalent political climate in shaping the FSA’s ‘light touch’ approach to supervision.²⁰ None of the newly created regulators can sustain a regulatory approach which is at odds of the views of the political majority for very long, regardless of what its legal mandate provides.

5 Ensuring accountability

The structures and mechanisms put in place to ensure that the new bodies are accountable are clearly of fundamental importance. Moreover, balancing independence with accountability can be a delicate task. There are five core questions that always need to be answered when considering the accountability of any decision making authority:

- to whom should a body be made accountable
- for what
- how

- when
- and with what consequences

Although it did not directly pose these questions, the Consultation Paper implicitly gave somewhat different answers to each of them with respect to each agency.

The Consultation Paper proposed that both agencies should be audited by the National Audit Office, breaking the link between public funding and public audit.²¹ This move had been heralded earlier this year, when the FSA was brought within the NAO's remit. For the CPMA it proposed to retain a similar set of accountability mechanisms as operate with respect to the FSA, viz a duty to hold annual public meetings, to establish consultative panels for consumers and business, to maintain a complaints mechanism, to provide for, the right of 'appeal' to the Upper Tribunal in enforcement cases and provision for the Treasury to order reviews and inquiries as the FSA.²² In addition, the CPMA, but not the PRA, would be required to consult on any rule changes and to conduct impact analysis, with the possibility of using a streamlined rule making process where the agency was implementing EU legislation. However, with respect to the PRA, beyond requiring the standard annual report, it left open the question as to whether or not these additional accountability mechanisms should be introduced.

The Summary of Responses indicated that most respondents supported the retention of the FSA's current accountability arrangements with respect to the CPMA, and some had also proposed the creation of a Markets Practitioners Panel.²³ Given the rapid changes in the structure, operation and systemic significance of the markets, not just equity markets but others including the derivatives and bond markets, there are good arguments for taking such a step.

However, few agreed with the Treasury's proposals for the PRA's accountability in their entirety, with most calling for greater accountability than that proposed in the Consultation Paper.²⁴ Indeed, it is difficult to see in principle why there should be much difference between the accountability arrangements of the two bodies. It could be argued that making the PRA internally accountable to the Bank is sufficient, but this arguably muddies the lines of accountability of the PRA and the Bank. This issue is already muddy enough, as discussed below. In addition, there seems in principle little reason why the PRA should not adopt standard practices of good regulation in formulating rules of general application, notably consultation

and cost benefit analysis, again except perhaps where the PRA is transposing EU legislation (although even here there may be some utility in considering what their particular impact in the UK is likely to be for it may be that, due to the nature of how EU provisions are created, the benefits do not always outweigh the costs, at least for the UK, and it will be important to identify those instances).

Those responding to the consultation also raised concerns at the concentration of power within the Bank of England as guardian of the triptych of monetary policy, financial stability and microprudential regulation. To counteract such concentration of power, some suggested broadening the board membership of the PRA to include more external members, and/or ensuring that the PRA had regular contact with the industry, for example through a consultative panel.²⁵ The membership of the FPC is deliberately to include external members who have experience of insurance, banking, investment banking and macro-economic expertise.²⁶ It is proposed that the board of the PRA should have a majority of non-executives, and that it could appoint an advisory group. However, it would be accountable to the Court of Directors of the Bank for its performance.

The debate thus far has focused in the main on the structure of the FPC and on ensuring parity in accountability arrangements between the CPMA and the PRA. Very little attention has been given to the impact of the reforms as a whole on the internal governance of the Bank of England itself, nor to the cumulative effects of the new reforms and those introduced in the Banking Act 2009 on the scope of its powers and responsibilities and on the accountability structures that should accompany them.

There are significant asymmetries of accountability developing between the regulatory functions the Bank performs with respect to the prudential supervision of financial institutions and those which has been given with respect to payment systems, and if current debates are to be believed, will perform with respect to clearing and settlement systems as well. Under the Banking Act, the Bank became a payments regulator, with powers to produce principles and a code and to impose sanctions, including fines. The current reports are that it will regulate clearing and settlement systems as an extension of this function. However, there are very few accountability arrangements attaching to the formalisation and extension of its powers with respect to payment systems under the Banking Act. For example, there are no consultation requirements attaching to the production

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of the Code other than that it has to be approved by the Treasury.²⁷ Ex post accountability rests on the Bank's usual channels of reporting to the Treasury and Parliament. The role of the Bank in overseeing the 'plumbing' of the financial system: payments, clearing and settlement, is about to be considerably enhanced. However there are no proposals to create a separate subsidiary to undertake these functions, or to introduce ex ante requirements for consultation or impact evaluation with respect to the production of principles or codes governing their operation. Again, many of these rules will emanate from the EU, but there may still be scope for the Bank to introduce its own rules, and, as noted above, independent impact assessments which are tailored to the UK situation may still be valuable sources of information, and act as potential negotiating points at EU level. Enhancing the accountability arrangements of the PRA to 'level up' to those of the CPMA is desirable, but unless equivalent accountability structures are put in place with respect to the Bank's regulatory functions over the 'plumbing' of the system as well the result will be a significant asymmetry in accountability arrangements with respect to the Bank's different regulatory functions which is hard to justify.

