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The Financial Services Bill as introduced to Parliament – A new approach to financial regulation

(H M Treasury January 2012)

Summary

The revised Financial Services Bill – which is little altered from the draft Bill published in June 2011 – has been published alongside the New Approach policy statement containing the Government's responses to the reports of the Joint Parliamentary Committee and the Treasury Select Committee on the Bill and various consultation papers. The Bill is exclusively concerned with the structure and delivery of United Kingdom financial sector regulation, creating and allocating new powers and reallocating existing powers between the new regulators. The existing legislative structure is little altered and the Bill amends (but largely preserves) the current Financial Services & Markets Act 2000. There is also no change to the substantive regulated activities and regulated investments, nor to the high-level prudential or detailed conduct of business rules. All of these are laid down in EU Directives and allow individual member states limited if any discretion.

The title of the New Approach policy statement succinctly conveys the Government agenda. Two objectives underlie the changes – financial stability and consumer protection, and neither this document nor the Bill contains much to give comfort to the financial services industry – it will have less leeway, fewer opportunities to influence the operation of regulation and any promise of a regulatory dividend of lighter regulation in return for good conduct has long since been withdrawn. The Bill is unquestionably the harbinger of harsher regulation, seeking to create a regulatory framework to institutionalise a more judgemental style of regulation, although the policy of "making judgements on management's judgements" is not new, having been employed by the FSA for several years and already experienced in its many facets by the larger banks and insurers.

The policy

The Chancellor's introductory statement sets out both **the problem…**

"During the last decade Britain experienced a debt-fuelled boom that ended in financial crisis [which] revealed fundamental flaws in our regulatory system ... Regulators failed to spot the enormous imbalances building up and proved incapable of dealing with the crisis when it first broke."

…and the **consequent policy determination:**

"We cannot live with an industry that puts the stability and the prosperity of the rest of the economy at risk ... the Government is fully committed to implementing the Vickers Committee's recommendations for a more stable and competitive UK banking sector. We are also committed to reform the failed system of financial services regulation which contributed to the crisis."

The paper notes that the Government's proposals, first put forward in July 2010, have received a broad degree of support and are therefore largely unchanged. The Bill, as now revised, contains the core reforms of:

- Making the **Bank of England** responsible for ensuring the stability of the financial system by (a) empowering it to lead the response to a financial crisis, and (b) creating the **Financial Policy Committee** (a committee of the Bank) to provide expert macro-prudential oversight of the regulatory system.

- Transferring the FSA's prudential oversight of banks, insurers and major broker dealers to a new **Prudential Regulatory Authority** and strengthening the FSA's (renamed the **Financial Conduct Authority**) oversight of market conduct.

Key changes

The paper refers to a number of changes resulting from both pre-legislative scrutiny and industry and consumer comment. These include

Ensuring that the new authorities have clear and focused statutory objectives

- The FPC must respond to the remit set by the Treasury and must clarify and expand on the key risks it oversees
- The FCA is to focus on ensuring that financial services and markets "work well" for users and participants
- The FCA should promote effective competition in the interests of consumers
- The responsibility of firms to their customers is to be given stronger statutory emphasis.

Ensuring that the new authorities have the necessary powers and responsibilities

- The Chancellor has clearer powers to direct the Bank during a financial crisis
- The PRA has been given an express duty to supervise firms
- Enhancing the "threshold conditions" that a firm must observe for authorisation and continuing approval to make them more useful supervisory tools

Designing systems of accountability and engagement for evaluating their performance

- The Governor of the Bank is to be restricted to a single eight year term
- Providing for a pan-regulatory complaints regime
- Consumer groups can make "super-complaints" to the FCA, requiring response within 90 days.

Banking reform

Banking reform is a further area of government focus. First, the majority of the Vickers Committee's reforms have been accepted, including those on ring-fencing, loss-absorbency, resolvability, competition and the regulation of payment systems. The Government will bring forward legislation with a view to implementation by 2019 which will bring about "the most far-reaching change to the structure of the banking system in modern history". In addition, and arising out of the FSA's recent report into the failure of RBS, two further proposals are under consideration:

- Whether the balance between risk and reward for senior managers should be adjusted – the Government will consult on this proposal "later this Spring".
- Whether regulatory approval is required for significant banking sector M&A activity. The Government will give further consideration to this proposal.

