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News Bulletin

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UK Treasury Consultation on the New Financial Regulatory Structure in the UK

Background

On 26 July 2010, HM Treasury ("HMT") published a consultation paper entitled "A New Approach to Financial Regulation: Judgement, Focus and Stability."[1]

The consultation paper sets out the UK coalition government's blueprint for the reform of the financial services regulatory structure in the UK, as previously announced by the Chancellor of the Exchequer, George Osborne MP in his Mansion House speech on 16 June 2010.[2]

These reforms will be far reaching and involve abolishing the Financial Services Authority ("FSA") and transferring its current functions to four new regulatory bodies:

- Financial Policy Committee ("FPC") of the Bank of England ("BoE");
- Prudential Regulation Authority ("PRA");
- Consumer Protection and Markets Authority ("CPMA"); and
- Economic Crime Agency.

The stated aim of the proposals is to ensure "the long-term stability and sustainability of the financial system." This in turn is regarded as vital to a sound economy based on production and investment, rather than speculation and excessive borrowing.[3]

The main features of the proposed reforms under consideration are summarised below.

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[1] HM Treasury Consultation Paper: A New Approach to Financial Regulation - Judgement, Focus and Stability (26 July 2010), http://www.hm-treasury.gov.uk/d/consult_financial_regulation_condoc.pdf (comments deadline: 18 October 2010); and Impact Assessment (26 July 2010), http://www.hm-treasury.gov.uk/d/consult_financial_regulation_ia.pdf. *See also* HM Treasury press notice: Financial Secretary to the Treasury launches consultation on the implementation of financial regulation reforms announced at Mansion House (26 July 2010), http://www.hm-treasury.gov.uk/press_32_10.htm.

[2] *See* Morrison & Foerster client alert: A step forward or backwards? FSA to be broken up (21 June 2010), http://www.mofo.com/files/Uploads/Images/100621FSA_to_be_Broken_Up.pdf.

[3] Speech by the Financial Secretary to the Treasury, Mark Hoban MP, at the London Stock Exchange: "Launch of 'a new approach to financial regulation: judgment, focus and stability'" (26 July 2010), https://financialsanctions.hm-treasury.gov.uk/speech_fst_260710.htm.

Changes to the BoE and the Creation of the FPC as the Macro-Prudential Authority

The BoE's statutory objectives

In the aftermath of the financial crisis, the Banking Act 2009 gave the BoE a new statutory objective of maintaining financial stability, overseen by a newly established Financial Stability Committee, and granted new powers to the BoE to intervene in failing banks under the special resolution regime.[4]

The UK government regards the current tripartite system whereby the regulatory responsibilities are currently shared among the BoE, the FSA and HMT as having failed to meet the above objective. It believes the BoE is best placed for such a role with regard to its broad macro-economic expertise, market knowledge and system-wide remit.

At present, the BoE has two statutory objectives:

- price stability, which is the remit of the Monetary Policy Committee ("MPC"); and
- financial stability, which is the remit of the financial stability committee.

Its existing financial stability objective under the Banking Act 2009 is framed in general terms, i.e. "to contribute to protecting and enhancing the stability of the financial systems" of the UK.

The government will review whether the statutory wording remains appropriate in light of the BoE's enhanced role and responsibilities.

The Financial Policy Committee

The existing Financial Stability Committee will be removed from the BoE's statute book. Instead, the FPC will be created within the BoE, as a committee of its Court of Directors with responsibility for macro-prudential regulation.

The FPC will monitor and address systemic risks and vulnerabilities that could threaten the stability of the financial sector, with potential repercussions on the wider economy. In this connection, the FPC will work to identify and address aggregate risks and vulnerabilities across the system and seek to enhance macro-economic stability by addressing imbalances through the financial system, e.g., by taking action to dampen the credit cycle.

Functions: The FPC's role will cover three broad functions:

- monitoring the UK financial system's stability;
- taking action in response to the risks and vulnerabilities, including giving directions or recommendations for regulatory action or tools to the PRA, the CPMA, the BoE and/or HMT; and
- reporting on actions by publishing regular six-monthly financial stability reports including an assessment of the outlook for the financial sector and highlighting systemic risks and potential exposures.

Macro-prudential tools

The FPC will be equipped with certain regulatory tools for macro-prudential policy interventions, including:

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[4] *See* Morrison & Foerster client alert: Update on the UK government's Banking Support Measures and the Banking Act 2009 (30 March 2009), http://www.mofo.com/files/Publication/a0b55b63-3800-4b35-981a-5b771a19c6ca/Presentation/PublicationAttachment/0fdb6b63-c456-48f2-b98b-66b30728a482/090330UKBank.pdf.

