

Financial regulation reform

The role of competition

Simon Orton, Rod Carlton, Christopher Robinson and Martin McElwee of Freshfields Bruckhaus Deringer LLP explore the role of competition in the new financial services regulatory regime, and the tensions that may arise.

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The government elected in 2010 committed itself to the replacement of the Financial Services Authority (FSA) with a new system of regulation for the financial services industry (see *Exclusively online article "Coalition agreement roundup"*, www.practicallaw.com/1-502-3232).

The government's principal rationale for reform has been explained as a concern that, under the regulatory system created by the Financial Services and Markets Act 2000 (FSMA), no single institution had responsibility, authority or powers to oversee the financial system as a whole. The government has explained that it believes that the Treasury and Bank of England (BoE) lacked the powers and detailed information required to identify and tackle the business practices that it believes led to the current financial crisis, while the FSA was too focused on detailed "tick-box" compliance with its rules to do so.

An important secondary rationale for reform is the government's belief (shared with the opposition) that competition in the financial services industry, particularly the banking sector, is not working as well as it should.



Detailed proposals for reform were set out in the Treasury's February 2011 consultation paper "A new approach to financial regulation: building a stronger system" (www.practicallaw.com/8-504-8677), and further developed in its June 2011 white paper "A new approach to financial regulation: the blueprint for reform", which included a draft Financial Services Bill (the Bill) (see *News Brief "UK financial regulation: reform*

gets closer", www.practicallaw.com/6-506-6403).

These papers set out the detail of the proposed new regulatory system, which will consist of three regulatory bodies: a Financial Policy Committee (FPC), a Prudential Regulation Authority (PRA) and a Financial Conduct Authority (FCA) (see boxes "The FPC", "The PRA" and "The FCA").

This article explores the role of competition in the new regulatory regime and the tensions that may arise in the new regime. In particular, it considers:

- The structure of the proposed new regulatory system (see box “*New UK regulatory system*”).
- The historic relationship between competition regulation and financial services regulation.
- The new regulators’ proposed statutory duties with regard to competition.
- The effect of the FCA’s regulatory approach to competition, including with respect to particular powers, such as the product intervention power.

As is to be expected at this early stage of the elaboration of the new regulatory structure, there are many questions which will need to be answered. Some of these are points of process or detail, but some arise from points of fundamental tension between the various goals and responsibilities of the FCA. In terms of regulatory philosophy, interaction between the regulators, and ensuring sufficiently rigorous decision making, the authorities will want to provide reassurance and clarity to the market sooner rather than later. This will ensure the realisation of the goal of a financial services sector that works well for consumers and contributes to the UK economy to its maximum potential.

CURRENT POSITION

The relationship between financial services regulation and competition has long been an important, but sometimes difficult, one.

The role of competition in the FSMA architecture was deliberately limited. The government gave it a firmly subsidiary role, mandating the FSA merely to “have regard to” competition, rather than having the promotion of competition as one of its statutory objectives.

The FPC

The Bank of England (BoE) will sit at the apex of the new regulatory system. Its existing statutory objective to “contribute to protecting and enhancing” financial stability will be replaced by a new objective to “protect and enhance” financial stability. The purpose of this change is to make plain that ultimate responsibility for financial stability rests with the BoE.

The purpose of the Financial Policy Committee (FPC) is to assist the BoE in achieving this objective. The FPC will be a committee of the Court of the Bank. It will be chaired by the Governor of the Bank and consist of external members, the Chief Executive of the Financial Conduct Authority (FCA) (see box “*The FCA*”) and certain senior officers of the Bank. Its role will be to identify and monitor systemic risks in the financial system and to take action to address them.

The FPC will have the power to issue advice and recommendations to a range of bodies with responsibilities for financial regulation, including the Prudential Regulation Authority (PRA) (see box “*The PRA*”) and FCA. It is envisaged that the FPC will also have the power to issue formal directions to the PRA and FCA using macro-prudential tools (the precise nature of which has not yet been decided).

Under FSMA, the Office of Fair Trading (OFT) also had certain duties, most importantly to keep the FSA’s regulations and practices under review from a competition perspective (section 160), to assess the competition effects of new applications for recognition by investment exchanges and clearing houses (section 303), and to keep under review the regulatory provisions and practices of recognised bodies (section 304).

