

The new regulatory order: the demise of FSA confirmed - the Banking Commission established

The UK government has finally announced its radical reforms for the domestic regulatory system. This essentially implements the full plan announced by the Conservative Party before the general election and involves more dramatic changes than recent statements suggested. At the same time, the government has announced the terms of reference and membership for its 'Independent Commission on Banking'.

The demise of FSA and the new institutional structure

The government's plans were announced in speeches at the Mansion House on Wednesday 16th June 2010 and further detail was provided in a ministerial statement the next day. The key points are:

- FSA will effectively be abolished and the model of a unitary (one stop shop) regulator/supervisor abandoned in favour of a twin peaks structure, i.e. one where financial institutions are each supervised by two separate regulators - a **Prudential Regulatory Authority (the PRA)** and a **Consumer Protection and Markets Authority (the CPMA)**;
- All banks, building societies, investment banks and insurers (both general and life and pure reinsurers) will be regulated by the new PRA, which will be a subsidiary of the Bank of England. The PRA will deal with prudential and financial regulation, both in setting policy and in supervising individual firms (so called 'micro-prudential' regulation). The PRA will be chaired by the Governor of the Bank of England and the CEO will be the Deputy Governor for prudential regulation;
- All firms will be regulated by the new CPMA, which will deal with various areas of regulation including conduct of business, market regulation, the FOS and the FSCS. Its primary objective will be promoting confidence in financial services and markets.
- Macro-prudential regulation will be the responsibility of the Bank of England and its new **Financial Policy Committee (the FPC)**. The FPC members will include the Governor of the Bank of England and the Deputy Governors for Financial Stability and for Prudential Regulation, together with the Chairman of the CPMA and a Treasury representative. The FPC's relationship with Parliament will be modelled on the current relationship with the Bank of England's Monetary Policy Committee; and the Financial Reporting Council (FRC).
- A new agency, the '**Serious Crime Authority (the SCA)**', will be created to take over the roles of various government departments and agencies (including the Serious Fraud Office).

Institutional structure charts

We have prepared charts that show the new institutions and their roles; these charts also include the new international arrangements and the proposed new EU regulatory institutions. There are additional charts that enable you to compare the new institutional structure with the current position at both the domestic and EU levels. To view these charts on our **RegZone** – please click [here](#).

Much still to be resolved

The announcements so far leave many important questions unanswered. More will be revealed in the forthcoming consultation and many important issues may not be resolved until that process is complete. The issues include:

- The precise roles of the new bodies and how FSA's current functions will be shared out. Many of these relate to both PRA and CPMA functions in the new structure, for example, authorisation, controllers and approved persons, systems and controls, enforcement and regulation in areas such as conflicts of interest;
- How the new authorities will coordinate their policy-making and supervisory roles. For example the FSCS will fall under the CPMA but both the PRA and FPC will also have to be involved; both authorities will have to implement EU legislation, such as the Markets in Financial Instruments Directive (MiFID), which is partly prudential and partly

conduct of business. Although its name might suggest otherwise, the new European System of Financial Supervision (ESFS) bodies will be concerned with EU rules setting both prudential and conduct of business requirements.

- Whether the **OFT's** consumer credit role (and its broader consumer protection role in relation to financial services) will be transferred to the CPMA (as the Conservatives originally proposed);
- The Conservatives had considered creating a markets authority, possibly within the Bank of England; this role is now to be given to the separate CPMA. The Conservatives had floated the idea of including the Take-over Panel and the Financial Reporting Council within the markets authority – in addition to the **FSA's market abuse and UK Listing Authority roles**; and
- How the enforcement of PRA and CPMA rules will be dealt with and the role of the new Economic Crime Agency.

An immediate appraisal

It is easy to see why the Government has acted in this way – the FSA was Labour's creation and one that, by some accounts, fell down when put to the test. But while this may explain the political impetus the proposals fall well short of a coherent thesis for these specific reforms. The Turner Review of March 2009 raised two key issues, and it is difficult to see how these reforms properly address either of them.

First, part of the cause of the recent financial instability was the growth of macro trends that were not properly understood or identified. The proposed fragmentation of regulation between two micro-supervisory agencies and a third responsible for macro regulatory issues is plainly not conducive to the joined up thinking that Turner persuasively called for. Second, Turner said that the choice was between more or less European intervention in financial regulation, with maintenance of the status quo of wide passporting and limited home state supervision being untenable. This issue is left unaddressed, at least for the time being, and it more than likely that further adjustments will be required once the EU's proposals – see below – take effect.

Transition and timing

A full consultation will be published before the summer recess with the legislation completed within two years; the permanent structure will take effect in 2012.

Hector Sants (who had previously announced his retirement from FSA) has agreed to stay on as chief executive of FSA during the transition and will then take up the role of chief executive of the PRA (and as Deputy Governor of the Bank of England).

Getting the policy right – the Independent Commission on Banking

The government has announced the terms of reference¹ and membership of its Independent Commission on Banking. Sir John Vickers (former Chief Economist at the Bank of England and former Chairman of the OFT) will chair the committee, which will report to the Cabinet Committee on Banking.

The TOR are very vague and wide ranging. Essentially this committee will continue the debate on some unresolved and thorny problems exposed by the recent crisis. It will seek to balance the regulatory imperative with competition concerns and will be faced by many of the conundrums with which the authorities have been wrestling recently, including:

- The dangers of large banks being 'too big to fail' – which involves issues such as Recovery and Resolution plans, resolution funding (and related moral hazard) and whether the three 'universal' UK banks should be broken up;
- Tougher financial requirements versus the need for increased lending and competition; and
- The new macro-prudential regime to reduce systemic risk.

