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A new approach to financial regulation:

securing stability, protecting consumers

Cm 8268

January 2012

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securing stability, protecting consumers

Presented to Parliament by
the Chancellor of the Exchequer
by Command of Her Majesty

January 2012

Cm 8268 £29.75

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This publication is also available on http://www.official-documents.gov.uk/

ISBN: 9780101826822
PU1259

Printed in the UK by The Stationery Office Limited on behalf of the Controller of Her Majesty's Stationery Office

Printed on paper containing 75% recycled fibre content minimum

ID P002474076 01/12

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Foreword

During the last decade Britain experienced a debt-fuelled boom that ended in financial crisis, recession and a debt overhang that is still holding back our economy. The crisis revealed fundamental flaws in our regulatory system, and in the structure of our banking sector. Regulators failed to spot the enormous imbalances building up and proved incapable of dealing with the crisis when it first broke. Huge global banks turned out to be "too big to fail" and as a result British taxpayers were forced to pump billions of pounds into the banking sector in order to prevent a financial meltdown. Consequently, reform of the financial sector has been one of this Government's key priorities since taking office in May 2010.

I am clear about the value of a thriving financial services industry to the UK. A healthy financial sector is a fundamental prerequisite for a successful modern economy. The City of London is the world's leading financial centre and it is in our interests that it remains as such. We should celebrate the links that are being built with major emerging economies, such as China, India and Brazil, which show that the UK continues to enhance its position as a global centre of expertise in financial services.

But the events of the financial crisis have shown what happens when things go wrong. The impact on the economies of the UK and its international partners in the G20 and beyond has been profound. Growth has been damaged. Confidence in the financial sector has been undermined and with ongoing problems in sovereign debt markets continuing to have an impact in the Eurozone, elements of the crisis are still playing themselves out. We should strive for global success in financial services, but we cannot live with an industry that puts the stability and the prosperity of the rest of our economy at risk.

To help resolve this dilemma in 2010 I set up the Independent Commission on Banking to look at how Britain can be home to one of the world's leading financial centres without exposing British taxpayers to the massive costs of those banks failing. The Commission has now reported, and the Government is fully committed to implementing its recommendations for a more stable and competitive UK banking sector.

But we are also committed to reform of the failed system of financial services regulation which contributed to the crisis. Over the past year and a half, the Government has consulted extensively, and Parliament has carried out pre-legislative scrutiny of our draft legislative proposals. We are now ready to bring forward our proposals to embed judgement, focus and accountability in the UK regulatory system, with the introduction of the Financial Services Bill into Parliament.

As well as our core reforms – to establish a new "macro-prudential" authority in the Bank of England, to bring responsibility for banking regulation back to the Bank of England, and to create a powerful new conduct regulator to protect consumers and promote competition – we are making two new announcements to strengthen the new regulatory system. In the aftermath of the financial crisis it became clear that that was no satisfactory answer to the question: "who is in charge?". So, as recommended by the Treasury Select Committee, we will create a targeted new power for the Treasury to ensure that Parliament and the public are in no doubt that the Chancellor is in charge when decisions are being made about whether and how to spend public money in a future financial crisis. We also want to provide greater protection to customers, so we will toughen up the regulation of consumer credit, including services such as "payday loans", by bringing them within the remit of the new Financial Conduct Authority.

Looking ahead, these proposals will be scrutinised – and no doubt improved – during the Bill's passage through Parliament. The Bank of England and Financial Services Authority will continue to carry out the practical planning and preparation needed to introduce the new system early next year. And the Government will continue to work with its international partners around the world, to make sure that action is being coordinated globally to strengthen the system as a whole.

We do not undertake these reforms lightly. This country is still dealing with the ramifications of the greatest banking crisis of our lifetime. However the introduction of this Bill is a major step forward in the implementation of the Government's reforms. With its progress we will help to create a dynamic, well-regulated financial sector, which is once again an asset, and not a threat, to the rest of our economy.

The Rt. Hon. George Osborne, MP
Chancellor of the Exchequer

27 January 2012

1 Introduction

1.1 Since May 2010, one of the Government's core priorities has been to tackle the difficult and dangerous legacy of the financial crisis that started in 2007. This has involved a comprehensive programme of initiatives, including:

- the program of domestic regulatory reform which is the subject of this policy document, and the Financial Services Bill which has now been introduced to Parliament;
- the creation of the Independent Commission on Banking (ICB), which has advised the Government on tackling the issue of banks that are too big to fail and the lack of competition in the banking sector, and the recommendations of which are now being carried forward in full by the Government;
- proactive and constructive diplomacy in European and international forums, to ensure that the global response to the financial crisis is effective and well-coordinated;
- the bank levy, to encourage banks to move to less risky funding profiles, and to ensure they make a fair and appropriate contribution to society, given the risks they pose;
- credit easing, to ensure that banks continue to lend to the economy and support the creation of jobs and economic growth; and
- the sale, in December 2011, of Northern Rock Plc to Virgin Money, representing an important step in returning public sector stakes in banks to the private sector, and creating a new credible competitor in the UK retail banking sector.

1.2 This is an ambitious programme, and much progress has already been made. However, the Government fully recognises that it cannot afford to be complacent, or to let up in its efforts to pursue reform. It is less than four years since two of the largest banks in the world had to be part-nationalised by the previous administration. The ongoing European debt crisis shows that the after-effects of the banking crisis are still being felt, and that significant financial disruption remains a clear and present threat. These factors continue to act as a brake on confidence and growth, both in the UK and abroad.

1.3 That is why it is important to maintain momentum and progress. The Government's recent response to the ICB report demonstrates its full commitment to fundamental and appropriate reform of the banking sector. The UK authorities – the Bank of England (the Bank) and Financial Services Authority (FSA), as well as the Government – continue to engage positively and constructively with their European and international partners. And the extensive consultation carried out by the Government on its proposals for domestic regulatory reform show that while it is fully committed to dealing quickly with the failings of the regulatory regime created by the previous administration, it is still taking the time to engage with stakeholders and Parliament to ensure that the reforms are effective and appropriate. To this end, the Government has:

- conducted three separate rounds of public consultation on its proposals for domestic regulatory reform;

- agreed to, and participated in, detailed pre-legislative scrutiny of a draft Bill for regulatory reform, conducted by the Joint Committee on the draft Financial Services Bill (the Joint Committee) from July to December last year; and
- given written and oral evidence to three separate Treasury Select Committee (TSC) enquiries into issues relating to regulatory reform.[1]

1.4 This latest document accompanies the introduction into Parliament of the Financial Services Bill. The document is structured into a series of substantive chapters, detailing the main changes the Government is making to the Bill. Annexes contain:

- the Government's formal responses to the Joint Committee's report on the draft Bill (published on 19 December 2011);
- the TSC's report on Bank of England governance and accountability (published last November);
- a summary of consultation responses received to the White Paper and draft Bill published in June 2011 (all consultation responses, except those where confidentiality has been requested, are separately published on the Treasury's website) and the updated impact assessment; and
- drafts of the memorandums of understanding on crisis management and international organisations which Parliament and stakeholders have asked to see during the course of the Bill's passage.

The new approach to financial regulation

1.5 Reflecting the broad degree of support it has received, the Government's proposed approach remains largely unchanged from the high-level model put forward in July 2010, shortly after the Government came to power.

1.6 The Government's primary objective in reforming financial regulation in the UK is to fundamentally strengthen the system by promoting the role of judgement and expertise. New regulatory bodies will be created, each with clarity of responsibility, a focused remit, appropriate tools and the flexibility to use them as they see fit. Tick-box compliance with rules has been shown to be of limited use as a model of supervision. Regulators must be empowered to look beyond compliance, to supervise proactively, and to challenge.

1.7 This is why the Government is pushing ahead with its plans to reform the UK system by:

- establishing a strong and expert macro-prudential authority, the Financial Policy Committee (FPC) within the Bank of England to monitor and respond to systemic risks;
- transferring responsibility for micro-prudential regulation of firms that manage complex risks on their balance sheets to a focused new regulator, the Prudential Regulation Authority (PRA), established as a subsidiary of the Bank of England; and

[1] In addition to its inquiries into preliminary consideration of the Government's proposals for regulatory reform (to which the Government responded in April 2011), and Bank of England accountability (to which the Government is formally responding in this document), the TSC has also conducted an inquiry into the FCA, which reported on 13 January. The conclusion of this inquiry came too late for the Government to take its recommendations into account in finalising its legislative proposals for introduction in the Financial Services Bill. However, the Government will consider the TSC's latest report in detail, and respond formally to the usual timetable. Should the Government consider it appropriate to bring forward any changes to its legislative proposals in response to the report, the Government will propose amendments to the Bill at an appropriate stage of its passage.

- providing for a focused new conduct of business regulator, the Financial Conduct Authority (FCA), to ensure that business across financial services and markets is conducted in a way that advances the interests of all users and participants.