For the most part, however, the financial services regulation architecture was kept distinctly separate from the competition law architecture.

Competition in financial services

In the years following the 2000 Cruickshank report on competition in the UK banking industry, the UK competition authorities took an ever-closer interest in the operation of financial services markets (see box “*OFT and CC reviews*” and News brief “*The Cruickshank report: competition in the banking industry under scrutiny*”, www.practicallaw.com/7-101-1508).

These individual inquiries were complemented in 2009 with a publication from the OFT which indicated the unique place of financial services in its work, a “Financial Services Strat-

egy” document. It covered the OFT’s consumer responsibilities as well as its competition responsibilities, with the clear implication that the regulatory impulse in government with respect to financial services could not always be relied upon to give competition proper prominence without active advocacy from the OFT.

Relationship between FSA and OFT

Of course, the FSA and the OFT developed an important working relationship, recognising their mutual interest in financial services and the need to be more joined up in their approach. In April 2006, they published a joint action plan, “*Delivering Better Regulatory Outcomes*”.

The focus of the plan was on streamlining regulation for jointly-regulated firms, and on improving their consumer-facing communications in financial services, but the document had little to say about joint efforts to promote competition in financial services.

Subsequent iterations of the joint action plan became more competition focused, as the OFT became increasingly interested in competition in the banking sector, and in 2009, the FSA and OFT entered into a memorandum of

understanding, which annexed a specific “competition concordat”. That concordat was described as “an agreement to co-operate on competition issues by sharing information and intelligence”, and foresaw regular contact between the authorities to discuss competition work in financial services. The memorandum also specifically provided for joint working by the OFT and FSA, including on competition issues.

In this period, the OFT and FSA worked together on a number of specific projects of common interest. Their work on payment protection insurance (PPI) is a notable example, with the FSA obtaining industry agreement to halt the selling of certain products and ensuring that adequate complaints procedures were put in place, and the competition authorities (while also prohibiting the selling of certain types of product) putting in place various measures to ensure that consumers were better informed in making their choices about PPI.

Independent Commission on Banking

Despite this work by the authorities, many of the conclusions of the Cruickshank report are echoed in the final report of the Independent Commission on Banking (ICB), chaired by Sir John Vickers and published in 2011 (ICB report) (*see News brief “the Vickers report: the first step on the way to banking reform”*, www.practicallaw.com/4-508-4530).

Importantly, in the ICB’s view, one of the reasons for long-standing problems of competition and consumer choice in banking, and financial services more generally, is that competition has not been central to financial regulation.

PROMOTING COMPETITION

It is in the context of the historic inter-relationship between the competition authorities and the FSA that proposed new competition provisions must be viewed.

The Bill makes some important changes to the role of competition in financial services regulation, but there remain

The PRA

The Prudential Regulation Authority (PRA) will be a new subsidiary of the Bank of England (BoE) responsible for the prudential regulation of firms of systemic significance, which will include banks, insurers and larger and more complex investment firms.

The PRA’s core objective will be to promote the safety and soundness of the firms it regulates. It is envisaged that the PRA will adopt a forward-looking, judgment-led approach to prudential regulation, focusing on whether firms it regulates are complying with the spirit of rules regulating capital, liquidity and levels of borrowing (in other words, a broader emphasis than mere technical compliance).

The government has proposed that the PRA will put in place a Proactive Intervention Framework (PIF). Pursuant to the PIF, different levels of regulatory intervention ranging from more intrusive monitoring at one end of the spectrum, to the winding up of a firm at the other, will apply at different levels of regulatory concern.

In circumstances where the PRA is concerned that actions taken by the Financial Conduct Authority (FCA) against firms regulated by the PRA may threaten the UK financial system, it will have the power to direct the FCA not to take those actions (*see box “The FCA”*).

disagreements as to whether they really do place competition at the heart of financial services regulation, or whether the new structures produce a system that risks inconsistency.

PRA and FPC’s responsibilities

Neither the PRA nor the FPC will have any specific role or responsibilities in connection with the promotion of competition.