The elements of the reforms

The Bank & the FPC

The Bill concentrates "responsibility for all aspects of financial stability within the Bank". Bringing financial stability under one roof is intended to create a "new judgement-led approach to safeguarding financial stability" by identifying and identifying risks to stability. The elements, as previously announced, are

- The FPC will have macro-prudential oversight;
- The PRA will ensure the safety and soundness of individual banks, insurers and major broker dealers and
- The Bank will regulate systemic infrastructure.

The Government rejects the proposal that the FPC be made subject to Treasury control in interpreting its remit, emphasising the importance of its expert independence so that it can make necessary but unpopular decisions, such as to limit the availability of credit in order to address an unsustainable asset bubble. However, the FPC should respond publicly to recommendations made by the Treasury, explaining when it disagrees. The Government will consult on the FPC's initial set of policy tools, and the FPC will be required to maintain a statement of policy setting out how it will use them. The Bill also contains two clarifications of the type of risk on which the FPC should focus.

The Bank will have primary operational responsibility for financial crisis management and, once it is clear that public funds may be put at risk, the Governor will have a statutory duty to notify the Chancellor with a crisis management MoU underpinning the process which addresses (a) the responsibilities of the Bank and the Treasury, especially in a crisis, (b) the duty of the Bank to notify the Treasury of a risk to public funds; and (c) the Chancellor's exercise of a power of direction over the Bank in a crisis. This is now backed up with a statutory duty to coordinate the exercise of their functions in a crisis. Further, intended as a power of last resort, the Treasury can direct the Bank to provide liquidity support during a crisis, and to exercise its powers under the special resolution regime. The New Approach paper does, however, emphasise that that this power is only exercisable where there is a real risk to financial stability, or public funds have already been used, and that the Bank otherwise retains operational autonomy when managing threats to stability in which public funds are not at risk.

The Prudential Regulatory Authority

The New Approach paper affirms the Government's belief that effective prudential regulation has a fundamental role in ensuring financial stability and so avoiding the failings that led to the financial crisis.

The Government has accepted many of the Joint Committee's recommendations that further empower a judgement-led culture and approach, and the new explicit "**duty to supervise**" is intended to ensure an "enduring statutory commitment to take a judgement-led supervisory approach to supervising individual firms through scrutiny of business models and forward-looking assessments of risk."

The **scope of the PRA** has been considered and a draft Statutory Instrument proposes the following remit:

- Accepting deposits (the core banking function)
- Effecting or carrying out contracts of insurance as principal (the core insurer and reinsurer function)
- Acting as a Lloyd's managing agent
- Dealing as principal if the PRA in its judgement individually designates a firm – the criteria are where the firm has an initial capital of €730k taking into account the size of its assets and its membership of a group. This will catch the major broker dealers.

Work will continue on the optimal structure for maintaining surveillance over the "shadow banking" sector. However, no change is proposed because there is thought to be sufficient flexibility to alter the regulatory perimeter through amending the regulated Activities Order.

The draft Bill gave the regulators power of direction over **group holding companies**. The EU review of the Financial Conglomerates Directive is currently reviewing this power but in the meantime the Government proposes that the regulators can

- Compel the parent undertaking of a regulated firm to provide information on a regular basis
- Exercise their proposed powers where they consider that the acts or omissions of the parent do or may have a material adverse effect on consolidated supervision
- Fine or censure the firm where its parent fails to comply.