1.8 A fundamental element of this programme of reform is returning responsibility to the Bank of England for regulating the stability of the financial system. As the UK's macro-prudential authority, the new FPC will be responsible for monitoring the financial sector for potential systemic risks, and responding with powerful macro-prudential tools, which will be provided to it by the Government and approved by Parliament.

1.9 Also in the Bank's group, the PRA will be responsible for regulating financial firms whose business activities require a significant degree of expert prudential supervision. Taken together, these two changes will return responsibility for the safety and soundness of the financial system to the institution – the Bank – with the experience, expertise and credibility to fulfil this vital function.

1.10 These changes will ensure that the failings of the previous Government's "tripartite" system for protecting financial stability – with its lack of clarity of responsibility for identifying and responding to emerging and crystallising risks so clearly exposed by the last crisis – are permanently fixed. A key part of this is that – building on its existing responsibilities for management of financial crisis, and particularly its role as resolution authority for banks in the special resolution regime established by the Banking Act 2009 – the Bank of England will be firmly in charge not only of preserving financial stability, but also leading the response when a crisis threatens stability.

1.11 As part of this clarification of responsibilities, the Government is also making sure that any decision involving the possible or actual use of public funds remains clearly and unequivocally the responsibility of the Chancellor of the Exchequer and the Treasury. This is vital to ensure appropriate democratic accountability for decisions involving taxpayers' money through the Government and Parliament. As detailed further below, and in the next chapter, to underline this point the Government has come forward with significant changes to its proposals for crisis management, responding positively to the recommendations of both the TSC and the Joint Committee. In particular, the Government is legislating to provide the Chancellor with a clear new power of direction over the Bank of England, which will be available during future crisis situations.

1.12 Alongside this focus on stability and prudential issues, the Government will establish the FCA as an integrated conduct of business regulator, dealing with issues ranging from consumer protection to market integrity, and with a clear mandate to tackle competition issues in the financial services sector. Creating a strong, proactive conduct regulator will be a crucial part of the Government's programme to establish a system of focused, expert regulators with the capability and credibility needed to place the exercise of judgement back at the core of financial regulation.

Fine-tuning the blueprint

1.13 As already noted, the Government's framework for financial regulation has proven fundamentally sound through multiple iterations of consultation and policy development over the past eighteen months and more. Nonetheless, changes have been made at each stage to improve the proposals in response to stakeholder feedback. This latest iteration is no exception. The Government has brought forward a number of significant changes as a result of the important work carried out by the Joint Committee and the TSC, as well as the continuing contributions of industry and consumer groups. This section summarises these developments.

1.14 As the Joint Committee notes in its report, regulatory practice and (in particular) culture are an extremely important component of reform, alongside the structural and institutional change being brought forward by the Government. The Government has been very clear that at the heart of its new approach is the principle that regulators must move to a more judgement-led and forward-looking model of supervising the financial sector, as opposed to box-ticking, compliance-led approach. As the Chancellor said when giving evidence to the TSC:

> "If I was to point to one principle behind the entire change we are making, it is that we would wish to emphasise more than was the case in the past the role of judgement in what is going to keep our system safe, competitive and prosperous."[2]

1.15 The Joint Committee focuses on three areas of the Government's proposals in making specific recommendations for changes to facilitate the cultural change identified as a priority:

- first, ensuring that all authorities have clear and focused statutory objectives;
- second, ensuring that they have the powers and responsibilities needed to fulfil those objectives effectively; and
- third, designing systems of accountability and engagement to ensure that the performance of the new authorities can be appropriately evaluated, and improvements made where necessary.

1.16 In each of these areas, the Government is making significant change in response to specific recommendations made by the Joint Committee. With respect to the **objectives** of the new authorities, the Government's key changes include:

- strengthening the requirement for the FPC to respond to the remit set for it by the Treasury;
- making specific changes to the objective of the FPC to clarify and expand upon key risks to financial stability which the new authority must take into account – the international and globally interconnected nature of the financial system;
- adopting significant changes to the strategic and operational objectives of the FCA to respond to two concerns of the Joint Committee (echoing the recommendations of the ICB). First, that the overall remit of the FCA should focus on making sure that financial services and markets that work well for those who use or participate in them; and second, that the FCA should have an operational objective to promote effective competition in financial services in the interests of consumers; and
- introducing stronger statutory provision to ensure that the responsibility of firms to their customers is appropriately recognised in legislation and the regulatory framework.

1.17 Regarding **responsibilities and powers**, among the changes the Government is bringing forward in response to the Joint Committee's recommendations are:

- providing the Chancellor with new powers to direct the Bank in financial crises where public money is at risk, as set out in more detail in the following chapter;
- adopting the suggestion of the Joint Committee that the PRA be placed under a clear duty to supervise firms, to underline its responsibility for carrying out forward-looking, judgement-led supervision;

[2] House of Lords, House of Commons – oral evidence taken before the Joint Committee on the draft Financial Services Bill (Tuesday 15 November 2011), question 1009. Available from www.parliament.uk

- provisions enabling the Government to transfer responsibility for regulation of consumer credit from the Office of Fair Trading to the FCA (subject to further consultation and impact assessment), to bring responsibility for protecting consumers of all financial services under a single regulator; and
- a firm commitment to make – and, as specifically recommended by the Joint Committee, consult upon – changes to the "threshold conditions" through which the PRA and FCA control entry and permit the ongoing operation of firms in financial services markets, to make them more useful as a supervisory tool, thus increasing the effectiveness of the new regulatory authorities.

1.18 On the question of **accountability**, changes being made by the Government in response to the Joint Committee include:

- adopting the TSC's recommendation that the term of Governor of the Bank of England is changed to a single eight-year term rather than two five-year terms;
- expanding the list of issues on which the regulators must regularly report to include engagement with stakeholders and coordination with European and international regulators;
- providing a single complaints scheme covering the PRA, FCA, and the Bank of England's regulatory functions – simplifying arrangements for firms and providing a mechanism that will bring regulatory coordination between the authorities into scope of the complaints regime;
- amendments to the Government's new system of reporting on regulatory failure, ensuring that such investigations can be effectively carried out without undermining ongoing enforcement or other regulatory action being carried out by the authorities; and
- adopting the Joint Committee's proposal to allow consumer groups to make "super-complaints" to the FCA on consumer issues, and receive a response from the FCA within 90 days.

1.19 The Government also notes that the Court of the Bank of England published its own response to the TSC's report on Bank accountability on 17 January. Court's response picks up on many of the suggestions made by the TSC, many endorsed by the Joint Committee, for radical changes to the Bank's own governance and accountability arrangements. Specifically, the Bank proposes to create an oversight committee for financial stability, made up entirely of non-executive members of Court. Court suggests that the oversight committee's remit should cover the entirety of the Bank's financial stability activities and members should have access to the meetings and papers of the Bank's policymaking committees, including the FPC. The oversight committee would also be able to commission periodic reviews of policymaking performance from expert external authorities.

1.20 On 23 January the TSC published a response to Court's proposals[3], in which it notes the importance of internal policy reviews, in addition to external assessments. The Chancellor has therefore agreed with the Governor and the Chair of Court that the oversight body will also be expected to commission retrospective internal reviews from the Bank's policymakers of policy-making and implementation performance – for example from the FPC, or from other parts of the Bank with responsibilities relevant to financial stability, such as infrastructure regulation or bank resolution.

[3] Treasury Select Committee, *Accountability of the Bank of England: Response from the Court of the Bank,* January 2012

1.21 To conclude, the above summary shows how seriously the Government has taken the recommendations of the Joint Committee, reflecting the importance of the scrutiny the Joint Committee has given to the draft Bill. The changes being made by the Government to the proposals it brought forward last June are detailed in full in the chapters that follow this introduction (and the full response of the Government to the Joint Committee can be found in Annex A).

Crisis management

1.22 One area of change which has received more attention than any other – understandably, given the failings of the current framework revealed by the financial crisis – has been crisis management. The TSC carried out a comprehensive review of this issue as part of its recent inquiry into accountability of the Bank, and made a number of important recommendations. The Joint Committee's report endorses the TSC's conclusion, and also calls upon the Government to implement these changes.

1.23 Chief amongst the recommendations made by the TSC is that the responsibility of the Chancellor and the Treasury for protecting public funds needs to be more clearly recognised in the statutory framework for crisis management. The draft Bill proposed a statutory framework for the Chancellor to safeguard public money in a crisis, through the duty on the Governor to notify the Chancellor once there is a material risk that public funds might be required in a crisis, and through the Treasury's power to veto resolution action proposed by the Bank where public funds are required. Nevertheless, the Government accepts that there would be benefit in enhancing statutory provisions to clarify and underline the Chancellor's primacy when it comes to the use of public money in a crisis.