Indeed, there may be a tension between the promotion of competition and the promotion of the safety and soundness of regulated firms. The BoE has recognised this. In a speech on the PRA given by Andrew Bailey of the Bank on 19 May 2011 it was recognised that: “the costs of attempting to achieve ‘a no-failure’ policy are easy to identify, not least that we would have an industry in which competition is severely reduced”.

A no-failure policy is, of course, a relatively extreme position. However, a prudential policy with a more measured aim, namely that of achieving lower levels of failure than in the past, must also run a similar risk of reducing competition. The entry of new competitors and the failure of existing firms is a fea-

ture of a competitive market, but the PRA’s tougher approach to prudential regulation could make it harder for new firms to enter the market in banking or insurance, for example if new entrants require levels of leverage higher than the PRA is prepared to countenance, or have lower levels of capital than the PRA considers appropriate.

The ICB report recognises this issue, and states that “in some cases, the application of prudential standards may have anti-competitive effects”. The ICB has suggested that its proposals to impose more onerous prudential standards on large institutions of systemic significance should stimulate competition, by giving an advantage to smaller firms subject to less onerous requirements. It remains to be seen whether the application of prudential principles more widely displays a similar recognition of this tension.

FCA’s objectives and duties

The FCA, by contrast with the PRA and FCP, will have specific objectives and duties relating to competition.

One of its operational objectives, albeit slightly opaquely, relates to competi-

tion: “facilitating efficiency and choice in the market for financial services”.

The Bill also sets out a general competition duty for the FCA: “The FCA must, so far as is compatible with its strategic and operational objectives, discharge its general functions in a way that promotes competition.” This will require the FCA to consider competition matters, and to act upon them, when it has identified a problem. The government has stated that it considers this to be a major step forward in enhancing the profile of competition within the regulatory framework, recognising the importance of competition in the delivery of good outcomes for consumers of financial services, and going significantly beyond the current FSMA framework

The FSA has indicated that the FCA will create a dedicated business and markets analysis team with competition expertise to assist it in discharging its proposed new duties.

However, the structure of the FCA's competition powers and responsibilities and indications to date on the manner in which it seems they are to be exercised, appear to leave some room for uncertainty at this stage.

Applying competition law directly. It has not been proposed that the FCA should have powers under competition law concurrent with those of the OFT (that is, the ability to apply Chapters 1 and 2 of the Competition Act 1998), as do certain other sectoral regulators such as Ofgem and Ofcom (an idea that had previously been mooted).

The importance of competition. Guidance from the government on how the specific provisions of the Bill will be applied appears slightly ambivalent as to the centrality of competition. The white paper explains that: “The FCA will be expected to opt for the solution that promotes competition, if there is more than one possible solution to an issue it is investigating.”

Commentators have queried whether this is the substantial step forward that

The FCA

It is proposed that the Financial Conduct Authority (FCA) will be responsible for the prudential regulation of firms not subject to Prudential Regulation Authority (PRA) regulation (*see box “The PRA”*), and for the conduct of business regulation of all firms.

The FCA will have a single strategic objective, namely to promote confidence in the UK financial system. This strategic objective will be underpinned by three operational objectives of:

- Securing an appropriate degree of protection for consumers. The term “consumers” is defined widely to cover (in broad summary) all persons who do business with regulated firms, ranging from individual retail customers to sophisticated financial institutions.
- Protecting and enhancing the integrity of the UK financial system. This objective is closely linked to the objectives of the Financial Policy Committee and PRA (*see boxes “The FPC” and “The PRA”*).
- Promoting efficiency and choice.

It is envisaged that the FCA, like the PRA, will adopt a more intrusive, forward-looking and judgment-led approach to regulation than did the Financial Services Authority. The government intends that, rather than focusing simply on checking compliance with detailed conduct of business rules, the FCA will focus on firms' business models, product design processes, culture and senior management decision making.

The FCA will be given new statutory powers to complement its new objectives and regulatory style. These include a new product intervention power enabling the FCA to impose bans or restrictions on financial institutions entering into particular types of agreements with their customers (*see “Product intervention” in the main text*).

has been talked about. The ICB has commented that the government's formulation of the role of competition in the FCA's application of its powers is liable to be read as making the competition aspect of the remit subordinate to the strategic and operational objectives.

