



HM TREASURY

# A new approach to financial regulation:

judgement, focus and stability





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A new approach to  
financial regulation:  
judgement, focus and stability

Presented to Parliament  
by Command of Her Majesty

July 2010

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# 1

## Introduction

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### The financial crisis and the failure of the UK regulatory framework

**1.1** The UK banking system is emerging from the most serious financial crisis in over a hundred years. In order to avert a total banking collapse, the last Government had to part-nationalise two of the largest banks in the world, and introduce financial sector interventions costing hundreds of billions of pounds.

**1.2** Much has been written – in academic journals, in the business press, and in books dedicated to the subject – about the recent financial crisis, and its impact on the global economy. There is now an emerging consensus on the fundamental causes of the crisis, citing factors such as:

- global economic imbalances;
- mispriced and misunderstood risk;
- unsustainable funding and business models for banks;
- excessive build up of debt across the financial system; and
- the growth of an unregulated ‘shadow banking’ system

**1.3** The UK financial system, which is one of the most open, globalised and successful in the world, was impacted by these factors as much as, if not more than, any other. Attempting to explain the crisis purely in terms of global trends, however, is to ignore a fundamentally important point; there were real and significant failings in the UK regulatory framework. This meant that regulators failed in recognising and responding to the problems that were emerging in the financial system.

**1.4** The UK’s ‘tripartite’ regulatory system made three authorities – the Bank of England (the Bank), the Financial Services Authority (FSA) and the Treasury – collectively responsible for financial stability, and, as a result, this system failed in a number of important ways. For example, it failed:

- to identify the problems that were building up in the financial system;
- to take steps to mitigate them before they led to significant instability in financial markets; and
- to deal adequately with the crisis when it did break, especially during the first part of the crisis in the summer of 2007.

**1.5** These failures arose because the tripartite model contains a number of inherent weaknesses and contradictions. For example:

- it places responsibility for all financial regulation in the hands of a single, monolithic financial regulator, the Financial Services Authority (FSA), which is expected to deal with issues ranging from the safety and soundness of the largest global investment banks to the customer practices of the smallest high-street financial adviser;

- it gives the Bank nominal responsibility – and, since the Banking Act 2009, statutory obligations – for financial stability, but does not provide it with the tools or levers to carry out this role effectively; and
- it gives the Treasury responsibility for maintaining the overall legal and institutional framework, but no clear responsibility for dealing with a crisis which put tens of billions of pounds worth of public funds at risk.

**1.6** Perhaps the most obvious failing of the UK system, however, is the fact that no single institution has the responsibility, authority or powers to monitor the system as a whole, identify potentially destabilising trends, and respond to them with concerted action. This is a problem which Lord Turner, the chairman of the FSA, and Paul Tucker, Deputy Governor of the Bank for financial stability, have referred to as ‘underlap’: a phenomenon whereby macro-prudential risk analysis and mitigation fell between the gaps in the UK regulatory system.

**1.7** Lord Turner has also identified, in addition to macro-prudential ‘underlap’, the fact that the FSA’s approach to micro-prudential regulation was flawed. In the run up to the financial crisis, financial supervision relied too much on ‘tick-box’ compliance with rules and directives at the expense of proper in-depth and strategic risk analysis. Effective prudential regulation of firms requires an approach based on understanding of their business models, and the ability to make judgements about the risks that firms’ activities pose to themselves and to the wider financial system as a whole.

**1.8** Under Lord Turner and Hector Sants, the FSA’s chief executive, the FSA has made significant progress in identifying and fixing these problems. The Government believes, however, that more fundamental reform than this will be necessary. This is why, as announced by the Chancellor in his Mansion House speech on 16 June 2010, the Government is now embarking on a programme of reform to renew the UK’s system of financial regulation, and to make it stronger and more effective for the future.

## Reforming the tripartite model

**1.9** In addition to dealing with the operational failings of the system introduced between 1997 and 2000, the Government believes that reform to the regulatory framework must address a number of fundamental issues.

### Macro-prudential regulation

**1.10** First, there must be a dedicated focus on macro-prudential analysis and action, to ensure that risks developing across the financial system as a whole are identified and responded to. That is why the Government will create a new Financial Policy Committee (FPC) in the Bank of England, with primary statutory responsibility for maintaining financial stability. Unlike in the current system, which provides the Bank with responsibility but no tools for financial stability, the Government will provide the FPC with control of macro-prudential tools to ensure that systemic risks to financial stability are dealt with.

**1.11** The majority of the FPC’s members will be Bank executives, to bring the expertise and understanding of the financial system that only a central bank can provide. The Governor and current Deputy Governors for financial stability and monetary policy will be joined by a new Deputy Governor for prudential regulation, as well as two other Bank executives. But the FPC will also include external members to ensure that wider perspectives – including from other regulatory bodies, and from the markets themselves – are fed into the Committee’s work. The FPC will be a transparent and accountable institution, with appropriate lines of accountability into the Court of Directors of the Bank of England and the Treasury, as well as broader accountability to Parliament.



**1.12** The Government recognises that in the modern, globalised financial system, macro-prudential action will need to be internationally coordinated to be effective. The FPC will therefore work internationally with similar systemically-focused authorities, such as the G20 Financial Stability Board, and the European Systemic Risk Board, as well as national regulators where appropriate, to coordinate macro-prudential policy.

## **Prudential regulation of individual firms**

**1.13** Second, the regulatory architecture has to ensure that macro-prudential regulation of the financial system is coordinated effectively with the prudential regulation of individual firms, and that a new, more judgement-focused approach to regulation of firms is adopted so that business models can be challenged, risks identified and action taken to preserve stability.

**1.14** That is why the Government will transfer operational responsibility for prudential regulation from the FSA to a new subsidiary of the Bank of England. This new Prudential Regulation Authority (PRA) will be responsible for prudential regulation of all deposit-taking institutions, insurers and investment banks. The PRA will have a board chaired by the Governor of the Bank, and a chief executive who will also be the newly created Deputy Governor for prudential regulation.

**1.15** By placing firm-specific prudential regulation under the auspices of the Bank, the Government will bring together responsibility for macro- and micro-prudential regulation in a single institution. There will no longer be a gap in which responsibilities are unclear, and regulatory powers uncertain. The FPC will be able, within the remit of macro-prudential policy, to require the PRA to take regulatory action with respect to all firms. For example, the FPC may require an increase in the capital held by firms during an upswing in the credit cycle. The PRA would implement this change and monitor compliance through its supervisory function. The FPC may also suggest amendments to rules to make the system more resilient. And the FPC could have similar macro-prudential controls over the new conduct regulator, the consumer protection and markets authority (CPMA), should conduct-based macro-prudential tools be developed.

**1.16** At the same time, the PRA will also be operationally responsible for the regulation and supervision of individual firms. It will provide firm-specific information to the FPC to illustrate the potential impact of emerging system-level risks on specific types of institution. Its board, chaired by the Governor, and with the Deputy Governor for prudential regulation as chief executive, will have responsibility for all rule-making. Responsibility for significant regulatory decisions affecting firms – for example, on authorisation, supervision, or enforcement of rules or sanctions – will be delegated from the board to an executive committee, which, where conflicts of interest allow, may include non-executive directors on an occasional basis to ensure that they are exposed to the mechanics of firm-specific regulatory and supervisory decision-making.

**1.17** A key function of this executive committee will be to rebalance the operations of the prudential regulator away from rules and more towards the exercise of judgements based on supervisory information. The executive committee will thus play an important leadership role in supporting the creation of a new regulatory culture within the PRA.

**1.18** As the prudential regulator, the PRA will represent the UK on the new European supervisory authorities for banking and insurance, ensuring that there is a strong and credible voice to promote the UK's interests in these new institutions, and cooperating effectively with European counterparts on the regulation of large, cross-border financial firms.

## **Consumer protection and markets regulation**

**1.19** Third, regulation of conduct within the financial system – including the conduct of firms towards their retail customers, and the conduct of participants in wholesale financial markets –

will be carried out by a dedicated, specialist body with focused and clear statutory objectives and regulatory functions.

**1.20** Prudential and conduct of business regulation require different approaches and cultures, and combining them in the same organisation is difficult. As a result of the combined remit of the FSA, participants in financial services and markets, particularly ordinary consumers of retail products, did not always get the degree of regulatory focus or the protection they may have expected or required.

**1.21** The Government will therefore create a dedicated consumer protection and markets authority (CPMA) with a primary statutory responsibility to promote confidence in financial services and markets. This objective will have two important components. First, the protection of consumers through a strong consumer division within the CPMA. And second, through promoting confidence in the integrity and efficiency of the UK's financial markets.

**1.22** In its consumer-focused role, the CPMA will therefore take on all the FSA's responsibilities for conduct of business regulation and supervision of all firms, as well as arms-length oversight of the Financial Ombudsman Service, the Consumer Financial Education Body, and the Financial Services Compensation Scheme. The creation of a regulator with specific responsibility for consumer protection will ensure that the interests of consumers are not forgotten about or subordinated.

**1.23** At the same time, a markets division within the CPMA will regulate all aspects of the conduct of participants in wholesale markets, as well as various elements of market infrastructure such as investment exchanges. The CPMA markets division will also represent the UK at the new European Securities and Markets Authority.

**1.24** These arrangements will enable the new conduct regulator to develop real focus and specialism in the two areas of its remit, consumer protection and market integrity. This will benefit not only consumers and wholesale markets, but will also enhance financial stability. By identifying potentially significant consumer protection or market integrity issues and bringing them to the attention of the FPC – on which its chief executive will sit – the CPMA will ensure that such risks are not only identified, but dealt with as quickly as possible.

## **Structure and purpose of this document**

**1.25** This document sets out the Government's plans in more detail, as follows:

- Chapter 2 describes changes to the Bank of England and the creation of the Financial Policy Committee as the macro-prudential authority;
- Chapters 3 and 4 set out the roles, responsibilities and governance of the PRA and the CPMA;
- Chapter 5 considers the issue of market regulation;
- Chapter 6 considers the coordination of the regulatory bodies in a potential crisis; and
- Chapter 7 sets out the next steps for the reform programme, including public consultation, legislative passage, and operational implementation by the Bank and FSA.

**1.26** The document presents a range of issues and questions for consultation. Annex A explains how readers can respond to the consultation process. The Government will, on the basis of this consultation and continuing policy development by the Treasury, present more detailed proposals – including draft legislation – for further consultation early in 2011. As indicated in

the Queen's Speech in June, the Government will bring forward legislation to implement its reform programme in the first session of the Parliament, with a view to securing Royal Assent within two years.



# 2

## The Bank of England and Financial Policy Committee

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### The evolving role of the Bank of England

**2.1** The Bank of England (the Bank) was established by Royal Charter in 1694, initially to provide funding to the Government and subsequently to act as the Government's banker. Over the centuries the Bank's functions have evolved, centred on the management of the UK's currency and its role at the heart of the financial system. Nationalised in 1946, by the early nineties the Bank's objectives were framed (in its 'core purposes statement') around maintaining the integrity and value of the currency, maintaining the stability of the financial system (including supervising individual institutions and markets) and ensuring the effectiveness of the UK's financial services.

**2.2** The first explicit inflation-targeting regime for monetary policy was introduced in 1992. The Bank of England Act 1998 transferred operational responsibility for monetary policy to an independent committee of the Bank, the Monetary Policy Committee (MPC), with a clear remit to deliver price stability by meeting the Government's inflation target. At the same time, responsibility for regulating the banking sector was transferred from the Bank to the newly created Financial Services Authority (FSA), the single integrated financial services regulator.

**2.3** Following the financial crisis, the Banking Act 2009 gave the Bank a statutory objective for contributing to the maintenance of financial stability, established a new Financial Stability Committee (FSC) and assigned the Bank lead responsibility in the newly created special resolution regime.

### The role of central banks in financial stability

**2.4** While over time a variety of different systems for regulation of the financial sector have developed in industrialised countries, a common element has tended to be a role for central banks in monitoring overall financial stability. Over the last 20 years, however, with many central banks focussing more narrowly on monetary policy and price stability, this 'systemic' oversight role has lost prominence. This is particularly the case in those countries where central banks are not responsible for the prudential regulation of firms, as has been the case in the UK since the establishment of the FSA in 1998.

**2.5** As noted in the introductory chapter, one important lesson from the financial crisis has been that insufficient attention was paid to the systemic or aggregate risks that built up in the financial sector. Regulation was excessively focused on individual institutions, and recent experience has exposed the limits of this approach – because of the intricate linkages within the financial sector, even institutions that seemed to be in good health came close to collapse.

**2.6** Macro-prudential regulation aims to address this problem by looking at the financial system as a whole, rather than individual institutions in isolation. It focuses on systemic risks and explores how financial markets interact with the wider economy. So, as well as enhancing financial stability, macro-prudential policy should also encourage wider economic stability.

### Box 2.A: What is macro-prudential regulation?

Macro-prudential policy has two main objectives:

- improving the overall resilience of the financial system by addressing aggregate risks and vulnerabilities across the system that have the potential to threaten stability; and
- enhancing macroeconomic stability by addressing cyclical imbalances through the financial system, e.g. by damping the credit cycle.

These objectives are complementary – success in managing systemic risks in the financial sector should contribute to wider economic stability. But whether policymakers can directly and successfully counter wider imbalances, such as rapid credit growth, will depend on the policy tools available. Further work will be necessary to assess the effectiveness of the tools in this regard.

The pro-cyclicality of the financial system is just one element of systemic risk. System-wide vulnerabilities can also arise through joint exposures and interactions that are unrelated to the economic cycle. For example, coordination failures, infrastructure weaknesses and a lack of transparency in markets can exaggerate shocks, increasing the vulnerability of the overall system. The recent crisis provides a clear example of this: the holders of US sub-prime mortgage assets were unknown, so financial institutions withdrew lending, creating severe liquidity problems. Declining confidence triggered sharp falls in asset prices, which further damaged financial-sector balance sheets and created a negative spiral.

In practice, therefore, macro-prudential policy has two broad components.

First, policymakers must try to identify, understand and monitor systemic risk. Domestically, this will be a vital role for the new Financial Policy Committee (FPC), but will also be the subject of work at the international level. In particular, the IMF is working closely with the G20's Financial Stability Board (FSB) and the EU has proposed a European Systemic Risk Board (ESRB), to undertake macro-prudential surveillance in Europe.

Second, when threats to financial stability are identified, policymakers should seek to counter these risks and vulnerabilities using a range of different tools, including regulatory measures to make the system more resilient, (which would also include measures such as facilitating improvement in market infrastructure), regulatory measures to lean against the cycle and also official communications (e.g. warning markets about potential risks).

### 2.7 There is an established international consensus on two points:

- that a macro-prudential or systemic perspective on regulation must be incorporated into financial regulatory systems around the world. The G20 agreed in 2009 'to reshape our regulatory systems so that our authorities are able to identify and take account of macro-prudential risks'<sup>1</sup>;
- that central banks' broad overview of the financial sector and the close link between monetary stability and systemic regulation make them ideally placed to lead on macro-prudential regulation. Jacques de Larosière's high-level group on financial supervision in the European Union commented on the 'urgent need to

<sup>1</sup> *Global plan for recovery and reform: the Communiqué from the London Summit*, Leaders of the group of 20, April 2009.

upgrade macro-prudential supervision' and concluded that 'central banks have a key role to play in a sound macro-prudential system'.<sup>2</sup>

**2.8** Domestically, a major deficiency in the UK's tripartite system has been precisely that no authority had clear, overall responsibility for identifying, monitoring and responding to risks building up and fault lines in the system as a whole. While recent attempts have been made to fill this gap by providing statutory objectives for financial stability to the Bank, and latterly, to the FSA, these changes assigned responsibility without appropriate powers, and entrenched rather than addressed the fundamental problem.

**2.9** The Government will therefore legislate to put the Bank of England in charge of macro-prudential regulation, by creating a strong Financial Policy Committee (FPC) within the Bank, with ultimate authority to identify imbalances, risks and vulnerabilities in the financial system and take decisive action to mitigate these in order to protect the wider economy.

**2.10** This proposal is discussed in more detail below from paragraph 2.19 to 2.63.

## **The role of central banks in prudential regulation**

**2.11** Improving macro-prudential or systemic oversight of the financial system is only part of the solution. The financial turbulence of the last few years has also exposed serious weaknesses in 'conventional' micro-prudential supervision and regulation of the financial sector.