Furthermore, the reforms will create a complex internal structure for the Bank, and it is not entirely clear who will be accountable to whom, for what, when, how and with what consequences. Should the Bank be accountable to the Treasury and Parliament for the activities, and omissions, of the PRA as its subsidiary, and indeed the FPC, on a 'one for all' basis? That creates a clear line of responsibility to the Bank for the PRA's activities, and would ensure accountability of the whole system of financial stability regulation, but leaves significant concentrations of power within the Bank with little external involvement in the accountability process, particularly with respect to the PRA. Should the PRA, FPC and the Bank each be accountable for the entirety of what is done, or not done, in the name of prudential supervision, on a 'all for one' basis? That would mean that each is made answerable for matters outside its remit, which does not seem appropriate. Or should each be accountable for its separate activities: 'each for itself'? The latter would mean each is only accountable for matters within its remit, which seems appropriate, but leaves no one accountable for the whole and the lines of responsibility between the PRA and the Bank arguably unclear.

Further, regarding the accountability of the PRA and the CPMA to the firms they regulate, there is the tricky question of the rights of appeal that firms should have against

decisions of the regulatory bodies. The question arises as to what decisions they should be allowed to appeal against. Whilst few would argue that firms should have the right to appeal against a sanction such as a fine, it is not clear that traditional enforcement/adjudicative processes are suited to certain types of decision in the prudential realm. Is it really right that a decision by the prudential regulator over how much capital a major banking institution should hold, based on an 'expert' risk assessment should be capable of being challenged by way of full merits-based re-hearing before a judicial tribunal? This has not been tested to date, but could well be soon. Conversely, disciplinary matters for conduct breaches certainly should be subject to such a Tribunal process. Of course, the CPMA will have prudential responsibilities and many aspects of "conduct regulation" require highly judgemental assessments of the adequacy of risk management. So this is not a question of a simplistic split between the CPMA and the PRA. But the current legislation does not really provide a terribly effective process which distinguishes for the Upper Tribunal any areas in which it should defer to the judgement of the regulator rather than embark on a full merits-based re-assessment of the matter before it, whether that be an insider dealing investigation or a decision that a high street bank's advanced risk modelling is not up to scratch.

Finally, there are strong arguments for instituting a statutory requirement that the systems and structures that are put in place are reviewed periodically, preferably every five to seven years, and that certain aspects, such as the operational arrangements for coordination between PRA and CPMA are reviewed more frequently, certainly initially, for example after the first year and every two to three years thereafter. Indeed, provision for periodic review is one of the OECD's recommended principles for effective financial regulation.²⁸

6

Summary and issues going forward

Breaking up is hard to do. As we stated at the outset, whether or not the FSA should be broken up is not up for debate. The consultation process focuses on how that decision should be implemented. In creating a structure to address one coordination problem there is a risk that the problem is simply displaced and a whole new set of coordination problems are created somewhere else in the

system. We have proposed seven key principles to guide the design of the new structure of UK financial regulation: ensuring that the new regulators have a clear and strong voice in Europe; that there is clarity of purpose and expectations as to what regulation can deliver; clarity of jurisdiction; adequate coordination; adequate independence balanced by appropriate accountability for the new authorities; and that the system as a whole is dynamic and capable of responding to rapid changes.

In particular, there is a need for a stronger recognition of the implications of the reform of European financial regulation and the emergence of the EU as the monopoly provider of financial regulatory rules and setter of a common supervisory culture. In the 'brave new world' of European financial regulation, ensuring that the new UK structure 'fits' with the new European structure is imperative if the UK is to be able to exert any influence over the way that its financial industry is regulated. Now that the debate as to whether to break up is over, the proposed new legislation provides an important opportunity to consider how best to recalibrate the objectives, duties, powers and functions of regulators in the light of the lessons learned from the financial crisis. This should not be a question of 'intelligent copy out' of the relevant provisions of FSMA into the mandates of the new agencies. The financial crisis revealed weaknesses in regulation which went far deeper than organisational structure. The new legislation alone cannot provide the solutions – but it will be an important tool for guiding the future conduct of regulators, as well as determining the name of the institution for which they will work.