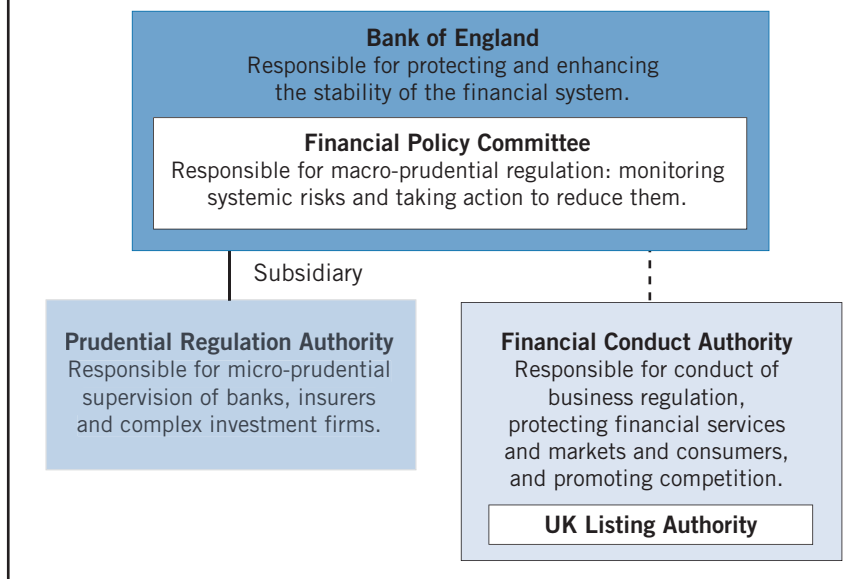
It therefore recommended replacing the efficiency and choice objective with a competition objective, namely that of promoting effective competition in markets for financial services, in order to avoid this potential problem. In its view, such a change would be entirely consistent with promotion of efficiency and choice because they are advanced by effective competition.

This view has the support of the Treasury Select Committee, which recom-

mended in its report on “Competition and Choice in Retail Banking” that the FCA should have a primary objective relating to competition. The government's response to that report appears merely to state that it believes that the formulation proposed is sufficient, without fully explaining why, and the Treasury Select Committee renewed its request for reconsideration in its report on the ICB's interim report. At the time of writing, it is consulting further in the context of its consideration of the ICB report.

That said, there are important signals that the authorities recognise the political imperative for a step-change in the regulator's approach to competition. The FSA's June 2011 paper on the FCA's “Approach to Regulation” (FSA paper)

New UK regulatory structure



made a strong statement in this respect: “The FCA will need a sound economic understanding of the way relevant markets operate in order that its regulatory interventions will promote competition and will effectively address the problems identified. This requires an approach to financial services markets that is significantly different to that of the FSA, both analytically and culturally.” (*www.practicallaw.com/4-507-0062*)

Moreover, the ICB has set out specific competition-related tasks that it believes the FCA (not, notably, the OFT) should undertake, including reviewing the effectiveness of the proposed redirection service (to make customer switching to a new bank easier) (to establish whether it has led to “enough of an increase in willingness by customers to switch products to lead to effective competitive tension”) and multiple proposals on enhancing transparency for customers vis-à-vis the costs of the banking services provided to them. Its approach to carrying out these tasks will provide an important insight into how the FCA will understand its new competition responsibilities and the importance it attaches to them.

FCA's regulatory approach

It is envisaged that the FCA will adopt a deliberately forward-looking and judgment-led approach to regulation (see box “*The FCA*”). At this stage,

there appears to be a risk that such an approach to regulation may not sit easily with its mandate also to stimulate greater competition in financial services markets for the following reasons:

- The risks and costs associated with intrusive regulation may deter new firms from entering the markets for financial products.
- Prescriptive regulation tends to reduce the margins for differentiation and innovation; two very important dimensions of competition.
- A regulatory philosophy based on avoiding perceived “bad outcomes” is not necessarily one that fits easily with the traditional approach of competition authorities, namely to protect (and enhance) the competitive process, on the basis that that process will in general produce better outcomes, but recognising that it may occasionally produce individual bad outcomes.

The proposals for the new product intervention power illustrate how these two parts of the FCA's regulatory role may not always sit easily with one another, from the point of view of each regulatory philosophy and good process (see “*Product intervention*” below). How these tensions are resolved with respect to this power may provide an

important indicator as to how the FCA will approach its new responsibilities more generally.