While the Government does not favour the Joint Committee's recommendation for a radical overhaul of the **Threshold Conditions** to strengthen this judgement-led approach, it will launch a consultation and is meanwhile removing proposed specific changes from the Bill. Proposals are that a firm regulated exclusively by the FCA will remain subject to a single set of conditions. For a dual regulated firm

- The PRA will assess whether the firm can conduct itself prudently and maintain adequate resources
- The FCA will assess whether the firm has the capacity and resources to comply with the conduct requirements
- Both regulators will assess whether they can adequately supervised it; and whether its business is carried on in a fit and proper manner with integrity and the appropriate level of professional skills

Both regulators will be given a power to make "**threshold condition codes**" which elaborate on the conditions and bind firms so that a regulator can on its initiative alter a firm's permissions by reference to them.

The PRA will **engage with and consult practitioners** and publish an annual report of its consultation activities, but there will be no formal Practitioners' Committee to avoid any opportunity for "industry capture" as is thought to have happened with the FSA.

The Financial Conduct Authority

The Government views good conduct of business regulation as an essential component of an efficient financial sector. The Bill provides the FCA with the legal framework for a more proactive and preventative approach to regulating conduct with the exercise of judgement a core part of its approach.

The FCA will have a revised set of objectives focusing on **making sure markets work well** including by, and not solely by, ensuring an appropriate degree of consumer protection and promoting competition in the interests of consumers. Securing **effective competition** in the market for financial services is a key mechanism for improving consumer outcomes and the current objective of "promoting efficiency and choice" will be replaced by one of "promoting effective competition in the interests of consumers". Together with the separate competition duty, this is intended to encourage the FCA to seek competition-led solutions to conduct issues. The paper suggests that the FCA is expected actively to promote competition and to use its powers (such as product intervention) to tackle competition problems such as products and services with the following characteristics

- One-off high value transactions
- Long term investments where problems only appear many years on
- Asymmetries of information
- Inherent complexities
- Linked-in sales practices such as tying and bundling
- Barriers to switching
- Barriers to entry.

While it will not be a prescriptive price regulator like a utilities regulator, the FCA will look at factors such as comparative prices, value for money and clarity of pricing.

The **principles of good regulation** apply to regulators, and include the principle that consumers should take responsibility for their decisions. In response to concerns expressed during the scrutiny process that greater focus should be placed upon firms' responsibilities, one new principle of good regulation and two significant alterations are proposed to guide the regulators in their formulation of general policy.

- **New** – To have regard to the general principle that firms should be expected to **provide an appropriate level of care**.
- **Revised** – To have regard to consumers' need for accurate, timely and fit-for-purpose **advice and information**.
- **Revised** – To have regard to the responsibilities of firms' **senior management** for their firm's compliance with the regulatory framework.

Fundamental change is required to keep up with the rapidly evolving **consumer credit** market and to tackle detrimental practices more swiftly. The Government will seek to achieve this by bringing the regulation of consumer credit within the financial services framework while preserving the existing consumer rights and protections contained in the existing legislation. The Government undertakes to work to develop a proportionate model of regulation but does not definitively commit to transferring consumer credit regulation to the FCA unless satisfied that this will be the right outcome.

The Government agrees to the recommendation that designated consumer bodies can make **super-complaints** to the FCA as well as to the OFT where a feature of a market for goods or services in the United Kingdom is, or appears to be, significantly harming consumer interests. This formula allows proactive and swift notification, and is intended to provide a mechanism under which the FCA can be alerted to an issue of apparent mass detriment and then held accountable for its response. The plan is that in such an instance the FCA will take the lead and the FOS will deal with individual cases although, where mass detriment is already occurring, the issue can be referred to the FCA which must respond within 90 days.

Points of detail

There will be a **single complaints commissioner** dealing with complaints made against both regulators and also the Bank's function as regulator of recognised clearing houses and payment schemes.

There is no change to the plan to announce **the issue of disciplinary warning notices** once a regulator has determined to take disciplinary action against a firm or an individual. Nor to the restriction on the **Tribunal substituting its judgement** for that of a regulator on a non-disciplinary matter – in the words of the Joint Committee *"Allowing the Tribunal to substitute its own opinion for that of the regulator would undermine the principle of judgement-based regulation".*

There will be a MoU between the Bank and the two regulators setting out their approach to the **regulation of market infrastructure**.

