



# The new structure for UK financial regulation

On 26 July 2010, HM Treasury published for consultation a paper setting out more detail on its proposals for an entirely new structure for financial regulation in the UK. This briefing explains the main proposals.

## Overview

On 26 July 2010, HM Treasury published for consultation a paper setting out its proposals for a new structure for financial regulation in the UK. This paper puts flesh on the bones of the statements made in June by the chancellor and the financial secretary to the Treasury. There are no major changes from the proposals previously outlined but a lot more detail is now given and the government has committed to publish draft legislation on core aspects of the new regime in early 2011 for further consultation.

The basic purpose of the new regime is to remedy the perceived failures of the existing tripartite regulatory system, consisting of the Bank of England (the Bank), the Financial Services Authority (FSA) and the Treasury, collectively responsible for financial stability. In place of the existing system a single authority, the Bank, will be put at the centre of the framework. A new Financial Policy Committee (FPC) will be established within the Bank to take responsibility for macro-prudential regulation (the stability of the system as a whole), and a new Prudential Regulatory Authority (PRA) will be established as a subsidiary of the Bank to take responsibility for micro-prudential regulation. Conduct of business and markets regulation will be handled by a new Consumer Protection and Markets Authority (CPMA) and the FSA will cease to exist.

## The Financial Policy Committee

The FPC will take responsibility for macro-prudential regulation. This is the regulation of the financial system as a whole and it comprises two elements:

- improving the system's resilience by addressing aggregate risks; and
- addressing cyclical imbalances that may arise from time to time.

The FPC will be a new committee of the Bank's governing body, the Court of Directors (the Court). The Bank's existing statutory objective 'to contribute to' protecting and enhancing financial stability will be reviewed to determine whether it remains appropriate in the light of the Bank's enhanced role. The government is also considering whether the objective should be supplemented by a requirement to have regard to matters such as the economic or fiscal impact of its decisions. The FPC will have 11 members: six Bank executives and five non-Bank members, plus a non-voting Treasury representative. It will be chaired by the governor.

In practice, the FPC will have three main functions: monitoring the system; taking action; and communicating its analysis and actions taken.

Its monitoring role will include:

- a general monitoring of the financial system (including identifying emerging risks and cyclical imbalances);
- assessing any financial stability implications of the activities of the PRA and the CPMA;

- monitoring the regulatory perimeter and boundaries (to understand potentially systemically important activities occurring in the unregulated sector and to ensure that the split in responsibilities between the PRA and the CPMA remains appropriate);
- ‘showing a close interest’ in other aspects of the Bank’s work that may have an impact on financial stability; and
- assessing the effectiveness of its own macro-prudential toolkit.

The FPC will take action only through others. It will have the power to give directions to the PRA (and, if relevant, the CPMA) on using regulatory tools to achieve macro-prudential aims. It may also make recommendations to the PRA and the CPMA on specific actions (including, possibly, rule changes). It may make recommendations to the Bank’s Court about other Bank responsibilities (such as liquidity provision), and to the Treasury about changes to the regulatory perimeter or the FPC’s macro-prudential toolkit.

The Treasury will be given the power to make secondary legislation to specify the macro-prudential tools available to the FPC. As the paper indicates, the range of tools that should be available to prudential supervisors is under consideration by various international bodies. Most of these are likely to involve using levers that fall within the PRA’s remit (eg capital and leverage rules). The FPC will operate these by giving directions to the PRA. If any relate to matters regulated by the CPMA, the FPC will have a similar power to direct the CPMA.

## The Prudential Regulation Authority

The PRA will be established as a legally distinct subsidiary of the Bank and will assume responsibility for firm-specific prudential regulation. The Treasury believes that financial supervision in the UK relied too much on ‘tick-box’ compliance in the period before the financial crisis. The intention is that the PRA should adopt a more judgement-led style of prudential regulation and that its legal framework should reflect and facilitate this.

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. It will also be required to have regard to a range of other matters. The Treasury is consulting on what these should

be. The paper states that two particular ‘have regards’ currently applicable to the FSA need to be reconsidered: facilitating innovation and the competitive position of the UK. The PRA may also be required to have regard to the wider economic impact of its actions.