- tools to address fundamental vulnerabilities in the system (e.g., insufficient transparency and structural weaknesses); and
- tools to increase the resilience of the financial system against cyclical developments (which could include (a) countercyclical capital requirements, (b) raising firm's capital requirements against specific types of lending, (c) imposing an overall limit on banks' leverage, and (d) imposing higher collateral requirements on certain types of lending).

Given the global, interconnected nature of financial markets, the UK government believes the policy tools should be adopted at international levels to ensure greater efficacy. Some of the above is already being considered by the Basel Committee on Banking Supervision as changes to the Basel capital framework and by the EU as proposed changes to the Capital Requirements Directive.

Membership and interaction with the MPC

The FPC will have a total of eleven members, comprising six internal BoE executives and five external members, plus a non-voting representative from HMT and will be chaired by the Governor of the BoE. It will have primary responsibility for financial stability and the MPC primary responsibility for price stability. The Governor and the Deputy Governors for financial stability and monetary policy will sit on both committees.

Links with the PRA and the CPMA

To facilitate close cooperation among the FPC, the PRA and the CPMA, the chief executives of the PRA and the CPMA will attend FPC meetings. However, the PRA's chief executive (who will also be a Deputy Governor of the BoE and directly responsible for prudential regulation) will not sit on the MPC to avoid him influencing monetary policy decisions. The PRA and the CPMA will be required to consult the FPC when making any rules which would have material implications for financial stability.

Transparency and accountability

The UK government will replicate the MPC's model of transparency and accountability mechanisms for the FPC. This includes the FPC publishing six-monthly financial stability reports. As a committee of the Court of Directors of the BoE, the FPC is directly accountable to it. The FPC will also be accountable to the Treasury Select Committee and HMT.

Roles, Responsibilities and Governance of the PRA and the CPMA

The Prudential Regulation Authority

Objectives: The PRA's primary objective will be to promote the stable and prudent operation of the financial system through effective regulation of financial firms which minimises the disruption caused by any failing firms. To this end, the PRA will be given a range of statutory factors to be considered in the conduct of its functions. These factors fall into three categories:

- the objectives of other regulatory authorities (to support effective coordination);
- principles of good regulation (to ensure that the regulatory burden placed on firms is appropriate); and
- other considerations (to ensure that the pursuit of its primary objective is also balanced against, or consistent with, important matters of public interest).

Scope: The PRA will be responsible for regulating banks and other deposit takers (including building societies and credit unions); investment banks (including broker-dealers); and insurers (including friendly societies).

Powers and functions: The PRA will be given appropriate powers to supervise and enforce its policies and rules. Its main functions will involve (i) assessing the safety and soundness of financial firms, and taking appropriate action; (ii) making the rules governing the conduct of regulated activities by financial firms (including remuneration); (iii) the authorisation of firms engage in regulated activities; (iv) supervision, and where necessary, enforcement of compliance with the rules; and (v) the approval of individuals with certain controlled functions.

Governance—Board and management structures: The PRA will be established as a subsidiary of the BoE, with its own board chaired by the Governor of the BoE. There will be a high degree of integration between the PRA's most senior management and that of the BoE and the CPMA, including the BoE's Deputy Governor for prudential regulation being the chief executive of the PRA.

Transparency and accountability: In addition to the Court of Directors of the BoE, the PRA will be accountable to Parliament and HMT and will be required to produce an annual report.

Consumer Protection and Markets Authority

Objectives: The CPMA is intended to act as a "consumer champion" in pursuit of a single objective to ensure that firms conduct themselves properly in financial services and markets, both in relation to consumers in retail markets and to other participants in wholesale markets.

Powers and functions: The CPMA will have the core regulatory function of making rules which govern the conduct of financial firms, in both the retail and wholesale spheres and will have the power to grant permissions for all regulated activities classified as non-prudential. In addition, the CPMA will have the powers and functions of (i) supervision and, where necessary, enforcement of compliance with conduct of business rules and relevant prudential activity, and (ii) the approval of individuals to perform relevant conduct-related controlled functions and approval of all controlled functions where firms are solely regulated by the CPMA. It is envisaged that the CPMA will work in close coordination and cooperation with the FPC and the PRA in carrying out its powers and functions.