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Martyn Hopper heads the financial services regulatory practice at Herbert Smith LLP. He is a barrister and a solicitor advocate. Prior to his return to private practice in 2004 he spent over nine years working as a senior in-house lawyer within the UK Financial Services Authority. There he was heavily involved in the development and implementation of the Financial Services and Markets Act 2000, the FSA's investigation and enforcement policies and procedures and the UK market abuse regime. After a period as Head of SFA and IMRO Enforcement he moved on to Head the then Market Integrity Group within the FSA's Enforcement Division where he led investigations and enforcement actions in relation to market conduct, corporate disclosure and investment banking conduct of business matters.

Since moving to Herbert Smith, Martyn has advised a wide range of clients including investment, commercial and retail banks, insurers, asset managers and brokers on regulatory issues. His work has involved advice on compliance risk management issues, conducting internal reviews and investigations and representing clients in regulatory investigations, enforcement actions and related tribunal and court proceedings.

Notes

A series of horizontal dotted lines for taking notes.

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Footnotes

1. Treasury, A New Approach to Financial Regulation: Judgement, Focus and Stability (HMSO, London, 2010) (the "Consultation Paper").
2. Treasury, A New Approach to Financial Regulation: Summary of Consultation Responses (HMSO, London, 2010) (the "Summary of Responses").
3. Hector Sants, Chief Executive of the FSA, 'Reforming Supervisory Practices: Progress to Date', speech to Reuters Newsmakers Event, 13 December 2010.
4. Consultation Paper, para 3.5.
5. Consultation Paper, para 4.6.
6. Ibid.
7. Consultation Paper para 3.9, see also para 4.11.
8. Summary of Responses, paras 2.13-2.20.
9. APRA Act s.8(2).
10. OSFI Act 1987 s.4.
11. Position of the European Parliament adopted at first reading on 22 September 2010 with a view to the adoption of Regulation (EU) No .../2010 of the European Parliament and of the Council establishing a European Supervisory Authority (European Securities and Markets Authority) P7_TC1-COD(2009)0144.
12. Position of the European Parliament adopted at first reading on 22 September 2010 with a view to the adoption of Regulation (EU) No .../2010 of the European Parliament and of the Council establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority) P7_TC1-COD(2009)0143. Article 1 paragraph 4.
13. FSA, Turner Review: A Regulatory Response to the Global Banking Crisis (FSA, London, 2009). The FSA explained early on in its life that, '[t]his principle is designed to guard against unnecessary intrusion by the regulator into firms' business and requires us to hold senior management responsible for risk management and controls within firms.' FSA, A New Regulator for a New Millennium. London: FSA, 2000.
14. That is, powers akin to FSMA s. 147 on control of information, which in effect enables the FSA to write rules overriding common law and to permit Chinese Walls to have the effect of creating 'safe harbours' in certain circumstances.
15. During the crisis, the statutory instruments used to manage the failures of Bradford and Bingley, Kaupthing Singer & Friedlander and Heritable Bank came into force several hours before they were laid before Parliament – no doubt necessary in the circumstances but Parliament can hardly act as an accountability mechanism in such cases: The Bradford and Bingley plc Transfer of Securities and Property etc Order SI 2546/2008; The Heritable Bank plc Transfer of Certain Rights and Liabilities Order 2008 SI 2644 and the Kaupthing Singer & Friedlander Limited Transfer of Certain Rights and Liabilities Order 2008 SI 2674.
16. APRA, Supervisory Oversight and Response System (APRA, Sydney, 2008).
17. OSFI, Guide to Intervention for Federally Regulated Deposit-Taking Institutions (OSFI, Ottawa, undated).
18. Consultation Paper para 3.17.
19. Consultation Paper para 3.18.
20. Treasury Select Committee, Minutes of Evidence 25 February 2009, Lord Turner Response to Q2145. See also his response to Q2160: 'it [the political philosophy] was expressed in speeches on both sides of the House but which suggested that the key priority in regulation was to keep it light rather than to ask ever more searching questions.'
21. Consultation Paper paras 3.3 and 4.37.
22. Consultation Paper para 4.36.
23. Summary of Responses, paras 3.25-3.29.
24. Ibid, para 3.18.
25. Ibid, para 3.19.
26. Consultation Paper paras 2.43-2.44.
27. Banking Act 2009 ss 188 and 189.
28. OECD, Policy Framework for Effective and Efficient Financial Regulation, Recommendation and Principles (OECD, Paris, 2009), V a and b.



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