1.24 Therefore, the Government has accepted the TSC's recommendation (which was backed up the Joint Committee) to establish a new targeted power of direction over the Bank of England, which the Chancellor may deploy following a notification by the Governor of a material risk to public funds. Although the Government does not consider it likely that this power would ever be needed in a crisis, it recognises the force of the argument that such a change will enhance accountability for the use of public money in a crisis by putting beyond legal question where ultimate responsibility lies – with the Chancellor and the Treasury, accountable to the wider public through Parliament.

1.25 The Government is also strengthening the responsibilities and accountability of the authorities in a crisis by accepting the Joint Committee's recommendation that the Bank and the Treasury should operate under a statutory duty to coordinate their action in a crisis management scenario. This duty, while recognising the separate and distinct responsibilities of each authority, provides statutory underpinning for the element of coordination which will be so important in ensuring that the response to a crisis is timely and effective.

1.26 Finally the Government is publishing the detail of how the Treasury and the Bank will work together during a crisis in a draft Memorandum of Understanding (which can be found at Annex E of this document).

The ICB and changes to the structure of the banking industry

1.27 The Joint Committee's report, in addition to considering the draft Financial Services Bill, also notes the findings of the ICB and makes specific recommendations in relation to Commission's findings.

1.28 The Government published its response to the ICB on 19 December last year, in which it broadly accepted the majority of the Commission's recommendations, including those on ring-fencing, loss-absorbency, resolvability (of banks and investment banks), competition, and the regulation of payment systems. The Government has also agreed to the ICB's recommended

implementation timetable, and will bring forward legislation in this Parliament, so that the measures will be in place by 2019.

1.29 Thus, recognising the crucial role played by banks in the economy, and recognising that the case for ensuring that banks no longer pose a risk to the stability and prosperity of the wider economy is stronger than ever, the Government is proposing the most far-reaching change to the structure of the banking system in modern history. The changes to the structure of banks, alongside measures to drive competition to ensure banks provide consumers and businesses with the best possible service and diverse range of financial products, will be a vital complement to the changes to the regulatory structure that are being introduced to Parliament in the Financial Services Bill.

The failure of RBS and the balance between risk and reward in banking

1.30 The FSA recently conducted a detailed inquiry into the failure of the Royal Bank of Scotland. Of all the firm failures that occurred during the banking crisis, RBS was perhaps the most significant. Not only did the Government have to provide £45.5bn of equity capital to the bank to avoid a catastrophic disorderly failure, but the risks being pursued by the bank's own management only months before its near-demise – most notably the acquisition of the Dutch bank ABN-AMRO – suggested unprecedented failures of both management and regulation.

1.31 The FSA's report was published on 12 December 2011, providing a comprehensive analysis of the mistakes that were made by the firm's management and the FSA's supervisors. But just as importantly, the report suggests two areas for significant further public debate, starting from the premise that banks, and the activities they undertake, are so important to the functioning of both the economy and society at large, that questions need to be asked about whether they should be subject to different regulatory standards than other types of private enterprise. The report poses two specific questions:

- whether the balance between risk and reward for the senior executives and managers of banks needs to be adjusted to take into account the wider impacts to which failings by such individuals can give rise; and
- whether the powers of the regulator need to include responsibility for pre-approving all significant merger and acquisition activity in the banking sector.

1.32 The Joint Committee, endorsing the findings of the RBS report, calls upon the Government to consider the first of these questions. The Government accepts this recommendation, and will be publishing a joint consultation document with the FSA later this spring, considering a wide range of possible measures. The Government will also consider the second of these recommendations further, working with the FSA and Bank of England.

Next steps

1.33 This package of reforms – with the new regulatory architecture at its core – is testament to the Government's commitment to learning the lessons of the financial crisis. The Financial Services Bill will now make its way through Parliament, and the Government is firmly committed to securing passage of the Bill by the end of 2012, so that the changes can be implemented early in 2013.

1.34 The FSA and the Bank of England are well advanced in preparing for implementation of the reforms. The FSA commenced the process of dividing its operations into separate prudential and conduct business units last April, and in the months following that milestone, the Bank and FSA published details of the approach that the two new regulatory authorities will each be taking to their new, more focused remits.

1.35 The Government and the Bank have also established an interim FPC which has met three times over the last seven months, and which is analysing current threats to financial stability – particularly those emerging from the Eurozone crisis – and making recommendations to strengthen the UK's financial sector in order to shield it from these risks. Looking further ahead, the interim FPC is also advising the Government on the macro-prudential toolkit which will be provided to the FPC once it is formally established. In line with both the TSC's and Joint Committee's concern that Parliament should have adequate time to scrutinise the proposed tools, the Government has committed to consulting publicly on this toolkit once the interim FPC has reported.

1.36 In summary, this document marks an important step in the Government's programme to reform the banking and financial services sectors. While it is therefore an important marker of progress, the Government recognises that it is just that – a milestone – and not the finish line. The Government remains resolutely committed to the hard work needed to fix the problems that gave rise to the financial crisis, for the benefit of the economy and society today and for generations to come.

2 Bank of England and Financial Policy Committee

2.1 The Financial Services Bill will bring together responsibility for all aspects of financial stability within the Bank of England group:

- the new Financial Policy Committee (FPC) will be responsible for macro-prudential oversight of the financial services system as a whole;
- the Prudential Regulation Authority (PRA) will be responsible for ensuring the safety and soundness of individual firms; and
- the Bank itself will be responsible for regulation of systemic infrastructure.

2.2 The Bank's expertise and experience of the financial sector will lead the creation of a new, judgement-led approach to safeguarding financial stability in the UK. Bringing financial stability under one roof will avoid the mistakes of the past, by ensuring that responsibility for identifying risks to stability – and more importantly, taking action to address those risks – cannot fall between different institutions.

2.3 Responses to the Government's proposals indicate that there is strong support for this approach, and in particular for the creation of the FPC. Both the Joint Committee on the Draft Financial Services Bill (the Joint Committee), and the Treasury Select Committee (TSC), broadly endorse the shape of the reforms. However, both Committees raise a number of specific questions on the detailed proposals, particularly in the areas of the role and powers of the FPC, crisis management, and the governance of the Bank.

2.4 This chapter describes the Government's responses to key questions that have been raised in relation to these matters. The Government's detailed responses to all of the Joint Committee's and TSC's recommendations can be found at Annexes A and B respectively.

Financial Policy Committee

The FPC's objective

2.5 As noted in the previous chapter, the Joint Committee argues that one of the key factors in determining the success of the new regime will be choosing the right objectives for the new authorities.[1] The Government agrees, and has emphasised the importance of clear, focused objectives throughout the development of these proposals. The FPC in particular will have wide-ranging influence across the sector and the regulators, so it is essential that its work is focused on the right outcomes.

2.6 The Government is clear that the current formulation of the FPC's objective, focusing on the importance of increasing the resilience of the financial sector and identifying and addressing systemic risks, represents a clear and credible approach. The Government notes that the Joint Committee has endorsed its view that an objective focused narrowly on the sustainable supply of credit would not be desirable, recognising that such a narrowly defined objective would

[1] House of Lords, House of Commons, *Report of the Joint Committee on the Draft Financial Services Bill*, December 2011,paragraph 27. Report available from www.parliament.uk

exclude many potential sources of financial instability, such as interconnections between firms, risks associated with activity taking place outside the perimeter of regulation, and structural risks.

2.7 While supporting the Government's general approach, the Joint Committee recommends two clarifications expanding upon the types of risk the FPC should focus on. The Government believes that the language in the draft Bill already covered the particular risks identified by the Joint Committee. However, in line with the Joint Committee's recommendation, the Bill has been amended to make this absolutely clear. Therefore:

- new section 9C (3) of the Bank of England Act 1998 (inserted by clause 3 of the Bill) now requires the FPC to look at "systemic risks attributable to structural features of financial markets, such as connections between financial institutions,". This language incorporates an explicit reference to the interconnected nature of the financial sector, as recommended by the Joint Committee; and
- new section 9C also makes clear that for the purposes of the definition of systemic risk it is immaterial whether the risks involved arise in the United Kingdom or elsewhere.

The FPC's remit

2.8 The draft Bill provided for the Treasury to set a remit for the FPC, in the form of recommendations about how the FPC should, in general, interpret and pursue its objective, or suggestions of other factors the FPC might consider in the exercise of its functions. In contrast to the Treasury's remit for the MPC, which is limited to defining the MPC's objective through the setting of a specific inflation target, the Treasury can go much wider in the remit it sets for the FPC, potentially making suggestions about how the FPC should fulfil its objective, or factors it should consider in pursuing that objective.

2.9 The Joint Committee recommends that "the draft Bill should be amended so that the Treasury, not the FPC, has the final say about the interpretation of the remit of the FPC"[2], and therefore that the Treasury's remit for the FPC should be binding. The Joint Committee argues that this is important for ensuring the FPC is accountable to Parliament through the Treasury.