**2.12** In the UK, the FSA identified serious shortcomings in its supervision of Northern Rock prior to that firm's failure in late 2007. In his 2009 review, the chairman of the FSA, Lord Turner, set out the FSA's proposals for addressing these flaws by implementing a more intrusive and proactive approach to its regulation of firms. Since then, the FSA has taken significant steps to improve its performance in this area.

**2.13** However, the recent financial crisis also brought into focus the question of the role of central banks in financial regulation, both in normal market conditions and during times of serious financial stress. The intimate relationship between macro-prudential regulation, micro-prudential regulation and supervision, and the provision of liquidity insurance to banks means that there are clear advantages and synergies in having these functions being carried out within the same organisation – namely the central bank.

**2.14** The Government believes that central bank involvement in financial supervision is desirable on the basis that central banks have a competitive edge due to their first hand exposure to markets and the depth of their staff's experience in the functioning of financial firms and markets. In addition, the information and knowledge that the central bank would acquire as supervisory authority would support it in performing its other functions more effectively, such as fulfilling its role as provider of liquidity insurance, because information would flow more smoothly into its lender of last resort function.

**2.15** The Group of Thirty's review of the structure of financial supervision found that where central banks have a role in protecting the safety and soundness of the banking sector, these central bankers 'believe that a bank's supervisory activities contribute to its financial stability role. They maintain that the link between liquidity management and central bank operations is key to effectively addressing financial crises'.<sup>3</sup>

**2.16** The Government believes a regulatory structure is needed in which both aspects of regulation – monitoring firms on a collective and an individual basis – are brought together. This will be achieved by bringing control of macro-prudential and oversight of micro-prudential

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<sup>2</sup> *Report of the high-level group on financial supervision in the EU*, February 2009.

<sup>3</sup> *The structure of financial supervision: approaches and challenges in a global marketplace*, Group of Thirty, 2008

regulation together under a single authority. The Government believes that the Bank of England – with its macroeconomic expertise, market knowledge, system-wide remit and position as a central bank – is the right authority to take on the new responsibilities of prudential regulation in the post-crisis financial system.

**2.17** The Government will therefore legislate to create a new Prudential Regulation Authority (PRA), which, while operating under the auspices of the Bank of England, with a board chaired by the Governor, and a chief executive who will also occupy the newly created post of Deputy Governor of the Bank for prudential regulation, will nevertheless be a separate legal entity.

**2.18** This will ensure that the day-to-day operations of firm-specific regulation will be undertaken by the new PRA, rather than falling to the Bank itself. In addition, the creation of a new Deputy Governor post will increase the capacity and breadth of the Bank's senior management team. The governance structure, remit and powers of the PRA are set out in more detail in chapter 3.

## The Financial Policy Committee

**2.19** As discussed above, the Government will create a new FPC within the Bank of England, with responsibility for macro-prudential regulation. The committee will monitor and address systemic or aggregate risks and vulnerabilities that could threaten the stability of the sector as a whole and endanger the wider economy.

**2.20** The FPC will be established as a committee of the Court of Directors of the Bank. At the same time, the Government will also legislate to remove the Bank's existing Financial Stability Committee from the statute book.

**2.21** The Bank of England currently has two statutory objectives: for price stability and financial stability. The Bank's existing financial stability objective is framed as: 'an objective of the Bank shall be to contribute to protecting and enhancing the stability of the financial systems of the United Kingdom'.<sup>4</sup>

**2.22** This statutory objective, provided for in the Banking Act 2009, is deliberately general. The practical difficulties in setting a more precise definition of financial stability are well-established – financial stability is a concept that is highly context-specific and subject to change over time. Moreover, the objective was drafted in the context of the tripartite framework, in which the Bank is one of three authorities with responsibility for financial stability, and the Bank's role is therefore framed in terms of its 'contributing to' financial stability.

**2.23** The Government, working closely with the Bank of England, will review the Bank's financial stability objective to determine whether the current wording remains appropriate; for example, the 'contribute to' formulation may need to be changed to reflect the Bank's enhanced roles and responsibilities. The Government also recognises that this objective must be backed up by credible policy tools and levers for the Bank to respond to threats to financial stability.

**2.24** Within the Bank's overall financial stability remit, the objective of the FPC will be to protect financial stability by:

- improving the resilience of the financial system by identifying and addressing aggregate risks and vulnerabilities across the system; and
- enhancing macroeconomic stability by addressing imbalances through the financial system, e.g. by damping the credit cycle.

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<sup>4</sup> Section 2A(1) Bank of England Act 1998 (as inserted by Section 238 Banking Act 2009)



**2.25** The Government believes that abolishing the tripartite system, and placing a single authority, the Bank, at the centre of the framework for preserving financial stability is the single most important reform needed to the UK financial regulatory system. The Government also recognises that concentrating authority in the Bank in this way, and providing it with new policy tools in macro-prudential regulation, will create a powerful body with significantly increased influence over the UK's financial system and economy.

**2.26** Decisions taken by the FPC, in particular, could have far-reaching consequences for the financial sector and the economy more widely. For example, the use of certain macro-prudential tools is likely to affect the levels of lending to businesses and families and the competitiveness and profitability of UK banks in relation to foreign competitors. It will be important for the FPC to take factors such as these into consideration when pursuing its primary objective. The FPC will also need to take into account the objectives of other regulatory authorities, to ensure a coherent overall regulatory impact.

**2.27** Therefore, in order to ensure that the FPC has absolute clarity around the factors it must take into account in pursuing its objective, **the Government will consider whether, in addition to its primary objective, the FPC should be mindful of any other secondary factors when determining a particular course of action.**

**2.28** Such factors might include, for example, the economic or fiscal impact of the FPC's macro-prudential decisions. Furthermore, given that the 'transmission mechanism' by which the FPC will implement macro-prudential policy will be regulatory action by the PRA (or, where relevant, the consumer protection and markets authority, or CPMA) there is also a case to be made that the FPC should, where appropriate, be required to have regard to the statutory objectives of these regulatory authorities in order to ensure consistency.

**2.29** The Government recognises the importance of balancing carefully the simplicity of a single primary statutory objective against the need for clarity and transparency around the factors that a public body should take into account in considering how to pursue its objective. It would be counter-productive to create a framework in which the FPC could not take effective action to meet its primary objective because of excessive constraints imposed by secondary considerations. On the other hand, given the vitally important role performed by the FPC, and the impact its decisions could have on matters of wider public interest than financial stability, there would also be merit in providing a clear and transparent exposition of the factors it would be legally obliged to consider.

#### **Box 2.B: Consultation questions**

- 1 Should the FPC have a single, clear, unconstrained objective relating to financial stability and its macro-prudential role, or should its objective be supplemented with secondary factors?
- 2 If you support the idea of secondary factors, what types of factors should be applied to the FPC?
- 3 How should these factors be formulated in legislation – for example, as a list of 'have regards' as is currently the case in the Financial Services and Markets Act 2000 (FSMA), or as a set of secondary statutory objectives which the FPC must balance?

## Functions

**2.30** The FPC's main function will be to undertake macro-prudential regulation. In practice, this will comprise three broad areas: monitoring the system to identify risks to financial stability, taking action as necessary to address the vulnerabilities and imbalances identified (or recommending action to the appropriate authority) and communicating to Parliament and the wider public the FPC's analysis and information on the action it has taken.

## Monitoring

**2.31** The FPC's 'monitoring' role will include the following key functions:

- monitoring the financial stability of the UK's financial system, identifying emerging risks and vulnerabilities, and cyclical imbalances;
- monitoring and assessing the activities of the PRA and the CPMA, in order to identify any financial stability implications that may derive from these authorities' actions;
- monitoring the regulatory perimeter, both to ensure that the split in responsibilities between the PRA and the CPMA remains appropriate and to ensure that activities being undertaken on or outside the boundary of prudential regulation with potentially systemic consequences are understood;
- showing a close interest in the other aspects of the Bank's work that are relevant to financial stability, such as infrastructure regulation, resolution arrangements for failing firms and the provision of liquidity insurance to the financial sector; and
- assessing the effectiveness of the FPC's macro-prudential tools and considering any potential additions or adjustments to the toolkit.

## Taking action

**2.32** The FPC will be empowered to take action in response to the risks and vulnerabilities it identifies in the following ways:

- deciding whether macro-prudential tools should be used to address specific vulnerabilities and imbalances (potential tools are discussed in detail below);
- giving directions to the PRA (and, if relevant, the CPMA) on the regulatory tools that should be deployed in pursuit of macro-prudential policy, and how they should be formulated or calculated;
- making recommendations to the PRA and the CPMA where the FPC believes that specific regulatory actions (including, potentially, amendments to rules) are required in order to protect financial stability;
- making recommendations to Court in relation to a specific course of action in another area of the Bank's activities that the FPC believes necessary in order to protect financial stability. By way of example, if the FPC perceives that there is a general lack of liquidity in the financial sector that would best be addressed through the Bank's liquidity insurance operations, it could make representations to Court that the Bank should use its liquidity insurance functions to provide the necessary liquidity;
- making recommendations to the Treasury on any changes the FPC believes necessary to the regulatory perimeter; and

- making recommendations to the Treasury on any necessary changes to the FPC’s macro-prudential toolkit.

## Reporting on action

**2.33** As well as being accountable within the Bank to the Court of Directors, the FPC will be externally accountable to the Government, Parliament, and the public. As explained in further detail in paragraphs 2.52 to 2.63 below, transparency will be an important aspect of this accountability, ensuring that the FPC fulfils its role effectively. Measures to provide transparency will include:

- publishing regular six-monthly financial stability reports that will include the FPC’s assessment of the outlook for the financial sector and a summary of the systemic risks, vulnerabilities and potential imbalances it has identified; and
- publishing, after each meeting, a record of the FPC’s deliberations, setting out the decisions it has taken and an explanation of the balance of arguments that led to those decisions.

## Macro-prudential tools

**2.34** In order to enable the FPC to fulfil its macro-prudential remit, the Government intends to provide the FPC with the control of specific macro-prudential tools.

**2.35** A number of potential macro-prudential tools are being considered and developed, primarily by the Basel Committee on Banking Supervision (BCBS) in the international arena and at the European level via proposed changes to the Capital Requirements Directive (CRD). Other bodies, such as Committee on the Global Financial System (CGFS) in the Bank of International Settlements (BIS) are also looking at these issues. Box 2.C describes some potential macro-prudential tools, some of which are currently under consideration by the bodies mentioned above. The Government and the other authorities, as appropriate, will continue to engage in ongoing international and European work to develop effective macro-prudential tools.

### Box 2.C: Potential macro-prudential tools

The Treasury, the Bank of England and the FSA have been considering and assessing potential macro-prudential additions to the UK’s economic policy framework since the onset of the financial crisis.

As set out in box 2.A, macro-prudential policy interventions can be broadly grouped into two categories – those that attempt to address fundamental vulnerabilities in the system (such as insufficient transparency and structural weaknesses) and those that attempt to increase the resilience of the financial system to cyclical developments (including potentially damping the cycle). The list below identifies possible levers that might be used for the second of these purposes:

- (i) **Countercyclical capital requirements:** These would add a ‘buffer’ to capital requirements based on the current cyclical position of the economy. For example, when private sector credit is growing rapidly, banks might be forced to hold additional levels of capital. This should increase the resilience of the banking sector by giving it more capital to absorb losses in any subsequent downturn, and may also damp the cycle by reducing lending in the upswing.

- (ii) **Variable risk weights:** This would involve raising capital requirements against specific types of lending. If the authorities felt financial institutions' exposure to a certain asset class was too great, they could try to discourage it in this way.
- (iii) **Leverage limits:** This would impose an overall limit on the amount of leverage financial institutions can hold. It would act as a 'backstop' to capital requirements, which are typically risk-weighted.
- (iv) **Forward-looking loss provisioning:** Banks would be forced to set aside provisions against prospective future losses on their lending. There are various ways this could be used as a macro-prudential tool, with Spain's 'dynamic provisioning' system offering a useful practical example. This system links loss provisions to the credit cycle, so banks are forced to hold higher provisions when credit is growing strongly. Any such approach should respect the integrity of international accounting standards.
- (v) **Collateral requirements:** These would limit specific types of lending by imposing higher collateral restrictions during times of unsustainable growth in that lending. Possible examples include loan-to-value limits on secured lending, margin requirements on stocks/purchases or the imposition of haircuts on repurchase transactions for investment banks.
- (vi) **Quantitative credit controls and reserve requirements:** These would limit lending by imposing limits on lenders and/or increasing financial institutions' short-term liquidity requirements. Such a system was used in the UK until the early 1980s, but is likely to lead to distortions if applied over an extended period.

Clearly some of these levers will be more suitable for practical application as macro-prudential tools than others. As mentioned previously, specific policy proposals for macro-prudential tools are being discussed at the international level, notably at the BCBS and in the EU as proposed changes to the CRD.

Given the global nature of financial markets, the Government believes these policy tools are likely to prove more effective if adopted at the international level and will continue to work with international counterparts to deliver such a system.

**2.36** The Government will legislate to provide the Treasury with a power to set out in secondary legislation the precise macro-prudential tools available to the FPC. These macro-prudential tools will be relatively untested, and there will inevitably need to be an initial learning process to adapt and fine-tune them. Setting out the tools in secondary legislation will allow the Treasury, in consultation with the FPC, to easily adapt the tools to any lessons learnt in this initial period, as well as periodically assess the suitability of the macro-prudential toolkit, and to incorporate any international developments in macro-prudential regulation.

**2.37** The majority of the macro-prudential tools that are being considered involve the use of classic micro-prudential levers (such as capital requirements and leverage limits) for a macro-prudential purpose. Therefore the legislation will stipulate that the PRA will be required to implement the FPC's decisions on the use of its macro-prudential tools by applying them across all relevant firms. If any of the macro-prudential tools set out by the Treasury are related to conduct regulation, the CPMA will be required to implement these in a similar way.

**2.38** In order to inform the creation of the permanent FPC's toolkit, one of the key responsibilities of the interim FPC will be to evaluate and consider possible macro-prudential tools. The role of the interim FPC during the transition is discussed in more detail in chapter 7.

## Membership

**2.39** The FPC will have a total membership of 11, comprising six executives of the Bank of England and five members from outside the Bank. In addition, the FPC will include a Treasury representative.

**2.40** The FPC will be chaired by the Governor and will include the existing Deputy Governors for monetary policy and financial stability and the newly created Deputy Governor for prudential regulation. There will also be two Bank executives (responsible for financial stability and markets) on the FPC.

**2.41** The chief executive of the CPMA will sit on the FPC. This will ensure that any systemic risks arising from the activities regulated by the CPMA are correctly captured and identified and that any impact of the FPC's decisions on those activities is adequately taken into account.

**2.42** The FPC (like the MPC) will have strong, credible external representation. The presence of external voices on the FPC will be important both in terms of ensuring the credibility of the system and providing a wider range of experience and knowledge and divergent points of view to the committee's discussions. In particular, it will provide scope for the FPC to challenge the prevailing consensus – a vital role for a successful macro-prudential policy.

**2.43** It will be important to ensure that the external members of the FPC are able to provide sufficient levels of expertise and challenge to the Committee's deliberations – this will not only include experience of banking, but also other financial sectors such as insurance and investment banking and, of course, macroeconomic expertise.

**2.44** In addition to the chief executive of the CPMA, the Chancellor will appoint four external members of the FPC using a similar recruitment process to that used for the MPC. The Government will look carefully at the best way to ensure that external members demonstrate ample relevant knowledge and experience and the ability to work constructively in a committee environment, without conflicts of interest that would prevent them participating fully in the work of the Committee.

**2.45** The Treasury will have a non-voting representative on the FPC, in order to feed in the Government's assessment of the macroeconomic climate, to ensure that the Government's economic priorities are taken into account, to identify any potential fiscal impact of the FPC's actions and in recognition of the Government's overall responsibilities, both domestically and in the international arena.

## Interaction with monetary policy

**2.46** One significant challenge for the Bank will be to manage the interaction between their two statutory responsibilities – monetary policy and financial stability. The instruments by which each objective is pursued could interact significantly, and the decisions of one Committee may have an effect on the deliberations and decisions of the other. Box 2.D considers this interaction in more detail.