ENHANCED REFERRALS

One further important new feature in the government's white paper and Bill is a power for the FCA to make an “enhanced referral” to the OFT. The government envisages that this power may be used in circumstances where the FCA “has identified a possible competition issue that may benefit from technical competition expertise or require recourse to powers under competition law that sit with the competition authorities”, for example, where structural features of the market merit competition law consideration by the OFT, in the view of the FCA.

The OFT is proposed to be obliged to respond to the enhanced referral within 90 days.

This power appears to owe something to the existing power of certain bodies to make a “super complaint” to the OFT, to which the OFT is obliged to respond, although it appears to be constructed in a deliberately wider fashion to allow more flexibility for the FCA in making such referrals. It will be interesting to see how the FCA will make use of this power in the light of its own powers (see “*FCA's regulatory approach*” above).

PRODUCT INTERVENTION

It is proposed to give the FCA a new product intervention power to prohibit authorised persons from:

- Entering into specified agreements.
- Entering into specified agreements unless requirements laid down by the FCA (which may include requirements as to the terms and conditions to be contained in the agreements) have been satisfied.
- Doing anything that might result in specified agreements being entered into (or being entered into without the FCA requirements having been satisfied).

This exceptionally wide new power accords with recent proposals made by the European Commission for the introduction of a broad new EU-wide product intervention power for national regulatory authorities and the European Securities and Markets Authority (ESMA) as part of reform of the Markets in Financial Instruments Directive (2004/39/EC) (MiFID) [see **feature article, this issue**].

The power could be exercised by the FCA if it appeared to the FCA necessary or expedient to do so for the purpose of advancing its consumer protection objective or its efficiency and choice objective.

The new power is to be exercised by rule-making by the FCA. The FCA's rule-making process, like that of the FSA, will not involve giving any statutory notice to individual firms affected by the rules. The consequence of this is that the exercise of the power would be challengeable by firms only by way of judicial review. Judicial review challenges are likely to be difficult given the breadth of the new power. Furthermore, the Bill provides that the FCA may make temporary product intervention rules for a period of 12 months without undertaking consultation or cost-benefit analysis.

The Bill requires the FCA to consult on and publish a statement of policy as to the circumstances in which the new power will be exercised. This statement will not be published until after the Bill has come into force, but a paper published by the FSA in January 2011 on product intervention (DP11/1) provides some guidance on the potential effects of the new power on competition.

Competition and product intervention

The FSA has made clear (in the FSA paper) that it will consider structural competition issues (that is, issues that arise from the way that a market operates) as well as behavioural issues (that is, issues that arise from the way that individual firms behave). This is a significant step away from the FSA's historical focus on individual firms' conduct.

OFT and CC reviews

Reviews undertaken by the Office of Fair Trading (OFT) and Competition Commission (CC) since 2000 have centred on retail banking, in particular, personal current accounts and SME banking, but have also covered many other aspects of financial services:

- 2000** ♦ CC monopoly report on banking services for SMEs.
- 2003** ♦ OFT market study on payment systems.
♦ OFT fact-finding study on store cards.
- 2004** ♦ OFT response to review of the Banking Code.
♦ CC market investigation on store cards.
♦ CC market investigation on home credit.
- 2006** ♦ OFT review of SME banking.
♦ OFT market study on payment protection insurance (PPI).
- 2007** ♦ OFT case on personal account charges under Unfair Terms in Consumer Contracts Regulations.
♦ OFT response to review of the Banking Code.
♦ CC market investigation on PPI.
- 2008** ♦ OFT review of UK Payments Council.
♦ OFT market study on personal current accounts.
♦ CC market investigation of personal banking in Northern Ireland.
- 2009** ♦ OFT high-cost credit review.
- 2010** ♦ OFT review of barriers to entry, expansion and exit in retail banking.
♦ OFT market study on equity underwriting.
♦ OFT response to super complaint on cash ISAs.

Where the FCA identifies a problem (structural or behavioural), it has indicated that it is prepared to consider the full range of remedial options. The FSA paper states that options used by the FCA to strengthen competition "are likely to include measures which reduce market power, including measures which affect firms such as reducing barriers to entry or exit, and measures which help consumers make better decisions by helping with search or switching."