2.10 The Government acknowledges the need for the FPC to be properly accountable to democratic institutions, but believes that this cannot be achieved unless there is absolute clarity about the FPC's responsibilities. The Government recognises that it is important to provide a mechanism for the Treasury to make recommendations to the FPC on how it pursues its objective; however, if the FPC was required in all cases to act in accordance with those recommendations, this would seriously compromise the independence of the FPC. Macro-prudential judgements are such that the FPC may need to make unpopular decisions – for example, to limit the availability of credit to address an unsustainable asset bubble. It is vital that such decisions can be taken independently of undue political influence; indeed, this is why the FPC has been given responsibility for macro-prudential supervision of financial services sector as an expert body in the Bank, independent of the Treasury.

2.11 However, the Government accepts that the FPC should not have complete discretion to disregard the Treasury's remit, and accepts the Joint Committee's suggestion (also proposed by the TSC) that where the FPC does not agree with the Treasury's recommendations, it should make its concerns public and explain why it does not intend to act in accordance with those recommendations. The Bill has therefore been amended to require the FPC to respond publicly to the Treasury's remit, setting out how it intends to comply with the recommendations and,

[2] *Report of the Joint Committee on the Draft Financial Services Bill,* paragraph 49

where appropriate, setting out its reasons why it does not intent to act in accordance with the remit.[3]

The FPC's macro-prudential powers

2.12 The interim FPC, established in February 2011, has been considering and evaluating potential macro-prudential instruments. In the record of its September meeting, the FPC gave its initial view on the permanent FPC's toolkit. The Committee "recognised that its understanding of how such instruments were likely to work would improve with experience" and "as such it was minded to recommend a relatively narrow initial set [of tools], which could then evolve over time"[4].

2.13 The Government welcomes the publication in December 2011 of a Bank discussion paper entitled *Instruments of macro-prudential policy*[5], which was approved by the FPC. The paper sets out and consults on the Bank and FSA's assessment of potential macro-prudential tools. The FPC will report to the Treasury after its first meeting in 2012, scheduled for 16 March, on its recommendations for the tools that should be included in the permanent FPC's toolkit.

2.14 The Government agrees with the Joint Committee that "the macro-prudential tools to be used by the FPC are of considerable importance" and recognises the need for Parliament to have sufficient opportunity to scrutinise proposals for the FPC's toolkit. The Government therefore intends to consult publicly on its proposals for the FPC's initial set of policy tools, before the order is laid in Parliament for approval by both Houses. Once the FPC has been provided with its first toolkit, it will also be vital that the FPC explain publicly how it intends to use those tools and what impact it would expect them to have. The Government has therefore amended the legislation so that new section 9L of the Bank of England Act 1998 (as inserted by clause 3 of the Bill) requires the Bank to maintain a statement of policy for all its macro-prudential tools, except where the FPC needs to use a tool for the first time as a matter of urgency.

FPC's access to information

2.15 In order to fully identify emerging risks to the stability of the financial sector, the FPC may, on occasion, need information from firms outside the regulatory perimeter. The draft Bill contained a power for the FPC to obtain this information through the PRA. Should the PRA not already have access to the firms or class of firms in question, the FPC would be able to recommend to the Treasury that the PRA's powers be extended. The Treasury could then extend the PRA's powers as requested, subject to the actions of the firms in question posing or being likely to pose "a serious threat to the stability of the UK financial system"[6]

2.16 The Joint Committee is concerned that this route for the FPC to access such information may be unduly slow and cumbersome. It therefore recommends that "the FPC should be given a reserve power if it thinks that requesting the information indirectly through the PRA could cause delay or have adverse consequences."[7]

2.17 The Government recognises that there is a possibility that the process set out in the draft Bill may cause difficulties. In particular, it may not be possible to ascertain quickly that the test for extending the powers of the PRA has been met. In order to ensure that the FPC can have access to the information it needs more quickly if necessary, the Bill has been amended to ensure that the Treasury is able to extend the PRA's information-gathering powers to new

[3] New section 9D of the Bank of England Act 1998, as inserted by clause 3 of the Bill

[4] Record available from www.bankofengland.co.uk

[5] Available from www.bankofengland.co.uk

[6] see paragraph 4, Schedule 12 of the Bill

[7] *Report of the Joint Committee on the Draft Financial Services Bill,* paragraph 148

activities or classes of firm once the FPC has advised the Treasury that the information is desirable for the exercise of its functions[8].

Crisis management

2.18 The new regulatory structure, alongside other reforms such as the Government's implementation of the recommendations of the Independent Commission on Banking, will reduce the frequency and severity of financial crises. But this risk cannot be eradicated entirely, and it is essential that when serious threats emerge, the Bank and the Treasury work together in a coordinated way to safeguard financial stability and protect public money.

2.19 The Government believes that the design of arrangements for managing financial crises should be guided by three fundamental principles:

- first, clarity of responsibilities, so that at all times it must be absolutely clear which authority is responsible for which decisions and actions;
- second, that the Chancellor is solely responsible for any use of public funds and must have the necessary powers to fulfil this responsibility; and
- third, that the arrangements must ensure that there are no surprises for either institution: notifications, information and decisions must be communicated in good time to allow the other institution to consider, respond and implement decisions where necessary.

2.20 As detailed in the White Paper and draft Bill published last June, and in line with the principle of clarity of responsibility, the Bank will have primary operational responsibility for financial crisis management. The Bank, together with the PRA, will be responsible for identification of threats to financial stability, and developing and implementing a response to those threats.

2.21 Responsibility for any decisions requiring the use of public funds will fall to the Chancellor. Once it is clear that public funds may be put at risk, the Governor will have a statutory duty to notify the Chancellor. A crisis management Memorandum of Understanding (MOU) will underpin this process, setting out how the decision to notify will be made, and the steps that will be taken by both the Bank and the Treasury to resolve the threat.

2.22 A draft of the crisis management MOU is published at Annex E, providing much more detail on how the relationship between the Treasury and the Bank is expected to operate where there is a risk to public funds. The Government, however, recognises that the TSC and the Joint Committee have expressed concerns that the arrangements set out last June may need strengthening.

2.23 The Government has therefore accepted the Joint Committee's recommendation that "a duty for these bodies to co-ordinate in a crisis should be on the face of the Bill"[9].The Government agrees that a statutory duty to coordinate, sitting alongside the statutory crisis MOU, will be a helpful clarification, and has amended the Bill introduced to Parliament accordingly. As a result, the Bank and the Treasury will be required to coordinate the exercise of their respective functions which relate to the stability of the UK financial system and which affect the public interest. The duty places a particular emphasis on coordination where the Governor has notified the Chancellor of a risk to public funds.[10]

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[8] New section 9O of the Bank of England Act, as inserted by Clause 3 of the Bill

[9] *Report of the Joint Committee on the Draft Financial Services Bill,* paragraph 140

[10] Clause 60 of the Bill

2.24 Linked to the need for the Bank and the Treasury to work effectively together during a crisis is the need for clear lines of responsibility and accountability, particularly democratic accountability, for decisions involving the use of public funds. Both the TSC and the Joint Committee have recommended that the Chancellor should have the power to direct the Bank when public money is at risk. The Joint Committee argues that this should be an automatic power "to direct the Bank after a formal warning of material risk to public funds"[11].

2.25 The Government agrees that a limited statutory power of direction for the Chancellor over the Bank in a time of financial crisis would be helpful in clarifying lines of responsibility and accountability. The Government concurs with both the TSC and the Joint Committee that the availability of the power should be linked directly to a notification of a risk to public funds. Therefore, the Bill now includes a power for the Treasury to direct the Bank to take action using its two primary tools for managing financial crises: the provision by the Bank of liquidity support (either liquidity assistance provided to individual financial institutions, or support offered to all firms. The power does not cover ordinary market assistance offered by the Bank on its usual terms) and the exercise by the Bank of its powers under the special resolution regime. Once a notification of a risk to public funds has been made by the Governor, the power will be available when there is a serious threat to financial stability, or when public funds have already been employed to resolve a threat to stability.[12]

2.26 This means that the Chancellor will have a power of direction when there is a real risk to the public purse, but that the Bank will continue to have operational autonomy when managing threats to stability in which public funds are not at risk. The Government agrees with the TSC's assessment that the Chancellor might well choose not to use the power. Indeed in most cases we would expect the coordination arrangements set out in the draft MOU to deliver the optimal result, both for stability and public funds, without the need for any direction to be made. The new power of direction therefore provides a backstop mechanism to ensure that in all cases the Chancellor has the ability to fulfil his ultimate responsibility for protecting taxpayers' money.