**2.47** The Government proposes the following mechanisms to manage this interactions:

- **Executive cross-membership of the FPC and MPC.** The Governor and Deputy Governors for financial stability and monetary policy will sit on both the FPC and the MPC, and will provide a degree of coordination and information sharing between the two Committees. The Government does not believe it appropriate for

the Deputy Governor directly responsible for prudential regulation to be able to directly influence monetary policy decisions, therefore the chief executive of the PRA will not sit on the MPC; and

- **Sequencing of meetings.** Meetings of the MPC and the FPC will be carefully sequenced in order to ensure that both committees are able to fully take into account the most recent decisions of the other.

#### **Box 2.D: The relationship between monetary policy and macro-prudential regulation**

The objectives of price stability and financial stability should generally be consistent and complementary. A stable financial system makes the effects of monetary policy more predictable and supports the orderly operation of monetary policy. Price stability should, in turn, generally support financial stability.

The possibility that monetary policy and macro-prudential policy could move in opposite directions does not necessarily represent potential conflict between the actions of the two committees. Instead, it demonstrates the way macro-prudential policy can help protect financial and economic stability. For example, in the build up to the financial crisis, while low inflation suggested that interest rates should be kept low, a macro-prudential policy body, like the FPC, could have taken action to slow growth in banks' balance sheets and restrain borrowing (possibly through one or more of the tools outlined in box 2.C). This highlights that the purpose and benefit of macro-prudential policy is that it can take action to, for example, enhance the resilience of the financial sector, while the MPC retains its focus on its price stability objective.

Still, the use of macro-prudential tools will interact with the conduct of monetary policy. The extent of this interaction is likely to depend on the macro-prudential tool(s) at the FPC's disposal. For example, broad banking sector-wide controls like counter-cyclical buffers, dynamic provisioning and credit controls might operate through similar channels to monetary policy. Other tools under consideration such as collateral requirements are more likely to work through a different set of channels. In addition, some of the ways monetary policy affects the economy, such as through exchange rates, are less likely to be affected by macro-prudential regulation.

The MPC should be able to calibrate its monetary policy settings appropriately in response to macro-prudential regulation in a similar manner to the interaction between fiscal policy and monetary policy, allowing monetary policy to retain its primacy as the marginal instrument for macroeconomic policy. But further analysis on the possible interactions between macro-prudential regulation and monetary policy will be needed as part of the wider discussions about the macro-prudential tool(s) assigned to the FPC.

The Government wishes to make clear that the independent MPC of the Bank of England will continue to target 2 per cent inflation, as measured by the 12-month increase in the Consumer Prices Index (CPI), within its current legislative framework.

### **Links with the PRA and CPMA**

**2.48** In order to enable the FPC to fulfil its role in identifying and assessing risks to financial stability across the financial system, there will need to be close cooperation between the FPC and the two regulators – the PRA and the CPMA – to ensure that the FPC is kept fully informed of any developments in the spheres of influence of the PRA and the CPMA that may have an impact on financial stability.

**2.49** As the chief executives of the PRA and the CPMA are both FPC members, this interchange will primarily take place within the FPC meetings themselves. Prior to each FPC meeting, the PRA will provide information to brief FPC members on the most significant system-wide and firm-specific risks being tackled by the PRA at the time. In a similar way, the CPMA will provide the FPC with information on the most significant prevailing retail and market conduct risks.

**2.50** As discussed in chapters 3 and 4, the PRA and CPMA will also be under a statutory obligation to consult the FPC on any rules they intend to make which they feel would have material implications for financial stability.

**2.51** The PRA (and CPMA where the FPC requires conduct-related information) will also be responsible for collecting the supervisory information which the FPC considers necessary for its role in monitoring systemic risk, subject to the legal constraints governing its general information-gathering powers. **The Government will legislate to create the necessary mechanisms and information gateways needed for these flows of information between the PRA and CPMA and the FPC.**

## **Transparency and accountability**

**2.52** The transparency and accountability mechanisms for the MPC are considered a critical part of its success and credibility. The Government intends to recreate, as far as possible, these mechanisms for the FPC.

**2.53** **The Government intends to legislate to establish that the FPC will publish a regular six-monthly Financial Stability Report (FSR).** These reports will include the FPC's assessment of the outlook for the financial sector and a summary and description of the systemic risks and vulnerabilities it has identified, including an assessment of their severity. If the FPC has decided to take specific action in reaction to these threats, it will set out what this action consists of, and its rationale for the decision.

**2.54** **The Government proposes that the legislation set out that the FPC will meet at least four times a year. The legislation will also establish that the FPC will publish a record of each meeting, within the period of 6 weeks, setting out the decisions it has taken and an explanation of the balance of arguments behind those decisions.** These meeting records will also describe the FPC's discussions in broad terms.

**2.55** The Government recognises that there are concerns around releasing commercially confidential details or information that may have a destabilising effect for individual firms or the market more widely. The Government will consider the best way to achieve the maximum level of transparency for the FPC without risking premature publication of destabilising or market-sensitive material.

## **Relationship to Court**

**2.56** The Government believes it is important to retain and strengthen the role of the Bank's Court of Directors in overseeing, evaluating and managing the Bank's activities in pursuit of its objectives. This is especially important in those areas in which the Bank's responsibilities and powers are being greatly increased.

**2.57** Establishing the FPC as a Committee of Court will draw a clear line of accountability to the Bank's governing body – the Court of Directors. Court will have responsibility for keeping the procedures followed by the FPC under review, and for ensuring high-quality and comprehensive support to the FPC – in the same way as it does for the MPC.

## Parliamentary accountability

**2.58** As noted above, the Government will legislate to require the FPC to produce six-monthly Financial Stability Reports. Once the FPC has completed and agreed its reports, it will submit them to the Treasury, which will, in turn, lay copies before Parliament. This will provide important lines of accountability from the FPC to Parliament, via the Treasury, and enable Parliament to examine and scrutinise the FPC's work. The Government will also legislate to require the Bank's annual report, which the Treasury lays before Parliament, to cover the work of the FPC.

**2.59** Since the creation of the MPC, the Treasury Select Committee (TSC) has played a vital role in scrutinising that Committee's decisions and deliberations, as well as the appointment of external members of the MPC. The Government looks forward to the TSC playing a similar scrutiny and challenge function for the FPC.

**2.60** The precise form of the TSC's scrutiny of the FPC is, of course, a matter for Parliament. However, the Government expects that this scrutiny could include the TSC holding hearings after the publication of the FPC's reports and hearing evidence from executive and external members and other relevant witnesses.

## Accountability to the Treasury

**2.61** As well as internal accountability (through Court) and external accountability to Parliament, given its important role in economic policy, the Government believes that the FPC must also have a direct line of accountability to the Treasury.

**2.62** Therefore, the Governor, in his capacity of chair of the FPC, will brief the Chancellor on a six-monthly basis, after the publication of each FSR. These briefings will serve to update the Chancellor on the prevailing and emerging risks to financial stability and the action proposed by the FPC to address them. The Governor will also use these meetings to inform the Chancellor of any other financial stability issues in the Bank's wider remit – including the PRA. The meetings will provide an opportunity for the Chancellor to comment on the risks to financial stability, and action being taken to address them. A high-level record of these conversations will be published.

**2.63** During a crisis, different arrangements will be needed to ensure effective coordination of the Treasury and the Bank. These arrangements are set out in detail in chapter 6.

## Implications for the Bank of England

**2.64** These changes to give the Bank control of macro-prudential regulation and oversight of micro-prudential regulation will mean a much greater and more operational role for the Bank in the financial system. This will have significant implications for the Bank in terms of its staff, resources, governance and transparency.

## Governance and transparency

**2.65** It is clear that the transparency and accountability of the Bank will be vital in its new role, not least in order to enable regulated firms, Parliament and the wider public to understand and scrutinise the Bank's decisions and hold it to account where appropriate.

**2.66** A recent IMF paper concluded that: 'if a central bank is given a stronger role in financial stability, including a stronger influence on the financial regulation of individual institutions, as well as a more clearly defined role in their resolution, these powers need to be complemented by robust mechanisms that ensure transparency and a high degree of accountability of the



central bank's actions in safeguarding financial stability'.<sup>5</sup> The Government endorses this conclusion.

**2.67** The proposed accountability mechanisms for the new FPC, including its publications and accountability to Parliament are set out in paragraphs 2.52 to 2.63 above. The governance and accountability of the PRA are discussed in chapter 3.

### **Funding**

**2.68** As discussed in more detail in chapters 3 and 4, the activities that are currently undertaken by the FSA will continue to be funded by the industry, via a statutory levy. The Bank's current responsibilities for monetary policy and financial stability are also industry-funded through the statutory Cash Ratio Deposit scheme. The Government's objective is to maintain the principle of fully funding these activities – including any new responsibilities – from industry contributions. The Government will work with the Bank to determine whether and, if so, how to adjust the current arrangements in order to implement this in a fair and transparent way, consulting more widely as appropriate.

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<sup>5</sup> *Financial Stability Frameworks and the Role of Central Banks: Lessons from the crisis*, Erlend W. Nier, April 2009



# 3

## Prudential Regulation Authority

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**3.1** As discussed in the introductory chapter, in the period before the financial crisis, financial supervision in the UK relied too much on ‘tick-box’ compliance with rules and directives at the expense of proper in-depth and strategic risk analysis. This meant that while supervisors ensured that firms complied with these detailed rules, the authorities did not pay enough attention to the build up of systemic risks both in individual firms and across the system as a whole. The Financial Services Authority (FSA) has taken significant steps since the crisis to improve the rigour and credibility of its supervisory activities (including the measures set out in the Turner Review<sup>6</sup>). However, the Government believes that more fundamental change is needed.

**3.2** The previous chapter discussed the importance of introducing a macro-prudential perspective into the regulatory system. While this will go a long way towards strengthening the UK system, it is also vital that macro-prudential regulation of the system be integrated with traditional, firm-specific prudential regulation of risk. Therefore, the Government will bring micro-prudential regulation under the auspices of the Bank of England (the Bank) through a newly created Prudential Regulation Authority (PRA), which will be established as a legally distinct subsidiary of the Bank.

**3.3** This will strengthen the UK’s financial system, and its resilience to financial crises, by putting in place a new body with the focus, expertise and mandate to ensure effective prudential supervision and regulation of individual firms. **To build upon this structural improvement, and to ensure that the failings of the past are fully addressed, the Government will ensure that the processes and legal framework of the new PRA will support and facilitate a new, more judgement-led style of prudential regulation.** In future supervisors should focus more on understanding institutions’ business models and strategies, with greater discretion to investigate and tackle risks and vulnerabilities within individual firms. By giving the PRA a clear focus on prudential regulation (rather than both prudential and conduct regulation, as was the case in the FSA), its supervisors will have the opportunity to develop greater expertise in this area.

**3.4** This chapter discusses the key features of the new PRA in turn. In describing the establishment and operation of the PRA, the discussion also inevitably touches upon the new conduct regulator, the consumer protection and markets authority (CPMA), with which it will have a close operational relationship.

### The role and functions of the PRA

#### Objectives

**3.5** The PRA will have a primary objective **to promote the stable and prudent operation of the financial system through the effective regulation of financial firms**, in a way which minimises the disruption caused by any firms which do fail. This objective will support the PRA in taking a credible and appropriately intrusive approach to regulation and supervision.

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<sup>6</sup> *The Turner Review: a regulatory response to the global banking crisis*, Financial Services Authority, March 2009

**3.6** The PRA will also be provided with a statutory range of factors to which it must have regard in the carrying out of functions in pursuit of its primary objective. In the event that these objectives conflict, however, the PRA will be required to defer to its primary objective.

**3.7** The Government is consulting on the scope and extent of these secondary factors for the PRA. The Government considers that such factors potentially fall into three categories:

- first, the objectives of other regulatory authorities, to which the PRA must have regard in carrying out its own functions in order to support effective coordination;
- second, principles of good regulation to which the PRA must have regard to ensure that the regulatory burden placed on firms is appropriate; and
- third, other considerations to which the PRA should have regard in order to ensure that its pursuit of its primary objective is also balanced against, or pursued in accordance with, important matters which relate to the public interest.

**3.8** With respect to the first type of ‘have regards’, a strong case can be made that the PRA should have regard to the primary objectives of both the FPC and CPMA. Balancing the PRA’s primary objective with considerations of the stability of the system as a whole on the one hand, and of the need to promote confidence in financial services and markets on the other would facilitate close cooperation and coordination between the three organisations. As discussed below, this would need to be supplemented with mechanisms for operational coordination and, where appropriate, formal consultation.

**3.9** Second, the PRA will, as is the case with any public body or regulator, be required to act proportionately and in accordance with regulatory good practice. The Government recognises that not all of the principles of good regulation which currently apply to the FSA under section 2 of the Financial Services and Markets Act 2000 (FSMA) should necessarily apply to the PRA. In particular, the Government considers that the case for making global competitiveness and innovation in financial services part of the responsibility of a regulator charged with ensuring the safety and soundness of risk-taking financial firms needs to be reconsidered. There is a strong argument that one of the reasons for regulatory failure leading up to the crisis was excessive concern for competitiveness leading to a generalised acceptance of a ‘light-touch’ orthodoxy, and that lack of sufficient consideration or understanding of the impact of complex new financial transactions and products was facilitated by the view that financial innovation should be supported at all costs.

**3.10** However, there are other principles from section 2 which relate purely to regulatory good practice, and the Government is seeking views on whether these should also apply to the PRA. These include requirements on the regulator to have regard to:

- the importance of using its resources in the most efficient and economic way;
- the responsibilities of those who manage the affairs of authorised persons; and
- the principle that a burden which is imposed on a person should be proportionate to the benefits which are expected to result.

**3.11** Finally, given the role of the PRA as both micro-prudential regulator and the key implementer of macro-prudential policy, the PRA may also need to have regard to wider factors, such as the potential wider economic impact of its policies or regulatory decisions, and effects on consumer and business lending.

### Box 3.A: Consultation questions

- 4 The Government welcomes respondents' views on:
- whether the PRA should have regard to the primary objectives of the CPMA and FPC;
  - whether some or all of the principles for good regulation currently set out in section 2 of FSMA, particularly those relating to good regulatory practice, should be retained for the PRA;
  - whether, specifically, the requirement to have regard to potential adverse impacts on innovation or the competitiveness of the UK financial services sector of regulatory action should be retained; and
  - whether there are any additional broader public interest considerations to which the PRA should have regard.

## Scope

**3.12** The Government will legislate to provide that the PRA will be responsible for the authorisation, regulation and day-to-day supervision of all firms who are subject to significant prudential regulation. The Government expects all of the following categories of firms to be regulated by the PRA:

- banks and other deposit-takers (including building societies and credit unions);
- broker-dealers (or investment banks); and
- insurers (including friendly societies).

**3.13** The Government recognises that the scope of regulated activities may change over time – for example, as a result of international discussions on financial reform (which, for example, may soon bring credit rating agencies within the regulatory perimeter), or through innovation in the financial sector (for example, the rise of 'shadow banking').

**3.14** Whilst the Treasury will remain responsible for specifying the scope of regulation, the FPC will be responsible for monitoring the perimeter of regulation, and making recommendations to the Treasury about which new firms and activities should be brought into the PRA's scope in the future.

**3.15** The Government will specify in secondary legislation precisely which regulated activities will be regulated by each new authority. For the PRA, these will include taking deposits, effecting and carrying out contracts of insurance, and dealing in investments as principal.

**3.16** The PRA and CPMA will each be responsible for granting or amending permissions to undertake the regulated activities (and associated systems, controls and processes) falling within their remit. In a similar way, each will be responsible for approving persons to undertake significant influence functions in authorised firms. The two authorities will need to work closely in making their respective decisions.

### Box 3.B: Coordination between the authorities

The basic principle regarding the scope of responsibilities of the PRA and CPMA is that each regulatory authority will be responsible for taking decisions – for example, on rule-making, authorisation, approval of individuals performing controlled functions, supervision and enforcement – in relation to the activities that it regulates.

While this principle is very clear, putting it into practice will require a significant degree of cooperation and coordination by the authorities to ensure that they avoid duplicating efforts, or cutting across each other's work. The need for such coordination will be particularly acute where action taken by one authority directly or indirectly interacts with the objectives of the other.