These issues have been debated internationally and domestically by a variety of bodies; the domestic work will now focus on the Commission, which will produce its final report in 2011. As with the current debate, some of the findings may have to be used to influence the international debate rather than being transposed into domestic rules.

In the meanwhile the **OFT has already launched a market study** on retail banking - click [here](#) to read our Law-Now report, (it has also launched a review on investment banking - click [here](#) to read our Law-Now report).

¹ The TOR refer to formulating policy recommendations with a view to:

- Reducing systemic risk in the banking sector, exploring the risks posed by banks of different size, scale and function;
- Mitigating moral hazard in the banking system;
- Reducing both the likelihood and impact of firm failure; and
- Promoting competition in both retail and investment banking with a view to ensuring that the needs of banks' customers and clients are efficiently served, and in particular considering the extent to which large banks gain competitive advantage from being perceived as 'too big to fail'.

Key issues for firms

There are many significant challenges in establishing, and migrating to, the new structure.

Europe – the government has said very little about how the new domestic policy will operate within the parameters of the extensive current EU legislation on financial services and the proposed reform of EU institutions with the emphasis on enhanced powers for the new European Supervisory Authorities (ESAs) (which comprise the ESFS - see the Institutional charts above) and greater standardisation of rules. There are many unresolved issues about, on the one hand, the harmonisation process and the powers of the ESAs in setting technical standards and the ESA supervisory and tie-breaker powers and, on the other hand, the discretion of national authorities both as policy makers and as supervisors. For example the European Parliament has proposed that the ESAs should regulate/supervise systemically important cross-border institutions.

Regulatory approach – There has been considerable emphasis placed on the need for different styles of regulation as between the CPMA role and that of the PRA. The strongest arguments in favour for adopting 'twin peaks' is the perceived need for different approaches in the two areas - combined with the proximity of a central bank to the banking sector (as the provider of liquidity, both as lender of last resort and via the discount window) and its natural place in the realm of macro-prudential policy.

The CPMA approach is seen as being rules based with strong enforcement. The Governor of the Bank of England believes that the PRA should adopt a new style of prudential regulation. This is described as being less legalistic and avoiding a compliance-driven style of regulation; he places great emphasis on the **judgement of the supervisor** and the need for **discretion** in setting capital and liquidity requirements. He anticipates changes to current legislation and rulebooks to achieve this new policy. He also refers to system-wide capital requirements as one of the macro-prudential tools.

Supervision – there are many concerns about how supervision will work under the twin peaks system. Will the PRA and CPMA conduct joint visits, how will reporting work and so on?

Insurance and other non-banking sectors – the government's plans are clearly driven by the lessons of the recent crisis in the banking sector. Insurers and other firms are concerned that insufficient attention has been paid to the impact of the changes on their sectors.

What does this mean for firms?

1. There will be a **period of upheaval**, probably prolonged over several years, while the regulators are re-shaped. This will cause uncertainty within the regulators, with significant staff turnover, possibly resulting in lower quality supervision and policy making, and in routine decisions being deferred and possibly new EU initiatives receiving less scrutiny and challenge than ought to be the case. This regulatory uncertainty may combine with the present uncertainty over the taxation regime to make the UK a relatively less attractive place to attract and retain financial services firms.
2. Firms in all sectors will need to **devote additional resources** to monitoring the developments, participating in such consultations that may be available and then in adapting their systems and controls to the new requirements.
3. The greatest impact may well be in terms of **firms' relationships with the new regulators**. Most obviously, the old FSA-style relationship management arrangement will need to be replicated across new regulators. A firm that previously had one port of call for a query, a variation of permission or an application for an approved person may need to duplicate the request.
4. There will be a **fragmentation of regulation**.
 - a. A firm will no longer benefit from a single set of rules, guidance and Dear CEO letters but a range of material (and no doubt styles of communication) from the various regulators.
 - b. Many current FSA functions do not map across into the new regime. Who will approve a corporate treasurer? Must a start-up bank file one, two or three applications for approval? Will there be one or three enforcement procedures? Each of these issues is key to the smooth operation of regulation, and firms must be prepared to ensure that their voices are heard on these issues.
 - c. There will also potentially be a multiplicity of routine supervisory inspections – prudential, conduct of business and financial crime. A return to the 1990's alphabet soup style of regulation would be an unwelcome development, so the Bank must take the lead in insisting on proper coordination and homogeneity, if not uniformity, of style.
5. There will be **changes in the rulebook regime** as the new regulators proceed to reformulate their rules or apply them to different sectors. However, in most cases such as best execution and suitability, the changes may be largely cosmetic as the FSA rules are required to implement standards laid down in EU directives such as CAD or MiFID. Financial regulation is more complex, the rules are heavily EU driven but the new PRA will clearly be

looking to treat EU requirements as minimum standards, with national supervisors retaining discretion on individual capital and liquidity requirements.

6. The bigger issue is **changes in supervisory standards**, which are (for the moment) not laid down by EU regulators. While promulgation of common supervisory standards is definitely on the EU agenda, certainly for major cross-border firms, supervisory stance is at present within FSA's discretion. We shall see whether concepts such as ARROW visits and close and continuous supervision survive into the new regime, but this does seem likely.
7. **Goldplating** will remain an issue to which firms must remain alert. FSA rules go well beyond the scope of EU directives in a number of ways, including its remuneration code, the rules resulting from the retail distribution review and some aspects of the market abuse regime. These, again, are likely to survive, but firms must remain vigilant in resisting further encroachments.

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