Bank of England governance

2.27 The Government recognises that the proposed new structure for financial regulation places a great deal of additional responsibility within the Bank of England. This has the potential to stretch the Bank of England's current governance structures and capacity of senior management. Both the TSC and the Joint Committee, as well as respondents to the June 2011 public consultation have made a number of suggestions aimed at strengthening the governance of the Bank. In particular, the TSC suggests the creation of a "supervisory board" with the ability to carry out retrospective policy reviews of the Bank's performance, where appropriate.

2.28 The Government agrees with the TSC that the current situation, whereby the Governor is subject to reappointment for a second five-year term, creates a risk of "instability and at least the perception of political interference in the Bank". As the Chancellor made clear in his evidence to the TSC in July 2011, the Government believes that the independence of the Governor of the Bank of England is vital. The Government has therefore amended the legislation to move the Governor to a single eight-year term, as recommended by the TSC.[13]

2.29 With respect to changes to structures of governance, the Court of the Bank of England published its response to the TSC's recommendations on 17 January, and the Government is pleased to note the positive and constructive approach the Court has taken to engaging with the TSC's report.[14] Court's model proposes the creation of an oversight committee for financial

[11] *Report of the Joint Committee on the Draft Financial Services Bill,* paragraph 143

[12] Clause 57 of the Bill

[13] Treasury Select Committee, *Accountability of the Bank of England,* November 2011 paragraph 143.

[14] This document is available from www.bankofengland.co.uk

stability, made up entirely of non-executive members of Court. The oversight committee's remit would cover the entirety of the Bank's financial stability activities and members would have access to the meetings and papers of the Bank's policy-making committees, including the FPC. In addition to conducting its own scrutiny of the processes and information used by the Bank and its committees to reach and implement their policy decisions, the oversight committee would also be expected to commission periodic or ad-hoc retrospective reviews of policy-making and implementation performance from expert external authorities – such as the International Monetary Fund (IMF).

2.30 On 23 January the TSC published a response to Court's proposals[15], in which it notes the importance of internal policy reviews, in addition to external assessments. The Chancellor has therefore agreed with the Governor and the Chair of Court that the oversight body will also be expected to commission retrospective internal reviews from the Bank's policymakers of policy-making and implementation performance – for example from the FPC, or from other parts of the Bank with responsibilities relevant to financial stability, such as infrastructure regulation or bank resolution. The oversight body will be responsible for setting the terms of reference of the reviews and ensuring that they are conducted properly and effectively, for publishing their findings and for ensuring that the conclusions are followed up.

2.31 The Government will consider how best to take forward these proposals for strengthening Bank governance, including what legislative provision may be necessary.

[15] Treasury Select Committee, *Accountability of the Bank of England: Response from the Court of the Bank,* January 2012

3 Prudential Regulation Authority

3.1 The provision of some financial services inherently involves the assumption of risk by their providers. Such risk must be properly managed if the services these firms provide are to fulfil their role as an important enabler of growth in the economy. However, a key lesson from the financial crisis was that these firms – and, crucially, their regulators – failed to understand and mitigate these prudential risks properly.

3.2 That is why the Government is establishing a new, specialised, expert regulator to address these failings. The Prudential Regulation Authority (PRA), established as a subsidiary of the Bank of England, will therefore be responsible for the prudential regulation of firms which manage significant risks on their balance sheet.

A new regulatory culture and approach

3.3 New structures and institutions – such as the PRA – are a key element of the Government's response to the failings of the current regulatory system. The Government also recognises the importance of creating a new regulatory culture in driving improvement – a point that has been emphasised in the Joint Committee's report. As the Government has made clear in previous consultation documents, the box-ticking approach to financial regulation in the run-up to the financial crisis failed. The new regulators must be empowered to use their judgement to examine firms' business models and determine their viability, not just in the present, but with a view to future risks.

3.4 The Joint Committee's report endorses, in a number of areas, the approach the Government is taking to this issue with respect to both the PRA and the new Financial Conduct Authority (FCA). The Government particularly welcomes the Joint Committee's support for measures included in the Bill to bring about a more judgement-led approach to regulation. For example the Committee welcomes the proposal in the draft Bill that remedies to the Upper Tribunal on appeal against certain regulatory decisions be limited, to prevent the Tribunal being able to undermine the judgement of the regulators.

3.5 The Joint Committee also suggests a number of changes to the legislation to further support the creation of a judgement-led culture and approach. The Government has accepted many of these recommendations, as detailed below.

3.6 First, the Joint Committee recommends that "the Bill should be amended to place a duty on the PRA to supervise firms" to provide an explicit legislative marker for the responsibility of the new regulator to carry out its supervisory role, in a way that goes beyond monitoring of compliance with requirements.

3.7 The Government agrees with this recommendation. The PRA should be explicitly empowered and required to go further than making rules and ensuring that authorised persons comply with them. Giving the PRA a specific "duty to supervise" will ensure an enduring statutory commitment for the PRA to take a judgement-led approach to supervising individual firms through engagement, scrutiny of business models, and forward-looking assessments of risk. It

will allow the PRA's supervisors to exercise judgement on aspects of a firm's business that affect safety and soundness, and to take action where they are of concern. The requirement on the PRA to maintain arrangements for the supervision of PRA-authorised persons delivers this.[1]

3.8 The Joint Committee also notes that the judgement-led approach could be further strengthened by reviewing the threshold conditions, which are the requirements that firms must meet in order to be authorised for business.[2]

3.9 The Government recognises that there is some scope for clarifying the threshold conditions to make their purpose clearer, and to ensure that the regulators can look at matters that are relevant to consideration of a firm's fitness to be an authorised person. The Government also notes, however, the Joint Committee's concerns that a radical overhaul of the threshold conditions would be a complex and potentially disruptive change. The Government has therefore taken into account the Joint Committee's balanced recommendations – to consider using the threshold conditions to empower judgement-led supervision on the one hand, while being mindful of the need to avoid potentially disruptive and inflexible change.

3.10 The Government will therefore conduct a detailed and comprehensive review of the threshold conditions before making any changes. FSMA already contains powers for the Treasury to add additional threshold conditions or amend the existing threshold conditions. The Bill extends this power to enable the Treasury to modify the existing threshold conditions to provide clear and separate sets for the PRA and FCA, and to add additional conditions if needed. The Government will consult on a draft Order implementing these changes during the passage of the Bill. The Government is therefore removing from the Bill those provisions included in the draft Bill which made specific amendments to the threshold conditions. These changes will be considered as part of the proposed review, and the changes brought forward in the Order.

3.11 This approach meets the Joint Committee's concern that any fundamental change should be subject to consultation. Box 3A sets out in high level terms the Government's initial thinking on how the threshold conditions may be divided between the PRA and FCA, and the additional matters that may be included in the new conditions, subject to consultation with industry and the wider public.

3.12 The Government also agrees that there would be merit in providing a mechanism for the regulators to set out in more detail what is required of firms to meet the threshold conditions. The Bill therefore provides the PRA and FCA with a power to make "threshold condition codes", which will elaborate on the conditions and how they will apply to different classes of firm. These codes will be stronger than the existing statutory guidance issued by the FSA, in that they will be binding on firms. This will mean, for example, that the regulators will be able to vary firms' permissions on their own initiative by reference to the codes. This will allow additional detail regarding the requirements expected of different types of regulated firm can be set out, providing firms with useful information on how the new authorities will be applying their judgement in determining the requirements for entry into, and continued operation in, the financial sector.

3.13 The Joint Committee also recommends that the new regulators, once established, should seek to provide clarity to firms on what their new approach will entail. The Government agrees with this recommendation and is encouraged by the work that has already been carried out in this area with the joint publication of approach documents for the PRA and FCA by the Bank of England and FSA. The approach documents have already started to provide firms with a clear

[1] New section 2J of FSMA, inserted by clause 5 of the Bill

[2] The threshold conditions are currently set out in Schedule 6 of the Financial Services and Markets Act 2000 (FSMA)

idea of what will be expected of them and this will be articulated further through the transition period.

Box 3.A: Dividing the threshold conditions

The Treasury will consult on a draft Order dividing the existing threshold conditions between the two regulators, and making any necessary clarifications or additions. For dual-regulated firms, the intention is that PRA will assess matters that are relevant for prudential purposes, in particular:

- whether the institution is capable of conducting itself prudently, including whether it has adequate financial resources, and whether it maintains adequate and appropriate non-financial resources to measure, manage and mitigate the prudential risk to the institution (or related persons) and to enable the institution to comply with the prudential duties imposed on it under FSMA;
- whether the institution is capable of being supervised effectively by the PRA, including whether any close links are likely to prevent effective prudential supervision.
- whether the business of the institution is carried on in a fit and proper manner including with integrity and the appropriate level of professional skills; and
- whether the institution complies with provisions about legal status and location of offices carried forward from the existing threshold conditions in FSMA.