This issue of coordination will be managed through a number of formal processes, for which the Government will legislate:

- by putting in statute **the requirement that each authority will have regard to the objectives of the other**, the legal framework will ensure that the authorities will have each other's interests in mind when making regulatory or supervisory decisions or considering new policy;
- cross-membership of boards will form the basis of ongoing information exchange between the bodies and will ensure that each authority is well briefed on the current key issues facing the other, as well as significant pieces of work or forthcoming rule-making initiatives. **The CEO of the PRA will sit ex-officio on the CPMA board, and vice versa;**
- **statutory Memoranda of Understanding (MOUs), which the PRA and CPMA will be obliged to draw up**, will set out in detail the mechanics of day to day cooperation and working together, as well as coordination on more strategic long-term thinking;
- where necessary, this cooperation and coordination will be operationalised in the MOU through **formal college-style mechanisms to support close joint working on the supervision of firms** where both the CPMA and PRA have a supervisory interest. Where groups containing entities prudentially supervised both by CPMA and PRA, it will be important for the PRA to have confidence that activities elsewhere in the group do not impact on the safety and soundness of the entities it supervises;
- these measures will be facilitated and complemented by **legal provision for information gateways between the PRA and CPMA** to allow the flow of supervisory information where necessary.
- the PRA and CPMA will, as a matter of course, consult each other on rules which they think may be relevant to the activities of the other. **Both authorities, furthermore, will be statutorily required to consult the FPC, in advance of any other consultative processes (such as with panels or the public), where either believes there is a risk that the rule it proposes could have material adverse financial stability consequences; and**
- **similarly, the CPMA will be required to consult the PRA in advance of taking any decision that could cause a firm-specific financial stability risk, and to take the PRA's advice in such matters.** The PRA's decision will be final, reflecting the important role of prudential judgement in the delivery of regulation.

### Box 3.C: Consultation questions

- 5 Is the model proposed in paragraph 3.16 – with each authority responsible for all decisions within their remit subject to financial stability considerations – appropriate, or would an integrated model (for example, giving one authority responsibility for authorisation and removal of permissions) be preferable?

## Powers and functions of the PRA

**3.17** The Government's goal is that the legal framework for the PRA should underpin a more informed and judgemental approach to regulation. **To this end, Government will examine the adequacy of FSMA as a template for the legal framework governing the operation of the PRA.** The Government will consider whether any modifications or alternatives to FSMA are required to accomplish the objective of judgement-led prudential regulation, bearing in mind the importance of adhering to the two-year legislative timetable to which the Government is committed. In doing so, it will work with the Bank and FSA, and is also seeking the views of respondents on this point.

**3.18** **Assuming that FSMA is to be the model for the PRA's legal framework, the Government will legislate to divide the powers and functions set out in FSMA into separate standalone prudential and conduct regulation frameworks.** To prepare this legislation, the Treasury will systematically work through FSMA – drawing on the expertise of the Bank of England and the FSA – to establish which of the current powers and functions provided for within FSMA each of the new authorities will require in their specific areas of responsibility, and any necessary modifications. In some cases, it may be appropriate for powers and function to be transferred exclusively to either the PRA or the CPMA; in other cases, there may need to be overlapping powers and functions. As discussed above, where there is such overlap, arrangements will be put in place to ensure that the authorities coordinate action appropriately to minimise the burden for firms.

**3.19** **The Government will consult on draft legislation to provide the necessary powers and functions to the PRA and CPMA.** This consultation will take place in early 2011, well in advance of the introduction of legislation to Parliament (more detail on the implementation timetable is set out in Chapter 7).

**3.20** The key functions of the PRA, supported by the necessary legal powers, will include:

- exercising judgements about the safety and soundness of financial firms, and taking appropriate action;
- the core regulatory function of making the rules which govern the performance of regulated activities by financial firms;
- the authorisation of firms via the provision of permissions to firms to engage in regulated activities;
- supervision, and where necessary, enforcement of compliance with rules;
- the approval of individuals to perform certain controlled functions within financial firms; and
- the raising of levies to fund the activities of the PRA.

## Rule making

**3.21** The PRA will be responsible for making prudential rules for the firms it regulates, covering all issues affecting the safety and soundness of individual firms (including, for example, remuneration). Rule-making will be a function of the PRA board which cannot be delegated to a sub-committee or members of the executive.

**3.22** The Government is considering whether the rule-making function should continue to be subject to statutory processes, including consultation with a practitioner panel, wider public consultation and the duty to carry out detailed cost-benefit analysis prior to the introduction of any new rules. These processes, which are a key part of the FSMA framework, reflect the fact that the power to make rules in this way is a quasi-legislative power that would normally be subject to Parliamentary oversight.

**3.23** If the Government considers that such processes are required, the Government will work with the FSA and the Bank to determine whether the current FSMA mechanisms around the rule-making process need to be simplified or streamlined to support the PRA's new approach to regulation.

### Box 3.D: Consultation questions

- 6 Is the approach outlined in paragraph 3.17 to 3.23 for transfer of regulatory functions and rule making sufficient to enable the PRA to take a more risk-based, judgement-focussed approach to supervision?
- 7 Are safeguards on the PRA's rule-making function required?
- 8 If safeguards are required, how should the current FSMA safeguards be streamlined?

**3.24** The Government generally expects that, as part of its new judgement-based approach, the PRA will seek to reduce and simplify the rules and guidance contained in what is currently the FSA handbook, consistent with the need for compliance with European law and the need for transparent regulation and legal certainty.

## Supervision and enforcement

**3.25** Supervision and enforcement are fundamentally important to the credibility of any regulatory regime. While it is clearly vital that the rules of doing business in a regulated industry are framed in such a way to ensure the appropriate regulatory outcomes, without effective supervision and enforcement, the rules will ultimately lack credibility. Indeed, it is only through the exercise of supervision that regulators are able to gather the information needed to make regulatory judgements, and appropriate powers of enforcement are also needed for them to be able to make firms act on these judgements. For this reason, the Government will ensure that each authority has its own credible and effective supervisory and enforcement powers.

**3.26** The PRA will conduct supervision and where necessary, enforcement, of all its policies and rules. As already noted in general terms, the PRA and CPMA will work together to coordinate supervisory action in relation to firms where both authorities have a supervisory interest. It may also be necessary, in some circumstances, for enforcement action to be coordinated. Coordination will be managed through supervisory colleges where appropriate, and supported by information gateways allowing the flow of supervisory information between authorities.



## Administrative functions

**3.27** The Court of the Bank of England will be responsible for the use of resources in the PRA, including its budget and remuneration, to ensure value for money. To achieve that end, support services will in general be based on an integrated model across the Bank of England and the PRA. In the case of information technology systems, there will be a review of the applications required by the new regulatory system in its entirety.

## Governance

**3.28** The governance arrangements of the new PRA will be designed to reflect its position as an integral part of the Bank of England group, while also recognising the broader accountabilities of a body exercising quasi-legislative functions in the public interest.

## Board and management structures

**3.29** The PRA will be established as a subsidiary of the Bank, so that it will benefit from the Bank's judgement-driven culture. Whilst the PRA will be responsible for implementing the macro-prudential tools specified by the FPC, as described in the previous chapter, in all other respects it will have operational independence for the day-to-day regulation and supervision of firms. In particular, neither the Bank nor the FPC will have any formal power of direction over the PRA in relation to firm-specific decisions or other operational matters.

**3.30** The Bank will exercise its responsibility for the PRA through its accountability to the Court of the Bank on administrative matters, and through Bank executives holding the offices of PRA chairman and chief executive.

**3.31** The Government also recognises the vital importance of re-establishing a link between the central banking and financial stability functions of the Bank on the one hand, and regulation of financial services and markets on the other. It is this consideration which underpins the Government's decision to re-establish the Bank as the body with ultimate responsibility for regulation of the financial system through the creation of the FPC and PRA to control macro-prudential and micro-prudential regulation respectively.

**3.32** Therefore, the Government will legislate to establish the PRA as a subsidiary of the Bank of England, with its own legal personality and its own board, chaired by the Governor of the Bank of England. Overall, the board will have a majority of non-executive members, who will be appointed by the Treasury and will need to be free of any conflicts of interest.

**3.33** The Deputy Governor for prudential regulation will be chief executive of the PRA. The Deputy Governor for financial stability and the chief executive of the CPMA will both be ex officio members of the PRA board. To ensure effective working between the PRA and CPMA, the chief executive of the PRA will sit on the CPMA's board, and vice versa.

**3.34** By integrating the PRA's most senior management with that of the Bank, the Government intends that the supervision of UK financial firms will benefit from the expertise, experience and credibility of the central bank. This strong link with the Bank, balanced by an independent board with a non-executive majority, will ensure effective oversight of supervision for the Bank, whilst preserving a constructive and independent challenge to rule-making.

**3.35** In the field of prudential regulation and supervision, regulatory decisions are often at least as important as those involving rules. The Government recognises, however, that it will be potentially difficult for a board with a non-executive majority to take decisions on significant regulatory or supervisory action relating to individual firms. **The Government will legislate to ensure that such decisions are taken by the executive of the PRA, or by a committee in which the executive members of the Board – including its chairman (the Governor), chief executive (Deputy**

Governor for prudential regulation) and the Deputy Governor for financial stability – are in a majority. The Government expects the PRA’s non-executive board members to participate in this executive committee where appropriate, to provide them with practical experience of the way in which rules are supervised and enforced, and regulatory judgements reached. The PRA board may also choose to establish a non-executive advisory group, along the lines of the former Board of Banking Supervisors.

**3.36** Finally, as the PRA will be a subsidiary of the Bank of England, there will be an important role for the Bank’s Court of Directors to play in overseeing the administration of the PRA. The Government will therefore legislate to ensure that PRA will be accountable to Court for administrative matters, including its budget and remuneration policy, value for money and performance against objectives.

## Transparency and accountability

**3.37** In addition to being accountable within the Bank to Court, the PRA will be externally accountable to Government, Parliament, and the public. As a starting point for ensuring this accountability, the PRA will be required to produce an annual report which the Treasury will lay before Parliament. The Government will seek to supplement this basic requirement with further practical accountability mechanisms which will reflect the significant public responsibilities with which the Bank is being provided.

**3.38** Given the quasi-legislative rule-making function of the PRA, including the power to raise levies from firms, the Government will give particular consideration to which, if any, of the accountability mechanisms currently established with respect to the FSA should be put in place for the PRA. These mechanisms are described in more detail in paragraph 4.36.

**3.39** The Government will also legislate to make the PRA subject to audit by the National Audit Office (NAO). This will deepen accountability and transparency, and NAO audit will also allow for further parliamentary scrutiny, as it will enable the NAO to investigate and produce reports on aspects of the economy, efficiency and effectiveness of the PRA’s performance, which the Public Accounts Committee (PAC) will be able to scrutinise.

**3.40** The Government also expects that the PRA will continue the practice adopted by the FSA whereby senior representatives agree to appear before the Treasury Select Committee as requested.

## Funding

**3.41** The PRA will be funded through the collection of levies from the firms for which it is lead regulator. Setting these levies will be a matter for the board of the PRA. Levy collection will take place in a way that minimises the administrative burden for firms. As discussed in the next chapter, the Government proposes that the CPMA – as the regulator which will have contact with all firms – should be responsible for collecting all levies.

### Box 3.E: Consultation question

- 9 The Government welcomes views on the measures proposed in paragraphs 3.28 to 3.41, which are designed to ensure that the operation of the PRA is transparent, operationally independent and accountable.

# 4

## Consumer Protection and Markets Authority

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**4.1** The previous model of a single integrated financial services regulator meant there was an in-built tension between:

- the need to focus on the prudential health of regulated firms on the one hand; and
- the need to devote sufficient attention to the conduct of firms in retail markets and participants in wholesale markets.

**4.2** Prudential and conduct of business regulation require different approaches and cultures, and combining them in the same organisation is difficult. As a result of the combined remit of the FSA, participants in financial services and markets, particularly ordinary consumers of retail products, did not always get the degree of regulatory focus or the protection they may have expected or required.

**4.3** The new consumer protection and markets authority (CPMA – this is a working title) will be a strong consumer champion in pursuit of a single objective – there will be no in-built tensions between different objectives, and a dedicated focus on the importance of proper conduct. This will provide greater clarity and ensure that the interests of consumers and participants in financial markets are placed at the heart of the conduct regulatory system and given the appropriate degree of priority.

**4.4** The CPMA will therefore be established as the single integrated conduct regulator, taking a tougher, more proactive and more focused approach to regulating conduct in financial services and markets. The CPMA will regulate:

- the conduct of all firms – including all firms authorised and subject to prudential supervision by the Prudential Regulation Authority (PRA) – in their dealings with ordinary retail consumers, taking a proactive approach as a strong consumer champion; and
- dealings in wholesale financial markets, including the conduct of all financial services firms in wholesale markets, firms providing market services (such as investment exchanges and providers of multilateral trading facilities) and market conduct more generally (including through the use of the existing FSMA powers to impose penalties on persons for market abuse to ensure the integrity of financial markets).

**4.5** This chapter discusses each of the key features of the new CPMA in turn. The regulation of markets and infrastructure is discussed in chapter 5.

### The role and functions of the CPMA

#### Objectives

**4.6** The Government will legislate to provide the CPMA with a primary objective of ensuring confidence in financial services and markets, with particular focus on protecting consumers and ensuring market integrity. This objective will allow the CPMA to adopt a focused and specialised approach to all aspects of conduct regulation.

**4.7** However, as with the PRA, the CPMA's primary objective will be balanced with a set of statutory secondary considerations that it must take into account in pursuit of its objective. As discussed in the previous chapter, the Government considers that such considerations – or 'have regards' – potentially fall into three categories:

- the objectives of other regulatory authorities;
- principles of good regulation; and
- other important linked matters which relate to the public interest.

**4.8** In cases of direct conflict between primary and secondary objectives, the Government would generally expect the primary objective to override any secondary considerations.

**4.9** 'Have regards' of the first type would include consideration by the CPMA of the impact of any of its policies or decisions on financial stability. In effect, this would require the CPMA to cooperate and coordinate closely with the PRA and Financial Policy Committee (FPC), as they each pursue their primary objectives relating to financial stability.

**4.10** A list of the second type of 'have regards' is set out in what are the FSA's current principles of good regulation, provided for by section 2 of the Financial Services and Markets Act 2000 (FSMA), which refers, in relation to the FSA, to:

- the need to use its resources in the most efficient and economic way;
- the responsibilities of those who manage the affairs of authorised persons;
- the principle that a burden which is imposed on a person should be proportionate to the benefits which are expected to result from the imposition of the burden;
- the desirability of facilitating innovation in connection with regulated activities;
- the international character of financial services and markets and the desirability of maintaining the competitive position of the UK;
- the need to minimise the adverse effects on competition that may arise; and
- the desirability of facilitating competition between those who are subject to any form of regulation by the Authority.

**4.11** The Government recognises that these principles may not all be appropriate for the new CPMA in its role as a dedicated conduct regulator. As discussed in the previous chapter, the Government considers that the case for regulators being responsible for the innovation and global competitiveness of the industries they regulate may, in particular, need to be reconsidered in the light of lessons learned from the financial crisis.

**4.12** The third type of 'have regards' for the CPMA – those relating to other public interest matters it ought to consider that are not currently in the principles of good regulation – could include factors such as:

- the potential impact of policies or regulatory decisions on consumer and business lending;
- promoting public understanding of the financial system;
- the need to maintain diversity in the financial services sector (for example, by removing barriers to entry where possible, and ensuring that its rules do not disadvantage mutually owned financial institutions); and

- promoting financial inclusion where possible, by encouraging access to suitable products and services.

**4.13** The Government is consulting on all aspects of the CPMA’s statutory ‘have regards’, as set out in box 4.A below.

#### **Box 4.A: Consultation questions**

- 10 The Government welcomes respondents’ views on:
- whether the CPMA should have regard to the stability of firms and the financial system as a whole, by reference to the primary objectives of the PRA and FPC;
  - whether some or all of the principles for good regulation currently set out in section 2 of FSMA should be retained for the CPMA, and if so, which;
  - whether, specifically, the requirement to have regard to potential adverse impacts on innovation or the competitiveness of the UK financial services sector of regulatory action should be retained; and
  - whether there are any additional broader public interest considerations to which the CPMA should have regard.

## **Scope**

**4.14** The Government will legislate to provide that the CPMA will have responsibility for the conduct-of-business regulation of all financial institutions, whether they are prudentially regulated by the PRA or not. The CPMA will regulate all conduct, including **retail** conduct of business, where firms provide services to consumers; and it will regulate **market** conduct where firms and others (particularly corporate clients of financial services firms) participate in dealings in wholesale financial markets.