The FCA will not be able to require that the **issuer of listed securities** be subject to the requirement to appoint a section 166 skilled person to prepare a report.

Regulatory process & coordination

Effective coordination between the PRA and FCA will be essential to ensure that they can effectively deliver their objectives. Mechanisms include cross-membership of boards, a statutory duty to coordinate their functions and preparation of a MoU explaining how this will happen, although the joint rule book and single point of contact that the industry would welcome are unlikely to be attainable and the confirmation of separate supervisory activity will be distinctly unwelcome. The draft Memorandum of Understanding provides for cooperation in the following areas:

General, policy and rule-making

- Coordinating supervisory responsibilities in relation to an insurer's **with-profits policies** and policyholders;
- **Sharing information** while maintaining confidentiality;
- Consulting each other on **policy initiatives** that impact the other's objectives together with routine cooperation on **rule-making**;

Authorisation & approvals process

- The FCA will **maintain the register** of PRA and FCA authorised firms and approved individuals;
- There will be a **single administrative authorisation process** led by the prospective prudential regulator; for dual regulated firms the PRA will lead and seek the FCA's consent. The FCA will consult the PRA before authorising a firm that is part of a group containing a dual regulated firm;
- The PRA will consult the FCA before designating a firm **as subject to its prudential regulation** because it has (or seeks) permission to deal as principal;
- Where both PRA and FCA need to consent to an application for an individual to perform **a significant influence function** a single regulator will lead and manage the administrative process. The PRA will lead on a firm's chairman and CEO (where the PRA will lead but require the FCA's consent) and the FCA on all functions interfacing with a firm's customers including client assets, AML and compliance (where the FCA has sole responsibility).

Supervision of firms subject to dual regulation

- The regulators will **share information** on firms dually regulated and in a dual-regulated group. So that supervisory judgements reflect all available information, this will include the PRA's views on resolvability, the firm's position on its Proactive Intervention Framework and the FCA's views on conduct risks.
- **Supervisory colleges** will be established as appropriate for major firms and groups, meeting once or twice a year. Smaller firms will be considered annually on a sector-focused basis.
- Regulators will normally **not conduct joint supervisory activity** because "to do so would lead to confusion about each regulator's objectives, focus and culture" and the firm will have different risk profiles reflecting the regulators' different statutory objectives.

Supervision of Lloyd's

- The PRA is the prudential regulator of the **Society of Lloyd's** and of managing agents while the FCA regulates their conduct. The FCA is the sole regulator of members' agents and advisers and Lloyd's brokers. There will be a supervisory college for the Society of Lloyd's, which will retain its supervision and enforcement powers.

Formal regulatory process

- The FCA and PRA will **coordinate in advance of formal action** in relation to firms dually regulated or in dual regulated groups and seek to avoid incompatible or conflicting actions. Areas for prior consultation include revoking or varying a firm's permission, withdrawing a person's approval, appointing investigators (which they may co-ordinate jointly), issuing a Warning or Decision Notice, taking enforcement action, approving a material rule waiver or a Part VII transfer. There are detailed provisions addressing passporting and approving a change in control. The PRA has a **limited right of veto** over the FCA's actions in defined circumstances.

Other regulatory functions

- The FCA has primary responsibility for the **regulatory perimeter**, taking action against a firm carrying on a regulated activity without authorisation, and will consult the PRA in relation to unauthorised deposit taking, insurance or activities impacting financial stability. It also has primary responsibility for combating **financial crime, alerting the PRA** to an investigation into a firm falling within its remit.

- The regulators will cooperate in relation to the **Financial Services Compensation Scheme**. The PRA is responsible for making rules for the FSCS in relation to deposits and contracts of insurance and the FCA will make the remaining rules.

- The FCA will collect **regulatory fees and levies** for itself and the PRA.

Further changes are

- Both FCA and FCA are to consent to a person performing a **significant influence function** in a dual-regulated firm.

- The Government will review the operation of the **duty of confidentiality** to which the regulators are subject with a view to increasing transparency (and thus reducing confidentiality).

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