The Treasury expects that the PRA will regulate banks and other deposit-takers, broker-dealers (or investment banks) and insurers (including friendly societies). The intention seems to be to identify these firms by the regulated activities they carry out, which will be specified in secondary legislation. Firms regulated by the PRA will include those that take deposits, effect and carry out contracts of insurance or deal in investments as principal. The PRA and CPMA will each be responsible for granting or amending permissions to undertake regulated activities within their respective remits and for regulating related systems and controls matters and approving persons to undertake ‘significant influence’ functions. In these and other areas, the PRA and CPMA will need to work closely together. It is clear that ensuring efficient co-operation and co-ordination between the various new regulatory bodies will be one of the main challenges for the new regime.

Much remains to be decided on the legal framework for the PRA’s powers and functions. The Treasury is considering whether the existing Financial Services and Markets Act 2000 (FSMA) might provide an adequate template for this. If FSMA is used as a starting point, new legislation will divide the powers and functions in it into separate stand-alone prudential and conduct frameworks. Draft legislation will be published in early 2011 on this, well in advance of the introduction of the Bill in parliament. The PRA will be responsible for making prudential rules for the firms it regulates. No decision has yet been made on whether this rule-making will be subject to the formal processes (eg on prior consultation and cost-benefit analysis) currently required under FSMA. In line with its more judgement-led approach, the PRA is expected to reduce and simplify the FSA’s existing prudential rules and guidance.

The PRA will represent the UK in the new European Banking Authority and the European Insurance and Occupational Pensions Authority (but not the European Securities and Markets Authority, in which the UK will be represented by the CPMA).

The PRA will be operationally independent of the Bank but nevertheless closely connected to it. On the one hand, it will be a subsidiary of the Bank, accountable to the Bank's Court on administrative matters, and its chairman and chief executive will be Bank executives. On the other hand, its board will have a majority of non-executive members appointed by the Treasury and neither the Bank nor the FPC will have any formal power to give it directions (except, in the case of the FPC, on macro-prudential matters).

The Treasury sees supervision and enforcement as fundamentally important to the credibility of the new regulatory regime and will ensure that each authority has its own credible and effective supervisory and enforcement powers. The PRA will supervise and, where appropriate, enforce all of its policies and rules (in some circumstances this is likely to be co-ordinated with the CPMA).

The PRA will be funded by levies raised on the firms it regulates.

## **The Consumer Protection and Markets Authority**

The CPMA will be the single regulator of conduct of business. The Treasury sees it as taking a 'tougher, more proactive and focused' approach. It will regulate the conduct of all firms (including those regulated by the PRA) in their dealings with retail customers 'as a strong consumer champion'. It will also regulate dealings in wholesale markets, including the conduct of financial services firms, investment exchanges and market abuse. It will also be solely responsible for authorising and supervising all financial institutions not prudentially regulated by the PRA (including the prudential regulation of those firms).

The CPMA's objective will be to ensure confidence in financial services and markets, with a particular focus on protecting consumers and ensuring market integrity. This objective will be supplemented by a list of matters to which the CPMA will be required to have regard.

The powers and functions of the CPMA will be based on those in FSMA, with some modification. Its rule-making will be subject to statutory requirements, including prior consultation and cost-benefit analysis. It will be

required to consult the PRA on any firm-specific actions it proposes to take that may affect the firm's stability and soundness. It will also consult the FPC on rules it proposes to make that may have an impact on the stability of firms generally.

The CPMA will be responsible for enforcing its rules, in both prudential and non-prudential matters, and will need to co-ordinate with the PRA on the former. It will continue with the FSA's Retail Distribution Review and Mortgage Market Review initiatives and will work on responsible lending that will be backed by strong enforcement to ensure credible deterrence. The CPMA will retain the FSA's powers to make market conduct rules and impose penalties for market abuse. However, the government is considering whether to transfer responsibility for prosecuting criminal offences involving insider dealing and other market abuse offences that are currently prosecuted by the FSA to a new prosecuting body, the Economic Crime Agency. This will be subject to a separate consultation.