**4.15** The CPMA will be solely responsible for the authorisation and supervision of all financial institutions not regulated prudentially by the PRA, and will also write the prudential regulatory framework for those firms.

**4.16** The CPMA will create and enforce retail conduct of business and market conduct rules, and its operations will therefore be supported by a strong and credible enforcement function.

## **Powers and functions of the CPMA**

**4.17** The legal framework for the CPMA’s powers and functions will be based on the model set out in FSMA, with modifications made to enable the new CPMA to carry out its conduct-focused responsibilities more effectively.

**4.18** The Government will legislate to confer on the CPMA the following powers and functions:

- the core regulatory function of making the rules which govern the conduct of financial firms, in both the retail and wholesale spheres;
- the granting of permissions for all regulated activities classified as ‘non-prudential’;
- supervision, and where necessary, enforcement of compliance with conduct of business rules, and of the prudential activity that sits within its remit;
- the approval of individuals to perform conduct-related controlled functions within financial firms that are also prudentially regulated by the PRA, and approval of all controlled functions where firms are solely regulated by the CPMA; and

- key administrative functions, including potentially the raising of levies to fund the activities of the PRA and CPMA and the collection of fees on behalf of the Financial Ombudsman Service (FOS), Financial Services Compensation Scheme (FSCS) and the Consumer Financial Education Body (CFEB).

## Rule making

**4.19** The CPMA will be responsible for making all conduct of business rules, and the prudential rules for those firms not regulated by the PRA. This will include rules around systems and controls where these relate to conduct functions.

**4.20** The rule-making function will be subject to statutory processes, including consultation with statutory panels, and wider public consultation. The CPMA will also be subject to the duty to carry out detailed market failure analysis and cost-benefit analysis prior to the introduction of any new rules.

## Authorisation

**4.21** The CPMA will provide permissions for all non-prudential regulated activities. It will, in effect, be responsible for the authorisation of firms not regulated by the PRA, as such firms will not require any permissions from the PRA. The CPMA will, in addition, also be responsible for providing permissions for conduct-based regulated activities undertaken by firms authorised by the PRA.

## Supervision and enforcement

**4.22** The CPMA will be responsible for supervision and enforcement of its conduct rules. These rules may relate to both prudential and non-prudential regulated activities. For example, the CPMA will be responsible for conduct of business supervision and enforcement for the activities of taking deposits, and dealing in investments as agent. In fulfilling the former function – conduct supervision of prudential activities – the CPMA will need to coordinate with the PRA’s supervision of its prudential rules.

**4.23** The FSA can currently take a range of actions in relation to firms through the own initiative variation of permission (OIVOP) powers, and the Government will legislate to ensure that both the PRA and CPMA have these same powers. However, there may be scope for enhancing OIVOP powers to ensure that they can be used more effectively. More detail on this is set out paragraphs 6.17 and 6.18. As part of its review, the Government will consider whether changes to the OIVOP powers could enhance the CPMA’s ability to provide effective consumer protection.

**4.24** In addition, the CPMA will build on the progress recently made by the FSA towards a more interventionist and pre-emptive approach to retail conduct regulation. As a starting point, it will adopt the FSA’s new Retail Conduct of Business Strategy, and it will continue with initiatives such as the Retail Distribution Review, Mortgage Market Review, and work on responsible lending. These initiatives recognise and respond to some of the distinctive characteristics of retail financial services that call for a more intrusive approach, such as long-term product payoffs, product complexity and asymmetry of information between consumers and producers. This will necessarily be backed by a strong approach to enforcement to ensure credible deterrence.

**4.25** The establishment of a new, focused body presents a key opportunity for a frank and open debate about achieving the appropriate balance between the regulation and supervision of firms, consumer responsibilities, consumer financial capability and the role of the state. These issues will be addressed as the CPMA is established.

**4.26** Separately, the CPMA will maintain, within its markets division, a separate market enforcement function. This is discussed in more detail in the next chapter.

## Coordination and cooperation with the PRA and the FPC

**4.27** The basic model proposed – in which each regulatory authority will be responsible for taking decisions in relation to the activities it regulates – whether they relate to rule-making, authorisation, approval of individuals performing controlled functions, supervision or enforcement – will require a significant degree of cooperation and coordination by the authorities. The model this interaction will take and the statutory processes which will formalise it are set out in more detail in box 3.B in the previous chapter.

**4.28** In addition, both the PRA and CPMA will work closely with the FPC on an ongoing basis- this relationship is described in more detail in paragraphs 2.48 to 2.51.

**4.29** In particular, the CPMA will be required to consult the PRA on any firm-specific actions it intends to take which it considers may have an adverse impact on the stability and soundness of the firm in question. It will also be required to consult the FPC on any rules it intends to make which it considers may have an impact on the stability of firms generally, or of the system as a whole.

## Governance and accountability

**4.30** The new CPMA will be independent of Government, and will take the corporate form of a company limited by guarantee, financed by the financial services industry. The Government is considering whether the CPMA should be established by adopting the legal corporate entity of the FSA, recognising that this option offers significant practical advantages in terms of implementation and may well represent the best value for money solution for the financial services sector.

**4.31** The Government considers it to be very important that clear mechanisms of governance and transparency be established around the new regulatory bodies, and further believes that these should be at least as rigorous as those placed on the FSA. More detail is set out below.

## Board and management structures

**4.32** The CPMA will be governed by a board with a majority of non-executives, appointed by the Treasury. The chief executive of the PRA will sit ex officio on the board of the CPMA.

**4.33** Non-executive board members will be expected to have the necessary skills and background to bring the viewpoint of all relevant stakeholder groups to the board, and the appointment process will ensure that this outcome is achieved. The Department for Business, Innovation and Skills (BIS) will have a strong interest in the new CPMA through its general responsibility for consumer and business issues. The Treasury and BIS will therefore jointly appoint a proportionate number of non-executives to the board to ensure that appropriate expertise in these areas is available to the board.

**4.34** The power to make rules and the power to raise levies from industry to fund the CPMA's work will be reserved to the CPMA's board. This firmly establishes the status of the CPMA board as a strong, independent rule-making body.

**4.35** The Government recognises that it will be potentially difficult for a board with a non-executive majority to take decisions on significant supervisory action relating to individual firms. Therefore, to complement the board of the CPMA, the Government will legislate to create an executive committee of the board, which will have responsibility for taking significant supervisory and regulatory decisions. The Government expects the CPMA's non-executive directors to participate in this executive committee where they do not have a conflict of interest.

## Transparency and accountability

4.36 The CPMA will be subject to the following accountability mechanisms set out in statute:

- a requirement to produce an annual report to be laid before Parliament by the Treasury;
- a requirement to hold annual public meetings;
- a duty to establish consultative panels (outlined in more detail below);
- a duty to maintain a complaints mechanism similar to that required of the FSA by schedule 1 of FSMA;
- decisions to be subject to appeals in the Upper Tribunal, where appropriate; and
- reviews and inquiries (along the lines of those provided for currently in sections 12 and 14 of FSMA).

4.37 The Government will legislate to make the CPMA subject to audit by the National Audit Office (NAO). This will deepen accountability and transparency, and NAO audit will also allow for further parliamentary scrutiny as it will enable the NAO to investigate and report on aspects of the economy, efficiency and effectiveness of the CPMA's performance. The Public Accounts Committee (PAC) will be able to scrutinise these reports.

4.38 Panels are also an important consultative mechanism providing external challenge and accountability. The CPMA will therefore retain the two current panels required under FSMA, the Consumer Panel and the Practitioner Panel. In addition, and in recognition of the important role it has played since its creation, the Small Business Practitioner Panel will also be placed on a statutory footing.

### Box 4.B: Consultation questions

- 11 Are the accountability mechanisms proposed for the CPMA appropriate and sufficient for its role as an independent conduct regulator?
- 12 The Government welcomes views on the role and membership of the three proposed statutory panels for the CPMA.

4.39 The Government expects that the CPMA will continue the practice adopted by the FSA whereby senior representatives agree to appear before the Treasury Select Committee as requested.

## Funding

4.40 The CPMA and PRA will each set the fees and make the rules in respect of the activities under their remit (with the CPMA setting fees for PRA-regulated firms only by reference to their conduct of business activity). Such a regime should ensure simplicity for firms, while avoiding cross-subsidy. In addition to setting the levy for its own activities, the CPMA will also be responsible for making rules in respect of industry funding of the FOS, FSCS and CFEB. Levy collection will take place in a way that minimises the administrative burden on firms.

4.41 A possible model for achieving this would be to have a single authority collect all fees, regardless of whether it is a firm's lead regulator. The CPMA would be the more logical candidate for this given, first, that it will have regulatory contact with all firms (as opposed to the PRA, which will only deal with firms conducting prudential activities), and second, its responsibility for collecting fees on behalf of the three associated bodies.



**4.42** This would mean that the CPMA would collect fees from both CPMA and PRA authorised firms in respect of conduct of business activity. The CPMA would also be appointed to act as the agent of the PRA, FOS, the FSCS and CFEB to collect relevant fees and levy data, raise and collect all payments due on their behalf. This would further reduce duplication and costs to firms.

#### **Box 4.C: Consultation questions**

- 13 The Government welcomes views on the proposed funding arrangements, in particular, the proposal that the CPMA will be the fee- and levy-collecting body for all regulatory authorities and associated bodies.

## **Associated bodies**

**4.43** The CPMA will take on the FSA's existing responsibility for FOS and oversee CFEB, which will play a key role in improving financial capability. The CPMA will also have responsibility for the FSCS but, given the important role it plays in financial stability, it will work closely with the PRA.

## **The Financial Ombudsman Service**

**4.44** It will be important for FOS to remain independent of the CPMA, as is currently the case with respect to the FSA. Its claim to impartiality, and hence its legitimacy in making rulings which are binding on firms, is only credible if it does not favour, or appear to favour, consumers. Therefore it should not be part of a consumer champion. Similarly, FOS decisions to reject particular complaints will only be credible if it is independent of bodies with, for example, a financial stability objective.

## **The Financial Services Compensation Scheme**

**4.45** The FSCS's key role is the provision of consumer protection when a firm is in default. Its core business of compensating consumers for the more frequent failures of small firms such as Independent Financial Advisers also fits within the remit of the CPMA. However, the role of the FSCS in the event of a failure of a bank, insurer or investment bank means that there is a clear link with the work of the PRA.

**4.46** One way to recognise these differing roles under the new arrangements would be for the PRA and the CPMA to make rules relating to compensation and levies for the different classes of firm which they regulate. This would imply the existence of separate compensation schemes, which could imply ending the current cross-subsidy between different classes of levy payers (under which investment firms or insurers have to contribute to the failure of banks, and vice versa). Under this model, it may nevertheless be appropriate for a single organisation (such as the FSCS) to continue to administer all compensation schemes.

**4.47** Alternatively, the FSCS could remain a single scheme under the remit of the CPMA, who would make all of their rules, including rules on levies. The FSCS would need to continue to work closely with the PRA and with the other authorities on contingency planning and on resolution in both models. It may also be necessary for the PRA to have a formal role, for example in nominating an FSCS board member to ensure close working.

#### **Box 4.D: Consultation questions**

- 14 The Government welcomes views on the proposed alternative options for operating models for the FSCS.

### **The Consumer Financial Education Body**

**4.48** CFEB will play a vital role in the Government's consumer protection framework, in particular in establishing the UK's first free national financial advice service and annual financial healthcheck. The Government intends to undertake a medium term review of the CFEB to ensure that this remains a suitable model to deliver consumer education and support the wider consumer protection agenda. This will take place within - but no sooner - than three to five years from the CFEB's creation.

**4.49** The CFEB will remain operationally independent, with limited points of accountability to the CPMA, such as final approval of its budget and plans. The Government will take steps to ensure effective collaboration between the CFEB and the CPMA. For example, the CFEB CEO could sit on the CPMA board (but not vice versa as this could risk undermining the CFEB's independence). This will be important to identify instances of consumer detriment and to ensure messages to consumers are strong and consistent.

### **Consumer protection and securing the right consumer outcomes**

**4.50** Consumers of financial services can be in particular need of protection, and assurance that help is available when things do go wrong. This is why it is particularly important in financial services to have the right mechanisms in place for consumer protection and redress. Such mechanisms should be both preventative, in the form of credible enforcement of an appropriate set of conduct rules and wider consumer protection framework, but also restorative, through a safety net in the form of an ombudsman and compensation scheme.

**4.51** The new CPMA will continue to have concurrent consumer protection powers where another body is the lead enforcer of a general piece of consumer protection legislation that also applies to financial services. For example, OFT is the lead enforcer in respect of the Unfair Terms in Consumer Contract Regulations (UTCCR) but the FSA currently has a role in enforcing unfair terms in consumer contracts in financial services. The Government envisages that the CPMA will assume all the FSA's existing functions in this respect to ensure that it can credibly carry out its role as a consumer champion and take action where it considers a term to be unfair.

**4.52** However, the Government will take the creation of the CPMA as an opportunity to examine how consumer protection is enshrined in FSMA and what changes may be needed to update or strengthen the regime. Combined with a more proactive, interventionist approach to retail conduct regulation by the new regulator, the Government's new framework will ensure that consumers are able to operate with greater certainty and confidence in financial services.

### **Consumer Credit**

**4.53** The creation of the CPMA as a strong consumer voice presents an ideal opportunity to look again at the manner in which consumer credit is regulated, and where this should be located, in order to maximise consumer protection and increase certainty and transparency for both consumers and businesses.

**4.54** Currently the responsibility for regulating consumer finance is divided between the FSA and the Office of Fair Trading (OFT). The FSA regulates most consumer financial services activity, including for example insurance, savings and deposits and first charge residential mortgages, but not currently the provision of consumer credit. Under the Consumer Credit Act 1974 the

OFT is the licensing authority and enforcement body for regulated consumer credit, including personal loans, credit cards and the provision of goods and services on credit as well as related activities such as debt collection and debt management. The FSA and OFT regulate approximately 29,000 and 99,000 firms respectively, and 16,000 of these are jointly regulated.

**4.55** This division across two regulatory bodies can lead to confusion, and potentially results in outcomes that are sub-optimal for both consumers and firms. For example, current accounts are subject to FSA rules if they are in credit, but when a current account goes into to debit it becomes subject to certain requirements of the Consumer Credit Act, enforced by OFT. Bringing together the FSA's and OFT's consumer credit functions within the scope of CPMA regulation and creating a regulatory regime covering both consumer credit and financial services could simplify the regulatory regime and lead to better, more integrated protection for consumers alongside simpler compliance for lenders and present an opportunity to remove unnecessary regulatory burdens and duplications.

**4.56** The Government therefore intends to consult on the merits of a transfer of responsibility for consumer credit from the OFT to the new CPMA. This consultation, to be published jointly by the Treasury and BIS in the autumn, will consider how the extensive legislative framework underpinning consumer credit regulation might be simplified and whether it should be brought under a single regulatory regime. The Government recognises the significant challenge in designing a regime that is proportionate yet effective and does not place unnecessary burdens on providers of consumer credit, and is therefore committed to extensive engagement and consultation on the issue. This may mean that work on transferring consumer credit may progress on a longer timetable to the regulatory reform work set out in this consultation paper. The Government is committed to ensuring that any change will deliver real and justifiable benefits in terms of consumer protection, and will only make a change to the status quo if there is a positive outcome of the consultation.



# 5

## Markets and infrastructure

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**5.1** A key area of financial regulation is the regulation of conduct in wholesale financial markets and of the infrastructure that supports those markets. The Government recognises the crucial importance of these markets, both to the operation of the financial system as a whole, and to London's position as a major global financial centre. A key imperative for the new structure, therefore, will be a stable and credible framework for market regulation which promotes confidence in the stability, integrity and efficiency of financial markets in the UK.

**5.2** The Government also recognises the importance of ensuring that the arrangements for wholesale markets regulation allow the UK authorities to play a full part in engaging with the new European Securities and Markets Authority (ESMA), to ensure that the right outcomes are delivered for London and the UK more generally. Ensuring that arrangements for market conduct and infrastructure regulation support this objective will also be a key priority.

**5.3** Therefore, the Government will establish, within the consumer protection and markets authority (CPMA), a strong markets division to lead on all market conduct regulation, and to be the lead authority representing the UK in ESMA.

**5.4** Recognising the key role of systemic market infrastructure to safeguarding the stability of the financial system, the Government will transfer regulation and supervision of settlement systems and central counterparty clearing houses (CCPs) to the Bank of England (the Bank). These functions will sit alongside its existing responsibilities for payment systems oversight.