Governance and accountability: The CPMA will be governed by a board with a majority of non-executives appointed by HMT and the Department for Business, Innovation and Skills. The PRA's chief executive will sit ex officio on the board of the CPMA. The CPMA will be subject to audit by the National Audit Office and be subject to accountability requirements, including producing an annual report to be laid before Parliament. It will be required to maintain a complaint mechanism similar to that currently required to be maintained by the FSA.

Associated bodies: The CPMA will take on the FSA's existing roles under the Financial Ombudsman Service, oversee the Consumer Financial Education Board and have responsibility for the financial services compensation scheme.

Consumer protection and securing the right consumer outcomes: HMT and the Department for Business Innovation & Skills will consult on consumer protection and redress issues in autumn 2010, including the merits of transferring the responsibility for consumer credit from the Office of Fair Trading to the CPMA and, more generally, on how consumer credit legislation might be simplified.

Roles, Responsibilities and Governance of the PRA and the CPMA

Market conduct

It is envisaged that a strong Markets Division will be established within the CPMA to direct regulation of all market conduct and to represent the UK in the new European Securities and Markets Authority. It will be responsible for regulating the conduct of participants in organised financial markets trading through investment exchanges and multilateral trading facilities as well as OTC financial markets and bilateral transactions between financial institutions and other large wholesale market participants.

Market infrastructure

The regulation and supervision of securities settlement systems and central counterparty clearing houses will be transferred to the BoE.

Listing and related activities

The UK government is considering whether the UK's Listing Authority should be merged with the Financial Reporting Council (which has remit for company reporting, audit and corporate governance) under the Department for Business Innovation & Skills.

Economic crime

The UK government will consult separately on whether to transfer the FSA's power to prosecute serious economic offences (including insider dealing) to the new Economic Crime Agency.

Coordination of the Regulatory Bodies in a Potential Crisis

The consultation paper also sets out an outline of how the UK government envisages the new regulatory structure should react to a financial crisis and further work it intends to undertake in this area.

Stability and crisis management framework

The Governor of the BoE will report to the Chancellor bi-annually on developments in prudential regulation and financial stability, including any macro-prudential decisions or significant regulatory actions of the PRA or the CPMA. This is intended to alert the Chancellor to any potential financial stability issues on the horizon and to give him an opportunity to respond.

In addition, the BoE Governor must notify the Chancellor as soon as he becomes aware of a potential call on public funds, allowing sufficient time for the Chancellor to consider and discuss all options. The Chancellor will have the final decision on any use of public funds.

Tools to deal with threats to financial stability

The UK government intends to explore whether further tools and powers will be needed for the new regulatory bodies to protect the interests of depositors and taxpayers and to promote financial stability. The following are currently under review:

BoE market operations: The modifications to the BoE's market operations, which have been introduced since 2008 in response to the recent financial crisis will be reviewed for greater flexibility in responding to liquidity pressures.

Heighted supervision and powers for regulators: Recovery and resolution plans,[5] regulators' powers to require management actions from firms and contingent capital are under review. In relation to contingent capital

[5] *See* Morrison & Foerster client alert: The Will to Live: Recovery and Resolution Plans for UK Banks (29 December 2009), http://www.mofo.com/files/Publication/498b4e62-dc03-487f-8da8-a403f7ad2260/Presentation/PublicationAttachment/62bc0757-0f9d-433a-9742-a6e126debe59/091229TheWilltoLiveRecoveryandResolutionPlansforUKBanks.pdf.

instruments, the potential value of such instruments is also being explored by the Basel Committee on Banking Supervision and the G20's Financial Stability Board.

Special Resolution Regime: Contingency planning and resolutions will be managed by the Deputy Governor for financial stability. The government will also consider possible changes to the special resolution regime in the light of the new regulatory authorities as well as improvements to enhance safeguards and overall effectiveness.

International issues

HMT will continue to represent UK's interests in G20, G7 and other international forums (including the EU). The BoE will continue to sit on various G20 and G7 bodies, including the Financial Stability Board.

Next Steps for the Reform Programme

The consultation invites public feedback on the proposals until 18 October 2010.

HMT intends to publish more detailed proposals, including the draft legislation, in early 2011 for further consultation, with the aim of enacting the legislation implementing the reforms in 2012.

Contacts

Peter Green
+44 20 7920 4013
pgreen@mofo.com

Jeremy Jennings-Mares
+44 20 7920 4072
jjenningsmares@mofo.com

Helen Kim
+44 20 7920 4147
hkim@mofo.com