For dual-regulated firms, the FCA will assess matters of particular relevance to the conduct of the firm, in particular :

- whether the institution has the capacity and resources to comply with conduct requirements imposed on it by or under FSMA;
- whether the person is capable of being supervised effectively by the FCA, including whether any close links are likely to prevent effective conduct supervision, and the person's vulnerability to being used for the purposes of financial crime;
- whether the business of the institution is carried on in a fit and proper manner, including with integrity and the appropriate level of professional skills; and
- for insurers, whether the institution complies with provisions about the appointment of claims representatives, carried forward from the existing threshold conditions in FSMA.

For firms that are subject to prudential and conduct regulation by the FCA, there will be a single set of threshold conditions, as now. The Treasury will also consider making further changes to allow the regulators to consider additional factors. In particular:

- in assessing whether the firm can be supervised effectively, both the PRA and FCA should take into account whether an institution is open and co-operative in its dealings with the regulators, including its willingness to provide the regulator with information;
- both PRA and FCA should consider whether the institution's business model gives rise to an unacceptable risk to their own objectives; and
- the PRA should consider the extent to which the institution is resolvable – i.e. the effect that its failure might be expected to have on the stability of the UK financial system.

3.14 The Government also agrees with the Joint Committee, and many respondents to the June consultation, that the calibre of staff will be absolutely critical in ensuring that the shift to a judgement-led approach is successfully achieved. The Bank and the FSA will, as part of the transition, publish further details on how they intend to build on their existing capabilities in order to recruit and retain the people needed to deliver the new approach.

The PRA's objectives

3.15 The Joint Committee notes the importance of statutory objectives in supporting the change in culture and approach. The Joint Committee recommended that a secondary "micro-prudential" objective be given to the PRA, which should be to reduce the potential costs of failure to the Financial Services Compensation Scheme (FSCS), taxpayer funds, and customers.

3.16 The Government acknowledges there may be some attractions to reframing the objective in terms of specific outcomes, as the Committee has suggested. However, this approach also creates a number of difficulties. For example, whether the failure of a firm results in a call on public funds will depend to an extent on the actions of the government of the day in taking a decision to nationalise or recapitalise a failing institution. In some circumstances, the failure of a firm followed by large FSCS payout may the best way of protecting depositors and taxpayers while maintaining market discipline. On balance, the Government believes that it is more appropriate to frame the objective more broadly, requiring the PRA to focus on the regulation of the safety and soundness of individual firms, so as to improve financial stability. This objective gives the PRA a clear mandate to intervene to ensure that firms address possible solvency and systemic risks for the benefit of all interested parties – customers, the financial system, and the economy as a whole – while ensuring that firms are also prepared for their own orderly failure, should they run into difficulty.

The insurance objective

3.17 The insurance objective for the PRA was strongly supported by a range of respondents to the June consultation, including from insurance companies and their representatives. The draft Bill supplemented the insurance objective with a provision that made it clear that, in relation to the regulation of "with profits" policies, it was the PRA which will be responsible for ensuring that the reasonable expectations of policyholders were protected. The principle behind this provision (that in relation to "with profits" policies there should be a single regulator with responsibility for balancing the interests of policyholders against the need to preserve the safety and soundness of the firm) was broadly welcomed.

3.18 The Joint Committee recommends that the phrase "reasonable expectations" of policyholders be replaced. The Government agrees with this recommendation and has adjusted the Bill to focus on "decisions by insurers relating to the making of payments under with-profits policies at the discretion of the insurer (including decisions affecting the amount, timing or distribution of such payments or the entitlement to future payments)".[3]

3.19 Recognising also the Joint Committee's recommendation that, in the regulation of providers of "with profits" policies, the PRA should be required to draw on the expertise of the FCA on consumer issues, the Bill requires the FCA and PRA to enter into and maintain arrangements for the FCA to provide the PRA with information and advice in connection with the regulation of "with profits" policies.

[3] New section 3F of FSMA as inserted by clause 5 of the Bill

The PRA's scope

3.20 In previous consultation documents, the Government has made clear its expectation that the PRA should focus its supervision of investment firms on those entities likely to cause systemic risk (or risk to PRA authorised persons) directly through their disorderly failure, and that the FCA should conduct prudential supervision of the majority of investment firms.

3.21 The Joint Committee raises the question of whether the PRA's scope should extend to investment firms who do not pose stability risks as individual firms but could be "systemic as a herd", including those investment firms conducting "rehypothecation" of their client's assets. The Government agrees that the risks posed by investment firms (including what is often referred to as the "shadow banking" sector) and the issues arising from the MF Global failure should continue to be subject to scrutiny by the authorities. The Government, the Bank, and the FSA will continue to work on this issue. There is also a role for the interim Financial Policy Committee, which has a mandate to advise the Government on issues relating to financial stability and the regulatory perimeter. However, no change has been made to the provisions of the Bill, as the legal framework already provides sufficient flexibility for changes to be made through secondary legislation – including the Regulated Activities Order[4], and the Order to be made under new section 22A (designation of activities requiring prudential regulation by the PRA), which permits changes to be made to the boundary between PRA and FCA regulation of firms dealing in investments as principal.

3.22 A draft of this designation Order is published on the Treasury's website, as recommended by the Joint Committee. The Order sets out the criteria which the PRA will apply when considering whether it should designate individual firms dealing in investment as principal for PRA regulation:

- the applicant must hold or be seeking to hold permission to deal in investment as principal; and
- the applicant must be required to have initial capital of at least €730k (a level defined in the Capital Adequacy Directives), which has the effect of excluding smaller investment firms.

3.23 In considering its decision to designate, the PRA must also have regard to additional criteria:

- the size of the investment firm. Where the value of the firm's assets is above a specified threshold, the PRA will normally designate the firm;
- whether the investment firm's activities could impact on the safety and soundness of other PRA-authorised entities in the group. To understand this, the PRA would undertake an analysis of the materiality of the firm's activities to the group; and
- the PRA will be able to look at investment firms in the group as a whole, so that a group cannot avoid designation of an investment firm by establishing several eligible investment firms that individually fall below the total asset threshold, but which in aggregate are above the threshold.

3.24 The decision to designate will involve the exercise of judgment. For example, a firm might only meet the designation criteria because of temporary factors. The PRA will consider periodically, or in response to a merger or acquisition, whether the conditions for designation are satisfied. To guard against "designation volatility", the criteria will be applied based on an

[4] The Regulated Activities Order is made by the Treasury in exercise of the powers conferred on them by sections 22(1) and (5), 426 and 428(3) of, and paragraph 25 of Schedule 2 to, the Financial Services and Markets Act 2000.

average value of assets over a specified period of time. Where the investment firm does satisfy the criteria and is designated, there will be a minimum period over which it will remain supervised by the PRA.

3.25 As required by the designation Order, the PRA will consult the FCA before designating an investment firm.

3.26 The Government agrees with the Joint Committee about the importance of the designation Order. Accordingly the Bill has been amended to make alterations to the Order subject to the affirmative procedure, to allow for enhanced Parliamentary scrutiny. The Bank of England and FSA will in due course publish further detail on how the PRA will interpret this Order when designating firms.

Holding companies

3.27 The draft Bill provided the regulator with a power of direction over financial holding companies which can be extended to non-financial holding companies by order, if necessary. The Joint Committee recommends that the Government provide the PRA with more comprehensive powers in regulating holding companies to ensure a consistent regulatory approach. The regulation of holding companies is currently being considered as part of the European Commission's fundamental review of the Financial Conglomerates Directive. The Government is actively involved in this process, given the particular issues around regulation of firms and holding companies across different national and supranational jurisdictions. Notwithstanding the importance of these European developments, the Government recognises the Joint Committee's concerns in this area and has bolstered the PRA's powers in relation to holding companies by strengthening supervisors' powers to monitor emerging risks at the holding company level, including:

- providing a new power for the PRA (and FCA) to make rules requiring classes of parent undertakings of authorised persons (the same as those subject to the power of direction) to provide information on a regular basis;
- widening the trigger for use of the power of direction, to enable the regulator to act in instances where it considers that acts or omissions of the parent undertaking are having or may have a material adverse effect on the effectiveness of consolidated supervision; and
- providing an enforcement mechanism for the power of direction that enables the regulator to issue a statement of censure or to fine where the parent undertaking fails to comply with the requirement (and aligning the enforcement of the power of direction with enforcement of own-initiative variation of permission).

Transparency and engagement

3.28 The draft Bill provided that the PRA should establish arrangements for engaging with and consulting practitioners, giving the PRA a degree of flexibility on how it chooses to fulfil the requirement. These arrangements will help the PRA to regulate more effectively, providing a channel to industry for the regulator to obtain information and analysis to feed into its own.

3.29 The Joint Committee agrees that this is the right approach for the PRA, and also recommend that the PRA should be required to report annually on its consultation activities. The Government welcomes the Joint Committee's endorsement of its proposals in this area, while noting its emphasis on the importance of ensuring that the arrangements the PRA establishes for consulting practitioners are transparent. The Government has therefore amended the Bill to include a requirement for the PRA to report annually on its consultation activities as part of its annual report.