**5.5** The remainder of this chapter sets out these arrangements in more detail.

### Market conduct

**5.6** The activities that are the focus of wholesale market conduct regulation are, in a number of important respects, considerably different from other types of financial services, particularly those provided to retail consumers. For example:

- they are different in terms of scale; some transactions between financial market participants are very large by any standards and almost all transactions on wholesale markets are large relative to the size of deals that ordinary retail consumers undertake; and
- they are different in the relative positions of the parties to the transaction; in particular, the parties to transactions can include large industrial, commercial or financial companies and other similar bodies who are (or should be) able to look after their own interests without recourse to significant regulatory protection (unlike normal retail consumers).

**5.7** Nevertheless, the underlying issues and the key legal concepts are ultimately the same for market conduct regulation as any other form of financial conduct regulation. These functions will be located within the CPMA, as part of its overall remit to regulate conduct in the sphere of financial services and markets.

**5.8** The Government proposes to make the CPMA responsible for regulating the conduct of participants in:

- organised financial markets whose facilities are provided by investment exchanges and multilateral trading facilities;
- over-the-counter (OTC) financial markets in which off-exchange dealings take place bilaterally between financial institutions and other large wholesale market participants; and
- in relation (in principle) to all financial instruments and other derivative contracts traded on those markets.

**5.9** As discussed in the previous chapter, the CPMA's primary statutory objective will reflect this role by including an explicit requirement related to the promotion of market efficiency and integrity.

**5.10** In recognition of the differences between retail financial services conduct and wholesale financial markets conduct issues, **responsibility for all market conduct regulation will be located within an operationally distinct division of the CPMA, which will also represent the UK in ESMA.**

**5.11** In performing its representative role within ESMA, the CPMA will work with other regulatory bodies with an interest in financial market issues – including the Bank and, potentially, the new companies regulator discussed below – to ensure that UK's interests are effectively represented.

## Regulation of infrastructure provision

**5.12** Market infrastructure providers are seen as a distinct category of financial services business. However, they actually include several different types of business such as:

- exchanges and other trading platform providers;
- CCPs;
- settlement systems;
- payment systems (some of which are already overseen by the Bank of England under Part 5 of the Banking Act 2009).

**5.13** The regulation of market infrastructure providers is often grouped with the regulation of market conduct. This may be because:

- some infrastructure providers (especially exchanges) have often themselves carried out regulatory activities, particularly before the introduction of formal systems of financial regulation in the last century. A typical exchange (often a mutual organisation owned by its member firms) would then have been solely responsible for regulating its membership, members' conduct in exchange trading and the investments that were traded on the exchange;
- infrastructure and facilities were very 'low tech'. Exchanges typically had trading floors or 'pits' and there was no computer-based trading. The scale of activity would typically have been relatively small compared to the volumes of transactions supported by infrastructure providers today.

**5.14** Modern infrastructure providers are more typically high technology businesses and they are united in some ways by their use of technology. However, this does not distinguish them from most large firms in the financial services industry, particularly those involved in dealing in securities and derivatives either on their own account or on behalf of customers.

**5.15** But clear distinctions can still be drawn between the roles of the different types of infrastructure firms. **The Government therefore proposes to make:**

- the markets division of the CPMA responsible for regulating exchanges and other trading platform providers – this reflects the importance of the facilities they provide for dealing in securities and derivatives and the significance of the activities of the providers and users for market conduct regulation; and
- the Bank responsible for overseeing CCPs and settlement systems alongside its existing responsibilities for payment systems oversight – this reflects the systemic importance of these types of infrastructure, the significant capital requirements and exposures that CCPs have and brings the regulation of all three types of body together for the first time.

**5.16** The Government expects that the supervision of market infrastructure will follow the same general principles of cooperation, coordination and consultation as for any other type of regulated entity. For example:

- in general, when regulating market infrastructure, the Bank will cooperate closely with the CPMA, reflecting the CPMA's responsibilities for: on-exchange and OTC financial markets; representing the UK in ESMA; and any conduct aspects of clearing houses and settlement systems; and
- in relation to individual firms subject to regulation by both the Bank and the CPMA (for example, where an investment exchange also operates its own in-house CCP) such a firm will be authorised and supervised by the Bank for clearing and settlement but it will be subject to conduct of business regulation and supervision by the CPMA in respect of non-financial stability matters.

**5.17** The Government proposes also to consider whether there is scope for rationalising the two regimes contained in the Financial Services and Markets Act 2000 or FSMA (authorisation under Part 4 and recognition under Part 18) under which trading platforms and CCPs are regulated. The separate regimes for the approval of operators of relevant settlement systems under the Uncertificated Securities Regulations 2001 and for designating systems for the purposes of the Financial Markets and Insolvency (Settlement Finality) Regulations 1999 are expected to continue largely unchanged.

**5.18** Payment systems will continue to be overseen by the Bank.

#### **Box 5.A: Consultation questions**

- 15 The Government welcomes views on the proposed division of responsibilities for markets and infrastructure regulation.
- 16 The Government welcomes views on the possible rationalisation of the FSMA regimes for regulating exchanges, trading platforms and clearing houses.

## **Listing and related activities**

**5.19** The FSA (as the UK Listing Authority, or UKLA) also regulates primary market activities such as:

- issuing investments such as shares or bonds for the first time;
- obtaining official listing of shares and bonds; and
- the related activity of disclosing information in accordance with the disclosure and transparency obligations that apply to listed issuers and their major shareholders.

**5.20** The Government recognises the important role played by the UKLA in making London a leading global venue for companies – in all sectors – to access capital markets by the issuance of securities.

**5.21** The Government believes, however, that the functions of the UKLA could be merged with other regulatory functions relating to companies and corporate information, notably those of the Financial Reporting Council (FRC). This would have the benefit of bringing the UKLA's regulation of primary market activity alongside FRC functions relating to company reporting, audit and corporate governance. **The Government is therefore considering whether the UKLA should be merged with the FRC under the Department for Business, Innovation and Skills (BIS), or whether it should remain within the CPMA markets division.**

**5.22** The Government believes that, within the proposed new regulatory architecture, there is a strong case for a powerful companies regulator established with responsibilities for regulating corporate governance, corporate information and its disclosure, and the stewardship of companies by institutional shareholders. This is a matter on which BIS will bring forward detailed proposals for consultation in due course, but the merger of the UKLA and FRC would be an important step towards such a reform.

**5.23** **The Government is also seeking views on whether there are other aspects of financial market regulation in which the links with companies law are sufficiently close to warrant consideration of transferring them to the potential new companies regulator.**

**5.24** In seeking views on these questions, the Government recognises that any arguments in favour of a change to the existing arrangements need to be set against: the synergies that exist between the UKLA and other markets functions that would remain within the markets division of the CPMA, especially market surveillance; and the fact that listings encompass other securities in addition to equities (for example, debt and securitisations). The proposed new body would therefore cooperate closely with the CPMA, with particular focus on effective representation of the UK in ESMA and other international bodies.

#### **Box 5.B: Consultation questions**

- 17 The Government would welcome views on whether the UKLA should be merged with the FRC, as a first step towards creating a companies regulator under BIS.
- 18 The Government would also welcome views on whether there are other aspects of financial market regulation which could be made more effective by being moved into the proposed new companies regulator.

## **Other matters**

### **Lloyd's of London**

**5.25** The FSA is currently responsible for the regulation of Lloyd's of London. The FSA also regulates the firms which provide services to the market, to names and to other market participants. Some of these activities would clearly fall to the PRA to regulate and some would fall to the CPMA to regulate in line with the general principles for dividing regulated activities between the new regulatory bodies. The Government will consider further in consultation with the Bank and the FSA how the regulated activities relating to Lloyd's of London will be allocated between the PRA and CPMA.



## Economic crime

**5.26** The Government proposes to consider, as part of possible wider reforms to the approach to tackling economic crime, whether to transfer responsibility for prosecuting criminal offences involving insider dealing, other forms of market abuse and other criminal law breaches which the FSA currently prosecutes to a new Economic Crime Agency (ECA). This will be subject to separate consultation in due course.



# 6

## Crisis management

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**6.1** As discussed in the introductory chapter, the financial crisis demonstrated the inadequacies of the tripartite system of financial stability regulation. The fragmented structure, with responsibilities, powers and capabilities split amongst institutions in an ill-defined way, was exposed as unable to address effectively the challenges the regulatory system faced.

**6.2** Previous chapters in this consultation document have set out the objectives, functions and powers of the new regulatory bodies and the arrangements for coordinating between them. In an emerging crisis situation, effective coordination becomes of paramount importance – not only between the regulatory authorities, but also as the Treasury becomes more involved in its role as custodian of public funds and the interests of taxpayer, as well as the wider public interest questions which may arise in a significant financial crisis.

**6.3** The Government recognises that the Bank of England (the Bank) and the Treasury will have discrete but complementary roles to play in responding to an emerging financial crisis:

- the Bank (as central bank, macro- and micro-prudential regulator and resolution authority) will be responsible for designing and executing most elements of the regulatory and resolution response;
- the Treasury will control any decisions involving the use of public funds.

**6.4** Performing these roles effectively will require close cooperation – concrete examples include, for example, emergency liquidity assistance provided by the Bank, use of public funds in a resolution (either directly or through loans to the Financial Services Compensation Scheme or FSCS), or through indemnifying a special liquidity scheme offered by the Bank.

**6.5** No two crises will be the same, and it is therefore important that there be flexibility within these arrangements for the authorities to respond in the most appropriate way to the challenges they face, within a context of clearly understood roles and responsibilities. The Government's framework for monitoring risks to financial stability – and managing them in the event of a crisis – is intended to provide this flexibility.

### Stability and crisis management framework

**6.6** Every six months, after the Financial Policy Committee (FPC) has published its Financial Stability Report, the Governor will report to the Chancellor on developments in prudential regulation and financial stability – including any macro-prudential decisions taken (or not taken) by the FPC, or significant regulatory actions by the Prudential Regulation Authority or PRA (or, where relevant to stability, the consumer protection and markets authority or CPMA). The purpose of these meetings will be to alert the Chancellor to any potential issues on the horizon, and to give the Chancellor a formal opportunity to respond. To ensure transparency and accountability, a high level record of these discussions will be published. These meetings will not, of course, preclude other discussions that the Governor and Chancellor may have on domestic and international financial sector issues.

**6.7** In addition to these regular formal meetings to monitor developments in financial stability, the Governor will be under an obligation to notify the Chancellor as soon as it becomes clear

that there is a potential call on public funds. Such notification must be provided with sufficient time to allow the Chancellor to consider and discuss all options. Once notification has been made, it will be vital that the Treasury and Bank (and other authorities) work closely together to develop sufficiently robust contingency plans that minimise the call on public funds whilst securing financial stability.

**6.8** The Chancellor will have the final decision on any use of public funds whether through emergency lending assistance, the provision of public funds in a resolution, or any indemnity required by the Bank. The regulatory authorities will retain their individual statutory responsibilities.

**6.9** Other areas of crisis management and coordination that the Chancellor will take a close interest in will include:

- identifying and assessing the wider economic implications of any proposed intervention;
- where appropriate, giving clear information to Parliament and the public about measures being taken to maintain financial stability; and
- increasingly (given the cross border nature of the majority of the UK’s largest banks) managing the interaction with overseas authorities, including central banks, regulators or resolution authorities. The Chancellor will remain ultimately responsible for ensuring that the UK complies with its international obligations.

**6.10** The Chancellor will be accountable to Parliament for the authorities’ crisis management strategy. The Government will bring forward proposals to ensure that there is full accountability for the actions taken by the various regulatory bodies, in particular actions that result in costs to the taxpayer or to the financial sector.

**6.11** The Treasury will retain its role in representing financial sector interests on COBR and other forums for dealing with general civil contingency events and operational crises. The Chancellor will consult and brief the authorities as appropriate in such cases.

**Table 6.A: Transition from peacetime to crisis**

Authority		‘Peacetime’	Emerging risks	Crisis management
HM Treasury		Economic and financial policy.	Contingency planning	Overall responsibility for decisions affecting public funds and international obligations
Bank of England	Bank	Monetary policy, central banking, and key infrastructure	Operation of liquidity insurance	Emergency liquidity
	FPC	Monitoring risks, vulnerabilities and imbalances; use of macro-prudential tools	Possible use of macro-prudential tools in response to emerging threat.	
	PRA	Normal prudential regulation of firms	Heightened supervision and intervention	Triggering SRR and crisis interventions
	SRU		Contingency planning	Operating the SRR

## Tools to deal with threats to financial stability

**6.12** The Government intends to explore whether further tools and powers are needed for the new regulatory bodies to ensure that they can act in concert to protect depositors, promote financial stability, and protect the interests of the taxpayer.

### Bank of England market operations

**6.13** Guided partly by experience of the recent crisis, the Bank has since 2008 introduced a number of modifications to the instruments and operating procedures it uses in the sterling money markets in discharging its monetary and financial stability responsibilities. These should allow greater flexibility in responding to liquidity pressures at both the market and the individual firm level.

### Heightened supervision and powers for regulators

#### Recovery and resolution plans

**6.14** The Government believes that firms must take responsibility for their own recovery if they are at risk. Recovery and resolution plans (RRPs) are a key tool, specifying recovery actions to restore a firm to health. **Under the new regulatory arrangements, the PRA will be responsible for making rules about and approving RRP, building on the initiatives that are currently being pursued by the FSA to ensure the orderly wind down of systemic firms.**

#### Powers to require management actions from firms

**6.15** The Government proposes to explore what further powers should be available to the PRA (working with the Bank's Special Resolution Unit or SRU) to require management actions to be taken to enable a firm to recover in the event that a firm fails to deliver actions detailed in its recovery plan, or those actions prove insufficient. Such management actions may include, for example, a requirement to issue new equity.

**6.16** These enhanced powers are likely to be used for recovery, rather than preparing a firm for resolution. The Government will consider the implications of the conclusions of the Independent Commission on Banking for crisis management issues, in particular as to whether the PRA should have wider powers, for example to require the break-up of large groups to assist with resolvability.

**6.17** The FSA can currently take a range of actions in relation firms through the own initiative variation of permission (OIVOP) powers. However, there may be scope for enhancing these powers to ensure that they can be used more effectively. For example:

- enhancing clarity about the OIVOP power and the circumstances in which it might be used;
- making intervention mandatory at a specified threshold, creating a regime similar to the 'prompt corrective action' regime used by the Office of the Comptroller of Currency (OCC) and other regulators in the US;
- changing the trigger points at which the regulator is able to take action to ensure intervention is possible before a breach of threshold conditions; and
- ascertaining what powers – if any – are required in respect of unregulated entities such as holding companies in the group structure of failing firm.

**6.18** In addition, the Government will look at whether changes to the OIVOP powers could enhance the CPMA's ability to provide effective consumer protection.

**6.19** The Government will continue to consider and develop proposals to enable the effective resolution of investment banking business.

### **Contingent capital**

**6.20** An additional element in firms' 'self-help' capacity in responding to financial stress might be provided by the issuance of 'contingent capital' – essentially debt instruments which, through a defined triggering mechanism, convert into equity capital or are subject to capital write down. The potential value of such instruments is being explored at the Basel committee and Financial Stability Board, or FSB (see paragraph 6.25).

### **Special resolution regime**

**6.21** The Banking Act 2009 established the special resolution regime (SRR), which provides tools for resolving failing banks and building societies. The Government will look at proposals to strengthen the accountability and effectiveness of the authorities in exercising their powers under the SRR, taking account of the regulatory authorities' new roles.

**6.22** Currently, the Chancellor of the Exchequer is accountable to Parliament for decisions involving the use of public funds, for compliance with the UK's international obligations, and for the exercise of certain powers, including the power to transfer a bank or a bank holding company into temporary public ownership and the power to amend the law to enable a power under the regime to be used effectively. The Bank is the lead resolution authority, responsible for the bridge bank and private sector purchaser stabilisation options.

**6.23** It is important to ensure that appropriate safeguards are in place to ensure that conflicts do not arise between the Bank's role as lead resolution authority and the Bank's new responsibilities in relation to the PRA, which will be responsible for pulling the trigger to put a failed institution into the SRR. The Government will therefore put in place arrangements to ensure that contingency planning and resolutions are managed distinctly from the Bank's functions in relation to the PRA. Specifically, resolution will be managed by the Deputy Governor for financial stability, and not the Deputy Governor for prudential regulation (the CEO of the PRA).

