Judgment, Focus and Stability? – An analysis of the Treasury Consultation Paper, 'A new approach to financial regulation'

In July 2010 the Government published a high-level consultation on its plans to reform the domestic regulatory system. Whilst casting some light on the Government's plans for a new regulatory order, this consultation leaves many important questions unanswered. For a full account of the consultation proposals read our **digested read of the HM Treasury paper** and for how this affects firms read our **Guide to the new regulatory order.** This report considers what we now know about the Government's plans for reform, as well as the issues on which firms will want to press policy-makers for clear and considered answers.

Issues arising from the consultation (1) – what we now know:

The Government's plans to restructure the institutional framework reflect a dramatic shift in regulatory philosophy – this is not business as usual.

Under the old system FSA took decisions based on a mix of objectives and considerations including the global competitiveness of the UK and innovation in financial services. The words 'financial stability' did not appear (although a rather weak reference to financial stability was added to FSA's objectives by the Financial Services Act 2010).

Under the new system, the FPC of the BoE will have a strong financial stability mandate with new macro-prudential powers or 'tools'. The FPC will effectively trump both the PRA and the CPMA: it will be able to require both regulators to implement its macro-prudential policies by imposing the FPC's requirements (on capital or liquidity or leverage etc) on individual firms (e.g. through PRA/CPMA rules).

In addition, the PRA will have a primary objective clearly focused on the same financial stability goal; a duty to *"promote the stable and prudent operation of the financial system through the effective regulation of firms in a way which minimises the disruption caused by any firms that do fail"* . Thus the PRA's *first priority* will be to make sound rules for financial institutions - and to supervise and enforce their implementation - so that national financial stability prevails.

'Planning for failure' will be a priority of the new regime

The PRA will be mandated to "*minimise the disruption caused by any firms that do fail"*. This novel primary objective will entrench some of the policies that have been discussed at high-level since the crisis. The PRA will be required to address and reach a final decision on much debated issues such as "too big to fail" and the break up of universal banks or complex systemically important institutions. The PRA will have to focus on establishing an effective regime for resolution and recovery planning[1] (living wills). This will bring a whole new layer of regulation into effect – amongst which will be living wills, planning for failure and reverse stress-testing. PRA will have to report on - and satisfy Parliamentary committees - that under its regime they can be confident that each firm can no longer pose systemic risk or risk to the taxpayer. A primary objective of this kind is likely to encourage a risk-adverse approach, resulting in broad and demanding PRA rules in these areas.

The Bank of England is the clear winner – it is deliberately being made an extremely powerful new regulatory force.

The Bank of England will clearly be in command; its FPC and PRA subsidiary will be hugely powerful (even when compared with the Bank of England's pre-FSA role) – with much broader oversight over firms, new objectives and much more powerful tools/levers at its disposal. The current consultation paper recognises the potential might of the new central-bank regulator; it even seems to suggest that an enforcement regime to deal, after the event, with PRA rules breach might not be necessary (presumably because firms will not be given the option of non-compliance?). It may be years before the full impact of the enhanced role, described above, is fully realised.

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[1] These powers were introduced under the 2010 act but FSA has not used them and they are only at the pre-consultation phase.

Firms face fragmentation; they will have to deal with a bewildering alphabet soup of authorities. Firms need to press for effective coordination but should assume that this is unlikely to be achieved.

Under the new system regulated firms will be directly responsible to a number of different bodies – including the PRA and CPMA. The FPC might take an interest in specific firms and will prescribe macro-prudential driven rules for firms. In addition, the new European authorities (the ESAs – ESM, EIOPS and EBS) are set to have greater powers – in both their rule-making and supervisory capacities. The new regime will be much more complex and difficult for firms as they will lose their single point of contact/rulebook/supervisor at FSA; this will be replaced by a mix of different and overlapping relationships with agencies that will have differing priorities and styles. The architecture is designed to achieve different policy focus and style at multiple agencies and the benefits for firms of a single regulator have had to be sacrificed to achieve this objective.

The new 'judgment-based *approach'* to prudential regulation is intended to be very different from the FSA regime – but how realistic is this?

One of the strongest arguments in favour of adopting "twin-peaks" is the perceived need for different approaches in the two distinct areas of consumer protection/market regulation and prudential regulation. The CPMA approach is seen as being rules-based with strong enforcement; however the Government proposes that the PRA will adopt a new style of prudential regulation. This is described as being less legalistic and avoiding a compliance-driven style of regulation. There will be greater emphasis on the judgement of the supervisor and potentially discretionary standards in setting capital and liquidity requirements.