3.30 The Joint Committee also recommends that the PRA's proposed consultation arrangements should be made available alongside scrutiny of the Bill in Parliament. The Government has therefore asked the Bank of England and FSA to provide a note in time for the Committee stage of the Bill, which will placed in the libraries of both Houses.

Complaints

3.31 The draft Bill published in June provided for the PRA to make suitable arrangements for the investigation of complaints and required the Bank of England to appoint an independent investigator. The Joint Committee suggests that these arrangements did not go far enough in providing a sufficiently independent complaints system and there should be a single complaints system with a single complaints commissioner, covering both the FCA and PRA.

3.32 The Government recognises the force of the Committee's recommendation, which is consistent with a number of responses received on this issue in various consultations. The Bill therefore provides for an independent complaints system with a single complaints commissioner and system operating across both the FCA and PRA. This reflects the Government's commitment to openness and transparency for the new regulators, and will ensure consistent investigation of complaints involving both regulators – including, as highlighted by the Joint Committee, possible complaints about the coordination arrangements between the FCA and PRA. This arrangement is also likely to be more cost effective than establishing and running two separate complaint systems. The external complaints scheme will also cover the Bank of England's regulatory functions in relation to recognised clearing houses and payment systems.

Mutuals

3.33 The Government remains strongly committed to the mutuals sector. Currently the FSA has responsibilities for mutuals under separate legislation from FSMA, covering building societies, credit unions, friendly societies, and industrial and provident societies. These responsibilities will be transferred to both the PRA and the FCA. The Government is therefore making the necessary amendments to the various pieces of legislation, has published a draft Mutuals Order[5] and will publish a consultation paper later this year in order to gather views from industry and the wider public on the policy approach and detail of the Order. For example, views will be sought on the balance of responsibilities between the PRA and FCA. The Government is also considering whether the PRA's objectives should be applied to its functions under mutuals legislation, and will consult on this as well. The draft Mutuals Order has been published with the PRA objective applied.

3.34 In principle, the remits will be split so that the PRA will be responsible for significant areas of prudential safety and soundness, enforcement of PRA-related offences, and where it is required to provide expert judgement. The FCA will be responsible for the other provisions, including those related to registration, the register and the public file, enforcement of non-PRA related offences, and the majority of those related to administering the system of regulation.

3.35 The Bill enables the registration of Northern Ireland Credit Unions to be transferred to the PRA and/or the FCA (in line with the wider draft Mutuals Order, the Government expects that the FCA will take on this role). The transfer of registration was consulted on by the Treasury and Department of Enterprise Trade and Investment Northern Ireland in 2010 and the joint response can be found on the HM Treasury website.[6]

[5] Available from www.hm-treasury.gov.uk

[6] www.hm-treasury.gov.uk

Building Societies Act

3.36 The Bill makes two changes to legislation affecting building societies: allowing building societies to grant floating charges in favour of payment and settlement systems, and widening the range of mutually owned institutions to which the regulator can direct that a building society transfers its business without a full member vote if the regulator considers a merger expedient in order to protect the investments of shareholders or depositors. Consultation respondents were in favour of these measures.

4 Financial Conduct Authority

4.1 The previous chapter described the fundamental role of effective prudential regulation in ensuring financial stability, and avoiding the failings that led to the financial crisis. But prudential regulation, while crucially important, is not the only element of an effective regulatory regime. Good conduct of business regulation is another essential component of an efficient financial sector capable of supporting the real economy. The Government believes that, under the regime introduced by the previous administration, the regulation of financial institutions' conduct did not receive the focus and attention that it requires.

4.2 The Government is therefore creating a new, dedicated conduct of business regulator: the Financial Conduct Authority (FCA). The Financial Services Bill provides the FCA with the legal framework for a more proactive and preventative approach to the regulation of firms' conduct. As with the Prudential Regulation Authority (PRA), the exercise of judgement within its area of responsibility will be a core part of the FCA's approach. The Government recognises, therefore, that the Joint Committee's observations about the importance of cultural change are as relevant to the FCA as they are to the PRA. The Government's approach to creating this culture within the FCA is entirely consistent with that advocated by the Joint Committee, and focuses on providing the FCA, through the Bill, with both a clear mandate (supported by appropriate mechanisms for accountability) and the appropriate tools to:

- promote effective competition as a key means of delivering better outcomes for consumers;
- intervene earlier in tackling emerging risks and minimise consumer detriment (but, importantly, not to pursue a zero-failure regime);
- look at product design and governance as well as information disclosure and sales processes;
- have a presumption in favour of transparency and disclosure as a regulatory tool; and
- back this up with its credible deterrence strategy.

The FCA's objectives

4.3 Following the consultation on the White Paper and draft Bill, and building in particular on recommendations made by both the Independent Commission on Banking (ICB) and the Joint Committee, the Government is introducing a revised set of objectives for the FCA. These new objectives will underpin the Government's vision for an FCA which will have a clear focus on making sure that markets work well including by ensuring an appropriate degree of protection for consumers and promoting competition in the interests of consumers.

Strategic objective

4.4 In its report, published in September last year, the ICB recommended that the Government clarify the FCA's strategic objective, noting that "the fundamental issue is to make markets work well- in terms of competition, choice, transparency and integrity"[1]. Similarly, and echoing the views of some consultation respondents (particularly from the consumer sector) the Joint Committee argues that the objective of the FCA should not be focused on confidence, noting that it is "justified confidence in markets, not confidence per se that is important". They argue that the FCA's focus should instead be on making markets work well, recommending that: "the FCA's strategic objective should be amended to focus on promoting fair, efficient and transparent services and markets that work well for users"[2]

4.5 The Government accepts the need for greater clarity and is therefore amending the FCA's strategic objective. The new strategic objective is framed in the Bill in terms of "ensuring that the relevant markets function well", in line with the recommendations made by both ICB and PLS.

Competition in the FCA's objectives

4.6 Securing effective competition in the market for financial services is a key mechanism for improving outcomes for consumers, and the FCA's new competition mandate will be central to achieving this. The draft Bill provided the FCA with an objective to promote efficiency and choice, and complemented this with a statutory competition duty.

4.7 The ICB report recognised that it is the Government's intention that the FCA play an important role in promoting competition. However, the ICB recommended that this be made clearer in the objectives, suggesting that "the efficiency and choice" operational objective should be replaced with an objective to "promote effective competition in markets for financial services". As with the strategic objective, the Joint Committee and consumer groups have endorsed the ICB's views on this question.

4.8 The Government is therefore recasting the FCA's efficiency and choice operational objective as "promoting effective competition in the interests of consumers". The Bill also retains the competition duty, recognising the important effect this will have in driving the FCA to seek competition-led solutions to conduct issues more generally and in pursuit of its "consumer protection" and "integrity" operational objectives. The new competition objective will be complemented by a set of factors to which the regulator may have regard in deciding what constitutes effective competition. The overall effect of these changes is that the FCA's competition mandate is now much stronger and more explicit. The revised objectives will encourage the FCA to actively promote effective competition, and provide a mandate for the FCA to take the initiative to use its powers to tackle competition problems more swiftly and effectively than the FSA did previously, for example by promoting switching, removing barriers to entry or addressing asymmetries of information.

The principle of firm responsibility

4.9 As described in the White Paper, the draft Bill included a set of "principles of good regulation" which set out behaviours that consumers and firms can expect from both the PRA and FCA. It is important to note that these principles do not place burdens or requirements on consumers or firms – they apply only to the regulators themselves. Based largely on a misunderstanding of this last point, the principle of consumer responsibility – which provides that regulators should have regard to the principle that consumers should take responsibility for

[1] Independent Commission on Banking, *Final Report*, September 2011, paragraph 8.87. Available from http://bankingcommission.independent.gov.uk

[2] *Report of the Joint Committee on the Draft Financial Services Bill,* paragraph 99

their decisions – met with opposition from some consultation respondents, particularly from consumer groups.

4.10 Based on its more nuanced interpretation of the issue, the Joint Committee argues that the balance between the responsibilities of consumers, firms' management and the regulator should be adjusted, given the difficulties that consumers face when navigating the complexities of many financial services products and the potential for conflicts of interest to arise (for instance through commission on sales). The Joint Committee therefore recommends that "the consumer responsibility principle be complemented by an amendment to the draft Bill to place a clear responsibility on firms to act honestly, fairly, and professionally in the best interests of their customers."[3]

4.11 The Government recognises that there can be significant information and capability asymmetries between firms and consumers, and that this can mean that consumers are not confident that they are equipped to engage with firms and make the right decisions. Indeed, the importance of ensuring a more level playing field between firms and consumers is reflected in the drafting of the consumer protection objective, which recognises that different consumers not only have different needs, but also have different levels of knowledge and understanding and will need appropriate information to assist them in making choices.