The CPMA's board will have a majority of non-executives and will be appointed by the Treasury. The chief executive of the PRA will be a member *ex officio*. The CPMA will be funded by fees raised from the firms it regulates.

The CPMA will assume the FSA's existing responsibility for the Financial Ombudsman Service and oversee the Consumer Financial Education Body. It will also be responsible for the Financial Services Compensation Scheme, working closely with the PRA. The government is to consult on the merits of transferring responsibility for consumer credit from the Office of Fair Trading to the CPMA.

## **Markets and infrastructure**

Market conduct will be regulated by an operationally distinct markets division of the CPMA, which will represent the UK in the new European Securities and Markets Authority. The markets division will regulate exchanges and other providers of trading platforms.

Responsibility for regulating and supervising settlement systems and central counterparty clearing systems will be moved to the Bank, to sit alongside its existing responsibility for payment systems.

The government is considering whether to rationalise the two distinct regulatory regimes for trading platforms (authorisation and recognition). The existing regimes to approve operators of settlement systems and designate systems to be covered by the Financial Markets and Insolvency (Settlement Finality) Regulations 1999 are expected to continue largely unchanged.

The government is also considering whether to merge the FSA's existing responsibilities as the UK Listing Authority with those of the Financial Reporting Council or whether these should remain within the CPMA markets division. Separately, the Department for Business, Innovation and Skills will be consulting in due course on establishing a companies regulator with responsibility for corporate governance, corporate information and its disclosure.

Responsibility for regulating Lloyd's of London will be divided between the PRA and the CPMA; the precise allocation of functions will be the subject of further consultation.

## **Crisis management**

The new stability and crisis management framework will require the governor to write to the chancellor every six months (after the FPC has produced its six-monthly financial stability report) on developments in prudential regulation and financial stability. The governor will also be required to notify the chancellor as soon as it becomes clear that there is a potential call on public funds. The chancellor will continue to have the final decision on using public funds, whether for emergency lending, in a resolution of a failing institution or by way of indemnity to the Bank. However, in contrast to the tripartite approach, the Bank will be very much in charge of crisis management.

The PRA will be the body responsible for making rules about and approving institutions' recovery and resolution plans. Consideration is being given to what further powers should be available to the PRA to require a firm's management to take specific actions (such as issuing new equity) if its recovery plan proves ineffective in practice. The recommendations of the Independent Commission on Banking may also be relevant for crisis management, including whether the PRA should have wider powers, such as a power to require the break-up

of large groups to help with resolvability. Another possibility is that 'own initiative variation of permission' (OIVOP) powers now available to the FSA under FSMA might be clarified and expanded. These could include making regulatory intervention mandatory at a specified threshold, ensuring that the regulator can take action before a breach of threshold conditions and seeing whether specific powers are needed for an institution's unregulated holding company.

The government will continue to develop proposals to enable the efficient resolution of investment banks and will review the existing statutory special resolution regime to see what improvements might be made.

## **Implementation**

Comments on this consultation paper will be taken into account when developing detailed legislative proposals, the core parts of which will be published for consultation early in 2011 with a view to bringing forward the Bill itself in mid-2011. The government will seek to ensure the passage of the primary legislation within two years.

As far as possible, the FSA will move towards the new structure on a non-statutory basis in advance of the new legislation being passed. The intention is to introduce a 'shadow' PRA and CPMA in the first quarter of 2011. A new operating model will be developed in the autumn and reviewed by the FSA's board towards the end of the year. The Bank will be involved in this process and will be represented on the relevant FSA committees leading the work. An interim FPC will also be established by the autumn.

## **Comments**

There would seem to be clear benefits in having prudential regulation and supervision housed within the Bank, given its central role in the financial system and, in particular, in dealing with a financial crisis. But in some respects the new regime will throw up new challenges. Creating separate prudential and conduct of business regulators will require the boundary between these two areas of regulation to be defined in a way that has not been necessary while the FSA has been responsible for both. And the need to ensure co-ordination and co-operation between different authorities, far from being

done away with, will be even more important under the new regime than it has been in the past. This issue will arise at many levels, including rule-making, supervision and enforcement. The new regime's success will depend largely on how well these issues can be dealt with in practice.

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