Financial institutions appreciate the clarity and transparency provided by the current weight of rules and guidance in FSA's Handbook. The consultation, however, proposes that in light of this new judgment-based approach, the PRA will seek to reduce and simplify the prudential parts of FSA's Handbook. It remains to be seen how this might be achieved in the face of ever greater EU harmonization.

The consumer protection role will be re-examined - more intervention on product regulation and competition are on the agenda.

The CPMA will be a "*strong consumer champion in pursuit of a single objective'.* The Government intends to examine whether the consumer protection regime enshrined in the Financial Services and Markets Act 2000 ought to be updated or strengthened in light of this. FSA's increasingly interventionist approach to consumer protection is likely to continue under the CPMA. The 2009 Turner Review considered means of enhancing consumer protection and Lord Turner has returned to this theme in recent speeches[2]. Options include more intensive supervision, a re-examination of competition in consumer banking and retail markets, as well as increased regulation and potential product regulation e.g. banning of unsafe high 'loan-to-income' and 'loan-to-value' mortgages.

Insurance (and other non-banking sectors) have been swept up in the aftermath of the banking crisis – many of the reforms are not necessary or appropriate for the insurance sector and insurance is being 'fitted in' to new regime driven by banking sector priorities and problems. Constant lobbying is required to avoid excessive read-across.

The government's plans are clearly driven by the lessons of the recent crisis in the banking sector. FSA regulation and supervision worked effectively in the insurance market and there seems to be no argument that a move to twin-peaks style regulation of insurers is necessary or beneficial. It seems clear that little attention has been paid to the insurance market in the design of the new regulatory regime; insurance is now being 'fitted into' a system driven by the priority being given to the reform in the banking sector. For example, the current consultation says little about how the Lloyd's insurance market will be regulated; the domestic regulator for insurance brokers – the CPMA – will not be a member of the new European Insurance and Occupational Pensions Authority (EIOPA), which will be responsible for broker regulation and supervision in the EU.

Issues arising from the consultation (2) – questions yet to be answered:

When will key issues be resolved and when will the detail emerge?

This is unclear. It seems that the timetable will be driven by the legislative process; so issues which have to be dealt with in the primary legislation (such as the precise wording of the statutory objectives for the new bodies) must be dealt with first. Key issues for firms – such as which firms will be regulated by the PRA – can be left to secondary legislation made at the end of the process. For example the July 2010 consultation says nothing about the regulation of the funds industry, which is strange given all the interest in the sector in the wake of the crisis. Firms will find it frustrating that many key issues for them have not been resolved yet and may remain open questions for some time. Firms may wish to press the government to address important issues sooner rather than later.

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[2] See Lord Adair Turner's speech to British Banking Association (BBA), 13 July 2010

How will coordination between the authorities be achieved? Firms should press the government on this key issue.

There is a clear conflict of interest between financial institutions who want clarity and transparency and Government and regulators who desire the flexibility provided by greater regulatory discretion. When necessary the PRA, CPMA and FPC will all be consulted on difficult decisions. Financial institutions will be concerned about potential confusion and delays to decision-making in these situations. Firms that are subject to both PRA and CPMA regulation will want the Government to be precise about what "dual competence" will mean in practice. All firms will want the Government to be exact about the circumstances in which one body is obliged to have regard to the objectives of the other. They will want to know the sorts of potential risks at firm level that will trigger the PRA and CPMA's obligation to report to the FPC.

Twin-peaks firms – regulated by both PRA and CPMA – are very concerned that the government has underestimated the dangers and difficulties in splitting regulation between different bodies. The consultation paper starts to grapple with these issues with suggestions for cross-membership of boards, memoranda of understanding between regulators and legal provisions to provide "information gateways" for the exchange of information and "college-style mechanisms" to coordinate supervision of firms. Financial institutions will question whether there is yet a viable plan for the supervision of twin-peaks firms and this will be a key area for responses to the consultations.

Groups The consultation is opaque on the extent to which the PRA will have reach into single-regulated firms that belong to groups that contain twin-peaks regulated institutions.

Incoming EEA firms It is as yet unclear how UK branches of EEA banks, insurers and broker-dealers will be regulated. Clearly they will be subject to CPMA regulation – CPMA deals with the majority of host state matters. However, some of the regulation that UK imposes on EEA firms will fall within the PRA remit – e.g. host state involvement in branch solvency.

Europe. How will the new EU and UK regimes operate together? The government has said very little about how the new domestic regime will operate within the parameters of the extensive current EU legislation on financial services and the proposed reform of EU institutions, with its emphasis on enhanced powers for the new European Supervisory Authorities (ESAs) 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.

Next Steps

The current consultation closes on 18 October 2010. Firms need to respond both with answers to the specific questions posed and with wider concerns and issues.