The FCA will have a wide range of legal tools at its disposal to impose such remedies. These include the product intervention power, but also its general rule-making power (which could be used, for example, to make rules governing the manner in which particular products

should be sold) and the FCA's enhanced power to vary a firm's permissions.

This gives rise to a number of risks and tensions.

Checks and balances. There are concerns that the FCA's powers may not be subject to sufficient checks and balances, notwithstanding their potentially very significant impact on firms. It is notable, for example, that the OFT's powers to impose market-wide solutions is deliberately circumscribed; it cannot itself impose remedies on individual firms or on the market as a whole, absent an actual breach of competition law (such as illegal co-operation between competitors or abuse of a dominant position). It is only when a market has undergone the very lengthy

scrutiny of a market investigation reference by the Competition Commission (CC) that measures can be directly imposed to make markets as a whole work better in the absence of an actual breach of competition law.

By contrast, there appear to be some gaps in the systems of checks and balances applicable to the FCA which may allow the FCA to rush to remedy perceived concerns. For example, the product intervention power involves the making of rules which can have a very significant and direct impact on firms' business (*see "Product intervention" above*). These powers can be exercised on the basis of relatively limited processes, which are challengeable only by judicial review. It is proposed that such rules could be imposed instantly for a period of 12 months, without any consultation or cost benefit analysis, despite the fact that even temporary rules could have a powerful effect on the operation of markets for particular products or services.

The effect of this disparity appears to be that the FCA (which is not a specialist competition authority) could take action instantly to address a perceived competition problem in circumstances where the same action could be taken by the competition authorities only after a very lengthy CC market investigation. This may, in part, be a reaction to the ICB report, which criticised the length of time taken by the FSA to take decisive action in respect of the alleged widespread misselling of PPI. However, if the length and complexity of the competition authorities' decision-making process reflects the depth of investigation and analysis that is considered necessary to make sound decisions about competition problems and how they should be addressed, it seems peculiar that the (non-specialist) FCA is to be given the power to take such interventionist measures with such limited protective processes.

Co-operation and consistency. It is not clear at this stage how the competition authorities and the FCA will decide who should take responsibility for dealing with competition problems (despite

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the new referral process (*see "Enhanced referrals" above*). Given the FCA's new competition role for the future, and its powers, such as the product regulation power, it will be important for the FCA and the OFT rapidly to provide guidance on how they envisage they will work together and how they see their respective roles. This is particularly important in the context of the proposed reforms to the institutional structure of the UK competition law system, which will add further uncertainty without good guidance from the authorities (*see Exclusively online article "Reform of the UK competition regime: room for improvement?"*, www.practicallaw.com/7-505-2066).

Some co-ordination will clearly be needed to ensure that the FCA and

the competition authorities will adopt a consistent approach to dealing with competition issues. For example, interventions to date by the competition authorities have tended to focus on improving the competitive process by ensuring better information for consumers and an easier process for switching. This is reflected again in the recommendations from the ICB and the tasks explicitly recommended for FCA action.

Focus on outcomes. The guidance provided to date on the exercise of the product intervention power seems suggestive still of an approach that focuses on preventing bad outcomes for consumers rather than a process that accepts that a competitive process will occasionally produce bad outcomes but is overall better for consumers than a

more regulated system. The FCA's guidance on the exercise of the product intervention power, perhaps surprisingly, appears to make little or no mention of the context deriving from the FCA's new competition powers and responsibilities.

The FSA seems to have been more historically sceptical of transparency-based remedies (although, to be fair to the competition authorities, they

themselves have noted the apparently limited effectiveness of such remedies in financial services markets). The wider clash between a regulatory approach focusing on preventing bad outcomes and an approach based on protecting the competitive process (even if that process does occasionally produce less than ideal outcomes in individual cases) looks still to be an important potential tension in the work of the FCA going forward. Clarification of how it un-

derstands its role in this respect will be welcome.

Simon Orton is a partner, and Christopher Robinson is a senior associate, in the Financial Institutions Disputes Group at Freshfields Bruckhaus Deringer LLP. Rod Carlton is a partner, and Martin McElwee is a senior associate, in the Antitrust, Competition and Trade Group at Freshfields Bruckhaus Deringer LLP.