**6.24** The Government will also consider what further changes may be needed to the SRR in the light of the creation of the new authorities, and what improvements may be required to enhance safeguards and overall effectiveness of the regime.

### **International issues**

**6.25** Internationally, the Treasury will continue to represent UK interests in G20, G7 and other international forums (including at the European level). The Bank of England also sits on various G20 and G7 bodies, including the FSB as discussed below. Prior to full implementation of the new arrangements, the Treasury will consider whether further clarification is required regarding the roles and mechanisms for the authorities' participation in international discussions to ensure that the UK's position is consistently and effectively represented.

**6.26** The Treasury is supportive of ongoing efforts to strengthen cross-border crisis management groups and stability groups at the international and European level for key cross-border financial institutions. These groups can play a central role in:

- enhancing contingency planning;
- initiating and monitoring processes for the development of internationally-consistent recovery and resolution plans; and

- ensuring authorities are in regular contact regarding stress-testing, the assessment of firm resolvability and preparing for resolution as necessary.

**6.27** The Treasury will continue to stress the importance of ensuring consistency between international and European level crisis management networks.

**6.28** A cross-border crisis management working group of the FSB, chaired by Paul Tucker (Deputy Governor of the Bank responsible for financial stability), is overseeing the development of firm-specific RRP for the largest global banks by the relevant 'Crisis Management Groups'. This work will improve the authorities' understanding of cross-border links within banks and will identify obstacles to information sharing and resolvability. The group is also developing standards around the key features and powers of national resolution regimes. One of the G20's central objectives is to reduce the moral hazard problems posed by large and complex firms (systemically important financial institutions or SIFIs). The authorities need to have the necessary powers to resolve such complex financial institutions in the event of a crisis in a way that protects financial stability and protects taxpayers.

**6.29** A number of proposals that may help to address moral hazard risk are being discussed in international forums, including mandatory requirements for banks to hold securities that are convertible into equity or subject to haircuts at a specific trigger point, legal powers for regulators to direct a recapitalisation of a failing firm, and harmonised and enhanced resolution regimes. **The Government will play an active role in international discussion about proposals to reduce the risks posed by SIFIs, and will consult if any changes to UK legislation are required.**

**6.30** The European Commission proposed in their October 2009 consultation on crisis management<sup>7</sup> that all Member States should have resolution tools capable of delivering similar outcomes to the SRR tools. The UK has engaged positively on this work to improve EU crisis management standards and has struck common positions with a wide variety of Member States. **The Government looks forward to the Commission's Communication later this year on measures to enhance national resolution arrangements and proposals to bolster cross-border cooperation.**

#### **Box 6.A: Consultation questions**

- 19 Do you have any overall comments on the arrangements for crisis management?
- 20 What further powers of heightened supervision should be made available to the PRA and the CPMA, and in particular would there be advantages to mandatory intervention, as described in paragraph 6.17?
- 21 What are your views about changes that may be required to enhance accountability within the SRR, as described in paragraphs 6.21 to 6.24?

<sup>7</sup> *Communication on an EU framework for crisis management in the banking sector*, European Commission, October 2009





# 7

## Implementation

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**7.1** As set out in the previous chapters, the Government will legislate to create a new Financial Policy Committee (FPC) within the Bank of England (the Bank) responsible for macro-prudential regulation. Alongside this, the Government will legislate to create two new regulators: a Prudential Regulation Authority (PRA) and a consumer protection and markets authority (CPMA).

### Consultation

**7.2** The reform programme outlined in this document is a complex and weighty undertaking. It will be vital to get the detail of the legislation right, as well as the practical implementation. Therefore the Government is committed to carrying out a full and comprehensive consultation process, in order to provide ample opportunities for interested parties to comment on these proposals over the course of their development and refinement.

**7.3** Comments provided in response to this initial high-level policy consultation will feed into the development of detailed legislative proposals, leading to **the publication early next year of a further consultation document including draft legislation on the core parts of the proposed Bill.**

### Transitional measures

**7.4** It will be essential to adopt transitional measures in tandem with the legislative process in order to minimise the time needed for implementation once the legislation is in place, thereby reducing disruption to affected organisations and regulated firms. These transitional measures will include a reorganisation of the internal structure of the Financial Services Authority (FSA), and establishment of the FPC on an interim basis.

**7.5** During the period of transition to the new regime, the Treasury and the regulatory authorities will be guided by the following principles:

- maintaining high quality, focused regulation during the transition;
- minimising uncertainty and transitional costs for firms;
- balancing swift implementation with proper appropriate scrutiny and consultation; and
- providing as much clarity and certainty as possible for FSA, Bank and other staff affected by the proposals.

### Financial Services Authority

**7.6** To ensure that FSA staff and regulated firms are prepared for the transition to this new regulatory structure, it will be essential to implement non-statutory changes to the internal structure of the FSA in advance of the legislation coming into force.

**7.7** The Government is very pleased that Hector Sants has agreed to continue as chief executive of the FSA to manage the transition and become the first chief executive of the PRA. The Government believes that the continuity, experience and leadership that Mr Sants will provide, supported by Andrew Bailey, executive director for banking at the Bank, will make a great difference in ensuring a smooth and orderly transition to the new regulatory structure.

**7.8** The transition from the current regulatory structure to the new one obviously carries the risk of some operational disruption of regulation. To address this issue, and to ensure that FSA staff and regulated firms have sufficient clarity and certainty in order to prepare for the transition to the new regulatory structure, the FSA will seek to move as fast as possible towards the structure envisaged under the new regime on a non-statutory basis.

**7.9** The FSA will work to introduce a 'shadow' internal structure, which will allocate FSA staff and responsibilities in anticipation of the formal creation of the CPMA and the PRA. The intention is to introduce this approach in the first quarter of 2011. A new operating model will also be developed in the autumn and reviewed by the FSA board towards the end of the year. It will address such issues as structure, resource and appropriate risk-based supervisory frameworks for each of the PRA and the CPMA. The Bank will be involved in this process and is represented on the FSA committees leading the work. The FSA will continue to engage with external stakeholders as appropriate as its thinking develops, and it and the Bank will continue to work closely with the Government on the development of the new regulatory structure.

**7.10** The FSA will work to ensure that business continues as usual while these changes are implemented, and will continue to implement its intensive supervisory approach and credible deterrence agenda. It will also be important to ensure that the UK continues to be well represented in international forums. In order to provide continuity during the transitional period the UK's institutional representation in international forums will not change until the legislation to create this new structure is enacted. However, as the reform programme advances, the Bank and the FSA will need to work closely together to ensure that all relevant views are taken into account and are adequately represented in international and EU negotiations.

### **Interim Financial Policy Committee**

**7.11** While the legislation to establish this new structure is being drafted and considered by Parliament, an interim FPC will be established by the autumn. Its membership will include, in addition to members of the Bank's executive, the chairman and chief executive of the FSA. The Government expects this body's role to be twofold:

- to carry out preparatory work and analysis in advance of the creation of the permanent FPC. Primarily, this will comprise working with the Bank and the Treasury to analyse and develop the macro-prudential toolkit, particularly while potential tools are being discussed and developed in international forums. The interim FPC could, for example, report to the Treasury setting out its recommendations for the toolkit for the permanent FPC. The interim FPC could also undertake a cumulative impact assessment of proposed international reform.
- to undertake, as far as practical, the permanent body's macro-prudential role. The interim FPC will therefore begin the 'monitoring' aspect of the macro-prudential function. It will prepare and publish six-monthly Financial Stability Reports, setting out its analysis of the outlook for the financial sector and identifying risks to stability and suggested action to address them. In advance of legislation to create formal powers for the FPC, the Bank and the FSA will need to work and cooperate closely together within the interim FPC to discuss and agree any necessary action.

## **Legislation**

**7.12** The Queen's speech outlined that the Government would bring forward a Bill to reform the regulation of financial services and markets in this parliamentary session. The Government intends this to be in mid-2011. This legislation will implement the regulatory reforms outlined in this document.

**7.13** The content of the legislation will cover, at a minimum:

- the creation of the FPC, its objectives and governance arrangements;
- any related reforms to the governance of the Bank of England, including the removal from statute of the Bank's Financial Stability Committee (FSC);
- the creation of the PRA and the CPMA (along with their objectives and governance arrangements);
- assigning regulatory functions to the PRA and CPMA; and
- practical and transitional arrangements such as staff and property transfer.

**7.14** In order to minimise uncertainty for regulated firms the Government will seek to ensure the passage of the necessary primary legislation within two years.



# A Consultation questions and how to respond

## Consultation questions

### The Bank of England and Financial Policy Committee (FPC)

- 1 Should the FPC have a single, clear, unconstrained objective relating to financial stability and its macro-prudential role, or should its objective be supplemented with secondary factors?
- 2 If you support the idea of secondary factors, what types of factors should be applied to the FPC?
- 3 How should these factors be formulated in legislation – for example, as a list of ‘have regards’ as is currently the case in the Financial Services and Markets Act 2000 (FSMA), or as a set of secondary statutory objectives which the FPC must balance?

### Prudential regulation authority (PRA)

- 4 The Government welcomes respondents’ views on:
  - whether the PRA should have regard to the primary objectives of the CPMA and FPC;
  - whether some or all of the principles for good regulation currently set out in section 2 of FSMA, particularly those relating to good regulatory practice, should be retained for the PRA;
  - whether, specifically, the requirement to have regard to potential adverse impacts on innovation or the competitiveness of the UK financial services sector of regulatory action should be retained; and
  - whether there are any additional broader public interest considerations to which the PRA should have regard.
- 5 Is the model proposed in paragraph 3.16 – with each authority responsible for all decisions within their remit subject to financial stability considerations – appropriate, or would an integrated model (for example, giving one authority responsibility for authorisation and removal of permissions) be preferable?
- 6 Is the approach outlined in paragraph 3.17 to 3.23 for transfer of regulatory functions and rule making sufficient to enable the PRA to take a more risk-based, judgement-focussed approach to supervision?
- 7 Are safeguards on the PRA’s rule-making function required?
- 8 If safeguards are required, how should the current FSMA safeguards be streamlined?
- 9 The Government welcomes views on the measures proposed in paragraphs 3.28 to 3.41, which are designed to ensure that the operation of the PRA is transparent, operationally independent and accountable.

### **Consumer protection and markets authority (CPMA)**

- 10 The Government welcomes respondents' views on:
  - whether the CPMA should have regard to the stability of firms and the financial system as a whole, by reference to the primary objectives of the PRA and FPC;
  - whether some or all of the principles for good regulation currently set out in section 2 of FSMA should be retained for the CPMA, and if so, which;
  - whether, specifically, the requirement to have regard to potential adverse impacts on innovation or the competitiveness of the UK financial services sector of regulatory action should be retained; and
  - whether there are any additional broader public interest considerations to which the CPMA should have regard.
- 11 Are the accountability mechanisms proposed for the CPMA appropriate and sufficient for its role as an independent conduct regulator?
- 12 The Government welcomes views on the role and membership of the three proposed statutory panels for the CPMA.
- 13 The Government welcomes views on the proposed funding arrangements, in particular, the proposal that the CPMA will be the fee- and levy-collecting body for all regulatory authorities and associated bodies.
- 14 The Government welcomes views on the proposed alternative options for operating models for the FSCS.

### **Markets and infrastructure**

- 15 The Government welcomes views on the proposed division of responsibilities for markets and infrastructure regulation.
- 16 The Government welcomes views on the possible rationalisation of the FSMA regimes for regulating exchanges, trading platforms and clearing houses.
- 17 The Government would welcome views on whether the UKLA should be merged with the FRC, as a first step towards creating a companies regulator under BIS.
- 18 The Government would also welcome views on whether there are other aspects of financial market regulation which could be made more effective by being moved into the proposed new companies regulator.

### **Crisis management**

- 19 Do you have any overall comments on the arrangements for crisis management?
- 20 What further powers of heightened supervision should be made available to the PRA and the CPMA, and in particular would there be advantages to mandatory intervention, as described in paragraph 6.17?
- 21 What are your views about changes that may be required to enhance accountability within the SRR, as described in paragraphs 6.21 to 6.24?

### **Impact assessment**

- 22 Annex B contains a preliminary impact assessment for the Government's proposals. As set out in that document, the Government welcomes comments from respondents on the assumptions made about transitional and ongoing costs for all types of firm. In particular, comments are sought from all types and size of deposit-taking, insurance and investment banking firms (including credit unions and friendly societies), and from groups containing such firms.

## How to respond

**A.1** This paper is available on the Treasury website at [www.hm-treasury.gov.uk](http://www.hm-treasury.gov.uk). For hard copies, please use the contact details below.

**A.2** Responses are requested by 18 October 2010. The Government will also engage directly with relevant stakeholders ahead of this date.

**A.3** Please ensure that responses are sent in before the closing date. The Government cannot guarantee that responses received after this date will be considered.

**A.4** Responses can be sent by email to: [financial.reform@hmtreasury.gsi.gov.uk](mailto:financial.reform@hmtreasury.gsi.gov.uk)

**A.5** Alternatively, they can be posted to:

Financial Regulation Strategy  
HM Treasury  
1 Horse Guards Road  
London  
SW1A 2HQ

**A.6** When responding, please state whether you are doing so as an individual or on behalf of an organisation.

## Confidentiality

**A.7** Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes (these are primarily the Freedom of Information Act (FOIA), the Data Protection Act 1998 and the Environmental Information Regulations 2004).

**A.8** **If you want the information that you provide to be treated as confidential, do mark this clearly in your response.** However, please be aware that under the FOIA, there is a Statutory Code of Practice with which public authorities must comply and which deals, among other things, with obligations of confidence. In view of this, it would be helpful if you could explain why you regard the information you provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances.

**A.9** In the case of electronic responses, general confidentiality disclaimers that often appear at the bottom of emails will be disregarded unless and explicit request for confidentiality is made in the body of the response.

## Code of practice for written consultation

This consultation process is being conducted in line with the Code of Practice (<http://www.berr.gov.uk/files/file47158.pdf>) which sets down the following criteria:

- When to consult. Formal consultation should take place at a stage when there is scope to influence the policy outcome.
- Duration of consultation exercises. Consultations should normally last for at least 12 weeks with consideration given to longer timescales where feasible and sensible.
- Clarity of scope and impact. Consultation documents should be clear about the consultation process, what is being proposed, the scope to influence and the expected costs and benefits of the proposals.
- Accessibility of consultation exercises. Consultation exercises should be designed to be accessible to, and clearly targeted at, those people the exercise is intended to reach.
- The burden of consultation. Keeping the burden of consultation to a minimum is essential if consultations are to be effective and if consultees' buy-in to the process is to be obtained.
- Responsiveness of consultation exercises. Consultation responses should be analysed carefully and clear feedback should be provided to participants following the consultation.
- Capacity to consult. Officials running consultations should seek guidance in how to run an effective consultation exercise and share what they have learned from the experience.

If you feel that this consultation does not fulfil these criteria, please contact:

Isabel Summers  
Growth and Productivity Team  
HM Treasury  
1 Horse Guards Road  
London  
SW1A 2HQ



# B

## Preliminary impact assessment

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**B.1** The following pages contain the Government preliminary impact assessment for the proposals contained in this consultation paper.

<b>Title:</b> <b>A new approach to financial regulation</b> <b>Lead department or agency:</b> HM Treasury <b>Other departments or agencies:</b>	<b>Impact Assessment (IA)</b>
	<b>IA No:</b>
	<b>Date:</b> 26 July 2010
	<b>Stage:</b> Consultation
	<b>Source of intervention:</b> Domestic
	<b>Type of measure:</b> Primary legislation
	<b>Contact for enquiries:</b> financial.reform@hmtreasury.gsi.gov.uk

## Summary: Intervention and Options

**What is the problem under consideration? Why is government intervention necessary?**  
 The tripartite system of financial regulation failed to ensure financial stability - in particular by failing to identify the risk posed by the rapid and unsustainable increase in debt in the economy. This resulted in considerable economic costs in lost output and in a substantial deterioration in public finances. The regulatory system cannot be restructured without primary legislation.

**What are the policy objectives and the intended effects?**  
 The policy objective is to reform the regulatory system for financial services to avoid a repeat of the financial crisis. The legislation will create a Financial Policy Committee in the Bank of England to take charge of macro-prudential regulation. It will also replace the Financial Services Authority (FSA) with two properly focused regulators. A prudential regulation authority (PRA) (which will be a subsidiary of the Bank of England) will conduct the prudential regulation of deposit-takers, insurers and investment banks. A consumer protection and markets authority (CPMA) will be responsible for consumer protection in financial services and the regulation of conduct of business, including the conduct of firms supervised by the PRA and secondary market conduct more generally.

**What policy options have been considered? Please justify preferred option (further details in Evidence Base)**  
 This is a consultation stage impact assessment intended to provide an assessment of the Government's proposals for reform of financial regulation. The options considered are the "do nothing" option (i.e. not to proceed with the proposed reforms) and proceeding with the proposed reforms (the "proceed" option). There are a number of variants in the proceed option based on different allocations of particular FSA functions or regulated firms between the PRA and CPMA, or other bodies. These are not considered further at this stage. It is impossible to quantify the benefits of the proceed option in a realistic way. The main quantifiable costs are one-off transitional resource costs for: (1) the Treasury, Bank of England, FSA, CPMA and PRA in the public sector; and (2) for those firms which will be supervised both PRA and CPMA. There may also be some extra ongoing costs for firms and regulators. There should be no significant increase in costs for the majority of firms which will be supervised only by the CPMA. The benefits from reducing the frequency or severity of financial crises such as outweigh the additional resource costs.

<b>When will the policy be reviewed to establish its impact and the extent to which the policy objectives have been achieved?</b>	Not applicable
<b>Are there arrangements in place that will allow a systematic collection of monitoring information for future policy review?</b>	Not applicable

**SELECT SIGNATORY Sign-off** For consultation stage Impact Assessments:

***I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.***

Signed by the responsible Minister:  ..... Date:.....

# Summary: Analysis and Evidence

Policy Option: proceed

## Description:

Proceeding with proposed reforms

Price Base Year 2010	PV Base Year 2010	Time Period Years n/a	Net Benefit (Present Value (PV)) (£m)		
			Low:	High:	Best Estimate: N/A

COSTS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low			
High			
Best Estimate	See text	See text	See text

### Description and scale of key monetised costs by 'main affected groups'

Transition costs spread over 2-3 years for the Treasury, Bank of England, FSA, CPMA and PRA in setting up the new institutional arrangements.  
Transition costs, probably mainly in years 3 and 4 for firms supervised by PRA and CPMA in future. These will be estimated more accurately based on consultation responses.

### Other key non-monetised costs by 'main affected groups'

None

BENEFITS (£m)	Total Transition (Constant Price) Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low			
High			
Best Estimate			

### Description and scale of key monetised benefits by 'main affected groups'

Benefits cannot be monetised (see evidence base).

### Other key non-monetised benefits by 'main affected groups'

Reduction in frequency and severity of financial crises in the UK. This is a benefit for the UK economy as a whole rather than for specific groups. There may also be collateral benefits for the rest of the world.

### Key assumptions/sensitivities/risks

Discount rate (%) 3.5

The key assumptions for this assessment are those made for the non-quantifiable benefits of a reduction in the frequency and severity of financial crises. The main sensitivities in relation to quantifiable costs are that (1) the costs of (or time taken in) setting up the new regulatory arrangements are materially underestimated; and (2) that any additional ongoing costs of financial regulation incurred by the PRA or CPMA, or by regulated persons are materially underestimated. The risk that these underestimates could be large enough to outweigh the benefits is considered to be small.

Impact on admin burden (AB) (£m):			Impact on policy cost savings (£m):		In scope
New AB: N/A	AB savings: N/A	Net: N/A	Policy cost savings:		N/A

## Enforcement, Implementation and Wider Impacts

What is the geographic coverage of the policy/option?			United Kingdom		
From what date will the policy be implemented?			1 January 2013 (provisional)		
Which organisation(s) will enforce the policy?			Not applicable		
What is the annual change in enforcement cost (£m)?			Not applicable		
Does enforcement comply with Hampton principles?			Yes		
Does implementation go beyond minimum EU requirements?			N/A		
What is the CO <sub>2</sub> equivalent change in greenhouse gas emissions? (Million tonnes CO <sub>2</sub> equivalent)			Traded: N/A	Non-traded: N/A	
Does the proposal have an impact on competition?			No		
What proportion (%) of Total PV costs/benefits is directly attributable to primary legislation, if applicable?			Costs: 100	Benefits: 100	
Annual cost (£m) per organisation (excl. Transition) (Constant Price)	Micro	< 20	Small	Medium	Large
Are any of these organisations exempt?	No	No	No	No	No

## Specific Impact Tests: Checklist

Does your policy option/proposal have an impact on...?	Impact	Page ref within IA
<b>Statutory equality duties</b> <a href="#">Statutory Equality Duties Impact Test guidance</a>	No	N/A
<b>Economic impacts</b>		
Competition <a href="#">Competition Assessment Impact Test guidance</a>	No	6
Small firms <a href="#">Small Firms Impact Test guidance</a>	No	7
<b>Environmental impacts</b>		
Greenhouse gas assessment <a href="#">Greenhouse Gas Assessment Impact Test guidance</a>	No	N/A
Wider environmental issues <a href="#">Wider Environmental Issues Impact Test guidance</a>	No	N/A
<b>Social impacts</b>		
Health and well-being <a href="#">Health and Well-being Impact Test guidance</a>	No	N/A
Human rights <a href="#">Human Rights Impact Test guidance</a>	No	N/A
Justice system <a href="#">Justice Impact Test guidance</a>	No	N/A
Rural proofing <a href="#">Rural Proofing Impact Test guidance</a>	No	N/A
<b>Sustainable development</b> <a href="#">Sustainable Development Impact Test guidance</a>	No	N/A

# Evidence Base

## References

No.	Legislation or publication
1	Financial Secretary's statement to Parliament: 17 June 2010: Hansard (Commons) Col 1056
2	Financial Secretary's written ministerial statement: 26 July 2010.

## Annual profile of monetised costs and benefits\* - (£m) constant prices

	Y <sub>0</sub>	Y <sub>1</sub>	Y <sub>2</sub>	Y <sub>3</sub>	Y <sub>4</sub>	Y <sub>5</sub>	Y <sub>6</sub>	Y <sub>7</sub>	Y <sub>8</sub>	Y <sub>9</sub>
<b>Transition costs</b>										
<b>Annual recurring cost</b>										
<b>Total annual costs</b>	See main evidence base text below									
<b>Transition benefits</b>										
<b>Annual recurring benefits</b>										
<b>Total annual benefits</b>										

\* For non-monetised benefits please see summary pages and main evidence base text below

## Introduction

This section sets out the assumptions supporting this consultation stage impact assessment and sets out the information which is sought from consultees. The impact assessment should be read in conjunction with the rest of the consultation document. The Government would also welcome any general comments on the impact assessment.

## Problem under consideration/Rationale for intervention/Policy objective

The tripartite system of financial regulation failed to ensure financial stability in the UK in 2007 and 2008. As a result there was the longest and deepest recession since the Second World War and a record budget deficit. The policy objective is to reduce the frequency and severity of financial crises.

## Description of options considered

There are two options: "do nothing" and "proceed" with the proposed reforms. Within the proceed option there are number of variants mainly relating to the allocation of particular functions between the PRA and CPMA. These are not considered further in this impact assessment but may be examined in the final impact assessment, depending on the results of consultation.

In the proceed option:

- a new Financial Policy Committee will be established in the Bank of England to have responsibility for considering the macro-economic and financial issues that may threaten financial stability;
- the Bank of England will have responsibility for the regulation of settlement systems and central counterparty clearing houses to sit alongside its existing responsibilities for payment system oversight;
- a prudential regulation authority (PRA) will be established as a subsidiary of the Bank of England to have responsibility for the prudential regulation of deposit-takers, insurers and broker-dealers (investment banks);
- a consumer protection and markets authority (CPMA) will be established to have responsibility for consumer protection in financial services and for regulating conduct in financial services, including in relation to firms authorised and supervised by the PRA. A CPMA markets division will lead on market conduct regulation. The CPMA will also be responsible for the regulation (including prudential regulation) of all firms not regulated by the PRA, including most investment firms, investment exchanges and providers of trading facilities, and the provision of consumer credit.

The Government is also considering whether the UK Listing Authority (UKLA) should be merged with the Financial Reporting Council (FRC) under the Department for Business, Innovation & Skills, or whether it should remain within the CPMA markets division.

## **Costs and benefits of each option**

### *Introduction*

This impact assessment only covers two options: “do nothing” and “proceed”. The costs and benefits can be compared by taking the do nothing option as the base case and measuring the costs and benefits of the proceed option from there. The costs and benefits discussed below are the costs and benefits of the proceed option.

This approach is straightforward for assessing the benefits since they may be assumed to arise only in the proceed option.

For the purposes of assessing the costs solely of the proposed changes to the regulatory structure, it is assumed that no changes will be made to the rules etc of the regulatory bodies. This is an unrealistic assumption but it can be justified because:

- a) certain rule etc changes will take place regardless of any changes to regulatory structure. This is most obviously the case for changes made in order to implement changes made in EU law. The costs and benefits of these changes will therefore be the same in both the do nothing and the proceed options and may be ignored in the comparison of the two options;
- b) other rule changes will be the subject of cost benefit analysis before they are made and may be assumed to deliver positive net benefits. Assuming no rule changes are made therefore means that the costs of the proceed option are overstated.

### *Costs – Treasury, Bank of England, FSA, CPMA and PRA*

The transitional costs for the Treasury, Bank of England, FSA, CPMA and PRA are largely the additional resource costs of developing and bringing in the necessary primary and secondary legislation, and of implementing the reforms by administrative measures. Based on preliminary estimates from the bodies concerned, this is expected to be of the order of £50 million spread over about 3 years.

The ongoing costs of the reforms will be mainly resource costs incurred by the PRA and CPMA. These will differ in the proceed option from the costs the FSA would incur in the do nothing option for three reasons: (1) changes in supervisory practice by the new regulators; (2) improvements in operating efficiency because of increased specialisation in the new regulators; and (3) losses of economies of scale due to the need to duplicate certain fixed costs in the new regulators. Increased specialisation is unlikely to be a significant source of savings as the FSA is probably large enough to ensure that there is a critical mass in both areas relevant to the CPMA and PRA. Some loss of economies of scale due to duplication of fixed costs is inevitable but, as both the CPMA and the PRA should be large enough to ensure sufficient scale of operation in key areas, there should not be any substantial increases in ongoing costs. There should be no significant additional ongoing costs in respect of functions transferred to the Bank of England or arising from the Financial Policy Committee (FPC).

The FSA is working with the Bank of England to determine the most appropriate operating model for the new regulators and has appointed KPMG to do a value-for-money study. Changes in supervisory practice could increase or reduce costs.

There should be no additional ongoing costs for the Treasury itself in the proceed option once the reforms have been implemented.

The impact assessment therefore assumes that there will be no significant additional ongoing costs for the Treasury, Bank of England, CPMA and PRA overall after the reforms have been implemented.

### *Costs – regulated firms*

Most of the approximately 20,000 firms currently regulated by the FSA will be regulated solely by the CPMA after the reforms have been implemented. These firms are unlikely to suffer any significant transitional costs or significant increases in ongoing costs as a result of the reforms.

About 1,500 – 2,000 firms are likely to prudentially supervised by the PRA while also subject to conduct of business regulation by the CPMA. These firms are likely to incur transitional costs in making arrangements to deal with two regulators rather than one and may face higher ongoing costs.

There are about 100 – 200 groups containing both PRA and CPMA firms which may be affected in the same way as PRA firms by higher transitional or ongoing costs. The Government will also be considering whether to extend supervisory powers to cover currently unregulated holding companies and unregulated entities within the group structure of financial institutions such as banks and insurers.

Most PRA firms will be large banks, insurance companies and investment banks and it may be reasonable to assume that the effect on ongoing costs for these firms will be minimal. (Most groups which contain PRA firms are likely to be large or to contain large firms of these types.) Large firms or groups will already have significant regular interaction with the FSA on prudential and conduct of business matters and replacing that with regular interaction with separate regulators of prudential and conduct of business may not be great. On the other hand, these firms or groups are likely to incur more significant transitional costs in setting up systems to deal with both regulators.

As well as certain large firms, the PRA will also be responsible for prudentially supervising much smaller firms which take deposits or effect and carry out contracts of insurance. Almost all credit unions and some friendly societies and building societies would fall to be considered as small firms. These firms are likely to suffer some increase in ongoing costs as a result of having to deal with two regulators but the transitional costs seem likely to be relatively less.

**The Treasury would welcome comments from consultees on the assumptions made about transitional and ongoing costs for all types of firm. In particular, comments are sought from all types and size of deposit-taking, insurance and investment banking firms (including credit unions and friendly societies), and from groups containing such firms.**

### *Benefits*

In principle, the benefits can be estimated by calculating the change in the present value of the total expected welfare losses from financial crises due to the reduction in the frequency and severity of financial crises. In practice, any such estimates would be entirely dependent upon the assumptions made. As the Bank of England notes in its Financial Stability Report for June 2010: "History suggests, however, that financial crises have often been extremely costly, with significant output losses and scarring effects that permanently reduce the level of output. For example, the IMF estimate that output remains 10% below its pre-crisis trend seven years after the start of a typical systemic crisis. So even if the probability of crises can be reduced slightly, the potential gains would be large. And there might be additional welfare benefits deriving from greater stability in a regime with less frequent crises."<sup>1</sup> The Government considers therefore that the benefits of the proceed option are likely to outweigh the costs by a significant margin.

### **Risks and assumptions**

The principal assumptions are those relating to the costs and benefits of a financial crisis (see above). The main risks are (1) that the transitional costs (i.e. development and implementation costs) for regulatory bodies or firms are materially underestimated (including the risk that implementation takes longer than anticipated); and (2) that the ongoing costs for regulatory bodies and firms are materially underestimated. These are real risks but the Government considers that the margin of benefits over costs is such that it is most unlikely that the implementation costs could increase by the amount necessary to reverse the ranking of the proceed and do nothing options.

### **Administrative burden and policy savings calculations**

See costs and benefits of each option.

### **Wider impacts**

The Government does not consider that the proposed reforms will have any effect in relation to: race, disability and gender equality or in respect of any requirements relating to Northern Ireland; greenhouse gases, wider environmental issues, health and well-being, human rights, the justice system, rural proofing and sustainable development.

The principal effect on competition from financial services regulation is through the effect on barriers to entry into the industry. The Government does not envisage that the proposed reforms to regulatory structure will in themselves change the conditions which firms have to satisfy to obtain authorisation from a regulator but there may be higher costs in obtaining authorisation for firms that need to apply to the PRA as that body will also need to consult the CPMA on certain aspects of the application. The

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<sup>1</sup> Bank of England Financial Stability Report, June 2010, Box 7, page 58.

Government does not expect these costs to be significant and there would in any event be no effect upon the ability of EEA firms to enter the UK market using a “passport” from their home State regulator issued under the relevant EU Directives. The Government does not consider, therefore, that the proposed reforms will have any significant effect on competition.

Small firms which take deposits or effect or carry out contracts of insurance will be regulated by the PRA and CPMA. The proposed reforms are likely to have some effect on their costs (see above). Most small firms in the financial services industry are not deposit-takers or insurers and will be regulated by the CPMA in succession to the FSA. They are not likely to be materially affected by the proposed reforms.

### **Summary and preferred option with description of implementation plan**

The Government’s preferred option is to proceed with the proposed reforms. The main implementing measure will be primary legislation which is expected to be enacted in 2012. Secondary legislation and administrative measures (including action by the Bank of England and the FSA) will be needed to complete implementation which is assumed, for the purposes of this impact assessment, to be essentially completed by 1 January 2013.



## Annex 1: Post Implementation Review (PIR) Plan

A PIR should be undertaken, usually three to five years after implementation of the policy, but exceptionally a longer period may be more appropriate. A PIR should examine the extent to which the implemented regulations have achieved their objectives, assess their costs and benefits and identify whether they are having any unintended consequences. Please set out the PIR Plan as detailed below. If there is no plan to do a PIR please provide reasons below.

**Basis of the review:** The Government will consider arrangements for post-implementation review at a later stage.

**Review objective:**

**Review approach and rationale:**

**Baseline:**

**Success criteria:**

**Monitoring information arrangements:**

**Reasons for not planning a PIR:**







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