4.12 To build upon this, and respond to the concerns expressed about the balance between consumers and firms, the Government is amending the proposed consumer protection objective in two important ways. First, the Government is adding a new "have regard" so that, in deciding what degree of protection is appropriate, the FCA will be required to have regard to the general principle that those providing regulated financial services should be expected to provide an appropriate level of care. Second, the Government is replacing the current "have regard" covering the need for accurate information with one setting out explicitly consumers' need for advice and information that is accurate, timely and fit for purpose.

4.13 In addition, the Government has also amended the senior management responsibility principle. The new wording requires the regulators to have regard to "the responsibilities of the senior management of persons subject to requirements imposed by or under this Act, including those affecting consumers, in relation to compliance with those requirements". This reflects the fact that the senior management of regulated firms are responsible for securing compliance with the regulatory framework, including requirements that affect consumers.

4.14 The Government is taking this approach, rather than introducing the firm responsibility principle recommended by the Joint Committee, because the creation of such a responsibility, falling directly upon firms but enforced by the regulator, would not be consistent with the operation of the regulatory framework. As noted above, the principles of good regulation are designed to apply to the regulators (not consumers, firms, or any other private person). Creating a free-standing responsibility on firms would be legally complex and potentially cumbersome, giving rise to the potential for litigation and dispute. In addition, the Government believes that the rule book of each regulator (and other measures imposing requirements) is the appropriate place in which to define the parameters of the responsibilities of firms in relation to their customers as appropriate and tailored to the consumers and products in question.

4.15 The Government continues to believe that the principles of good regulation, as applied to the regulator, play an important role. The complementary principles of senior management and consumer responsibility, together with the changes which the Government has made, frame the responsibilities of the FCA and set the right expectations on the regulators.

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[3] *Report of the Joint Committee on the Draft Financial Services Bill*, paragraph 126.

Consumer credit and the scope of FCA responsibility

4.16 As part of the Government's package of reforms, in December 2010 the Treasury and the Department for Business, Innovation and Skills (BIS) issued a joint consultation on the merits of transferring the responsibility for consumer credit regulation from the Office of Fair Trading (OFT) under the Consumer Credit Act 1974 (CCA) to the FCA under the Financial Services and Markets Act 2000 (FSMA) as amended by the Financial Services Bill.

4.17 The Joint Committee welcomes the Government's decision to consider the question of whether consumer credit regulation should be moved to the FCA. The Committee recognises that consumer credit may pose a different set of regulatory problems to those arising for other financial products; it also notes the importance that any changes result in a proportionate system of regulation. But, the Committee concludes that given the potential for consumer detriment there would be significant benefits in transferring responsibility for consumer credit to the FCA.

4.18 The Government believes that fundamental change is necessary to ensure that regulation is able to keep up with a rapidly changing market and to tackle detrimental practices more swiftly. The Government also believes that this change can best be achieved by bringing consumer credit into the same regulatory regime as other financial services (FSMA), while retaining the existing consumer rights and protections in the CCA.

4.19 Respondents to the Government's consultation on the credit regime generally supported the proposal for a single regulator for all retail financial services, and a stronger, more flexible regime than is currently possible under the CCA. However, respondents also emphasised the diversity of firms and activities covered by CCA and the need for a proportionate, risk-based approach. They also noted that the consumer credit industry has only recently had to adapt to changes to the CCA. Further detail can be found in the summary of responses published in July 2011on the Treasury's website.[4]

4.20 Further engagement with stakeholders in recent months has made clear that many would welcome an outcome that brings consumer credit firms, particularly providers of high-cost credit, within FCA regulation, while maintaining the core rights and protections provided by the CCA.

4.21 Therefore, the Government is now working to develop a model that will ensure that regulation does more to protect consumers, but also reflects the particular characteristics of the consumer credit market, and remains proportionate.

4.22 The Financial Services Bill therefore includes provisions enabling a full transfer of consumer credit regulation to the FCA, with retention of substantive CCA provisions. The Government will exercise these powers if and when it has identified a model of FCA regulation that is proportionate for the different segments of the consumer credit market. The exercise of these powers will be subject to impact assessment and the approval of both Houses of Parliament.

4.23 The Government is confident that a proportionate and effective consumer credit regime in the FCA will be deliverable. However, the Government retains the option to improve consumer protection by enhancing the regulatory powers and approach under CCA, should it conclude that a model for consumer credit regulation under FSMA and the FCA cannot be delivered in a way that improves consumer protection while delivering good regulatory proportionality and value.

[4] www.hmtreasury.gov.uk

The FCA's powers

4.24 The Government is committed to providing the FCA with a comprehensive set of new powers to enable it to take forward its new approach to conduct regulation. Previous consultations have discussed new powers to:

- ban or impose requirements on products (product intervention);
- disclose the fact that a warning notice in respect of disciplinary action has been issued; and
- publicise details of actions taken against misleading financial promotions.

4.25 The Joint Committee noted the creation of the powerful new tool enabling the FCA to make temporary product intervention rules. The Joint Committee do not make any recommendations regarding this power, and the Government has not made any changes to it. A more detailed discussion of the responses received on product intervention is provided in Box 4.A.

Box 4.A: Consultation on the product intervention power

Consultation respondents generally welcomed the FCA's new product intervention power, although some industry respondents argued that there should be greater safeguards around its use. A more detailed discussion of the responses received on product intervention is provided in Annex C.

The Government believes that the safeguards set out in the June White Paper strike the right balance in terms of giving the FCA sufficient flexibility to act while providing the right framework to ensure the power is used in an appropriate and targeted way that is transparent to both firms and consumers. The Government does not expect the FCA to use the new product intervention power routinely in its work, but rather, where possible, look to greater transparency, disclosure and competition to promote better consumer outcomes. Nevertheless, the power must give sufficient flexibility to the FCA to take timely and effective action, regardless of how a product is structured.

Further clarification on the making of temporary product intervention rules will be provided in the statement of policy required of the FCA. This statement will describe, among other things, the circumstances in which the FCA will make temporary product intervention rules and the factors that it will generally consider before doing so. The Government has also clarified some aspects of how the power works in the Explanatory Notes in response to specific issues raised by respondents.

4.26 In relation to the power to disclose the fact that a warning notice has been issued in respect of disciplinary action, the Joint Committee recommends that the requirement to consult the firm or individual subject to the notice ahead of disclosure should be removed. This position is supported by a number of stakeholders, including many consumer groups. Industry respondents on the other hand were either opposed to the power in principle or called for it to be subject to additional safeguards. The Government believes that the proposal it set out in June 2011 strikes the right balance between making the power usable and providing appropriate safeguards for those affected. The Government notes that the requirement to consult does not mean that the regulator must seek the consent of the firm or individual in question, but considers that pre-disclosure dialogue is crucial to allow the regulator to determine whether disclosure is appropriate in the circumstances. The Government also notes that the power as drafted ensures procedural fairness. The Government has therefore not made any changes to this power.

4.27 The proposed power in relation to misleading financial promotions received a positive response from stakeholders and is not subject to a recommendation by the Joint Committee. The power therefore remains unchanged from the draft Bill.

Competition powers

4.28 A strong mandate and appropriate powers to tackle competition problems in the financial services will be a key change in making the FCA a more effective conduct regulator. The FCA will utilise its expertise in financial services to identify competition problems and will be able to use all of its powers, including significant new product intervention powers, to promote effective competition. Where the FCA does not have particular specialised expertise or powers it will be able to engage the competition authorities. The draft Bill provided the FCA with a specific power to refer specific issues to the Office of Fair Trading (OFT). This mechanism was generally welcomed by both consumer groups and industry.

4.29 The Government has carefully considered the question of whether the FCA's strengthened remit means it should have access to more specific competition powers. The report of the Joint Committee highlights the fact that in many other sectors the sector regulator has its own power to make a market investigation reference (MIR) to the Competition Commission, which operates concurrently with that of the OFT. The Joint Committee concludes that the FCA must be provided with powers commensurate with its competition remit, and therefore recommended that the FCA be given MIR powers, concurrent with the OFT. By contrast, the Treasury Select Committee report on the Financial Conduct Authority supports the existing mechanism and suggests the question of whether the FCA should have MIR powers should be revisited once the FCA has bedded down.

4.30 The Government has concluded that no change to the mechanism proposed in the draft Bill is required, and has retained these provisions in the Bill. However, the Government is clear that in order to fulfil its competition objective the FCA will need to keep markets in financial services under review. The FCA will, of course, be able to conduct its own market studies. At times it may also wish to draw on the expertise or powers of the competition authorities. The mechanism provided for in the Bill will allow the FCA to engage the competition authorities by making a reference to the OFT rather than the Competition Commission. The Government believes this tailored power is preferable to concurrent MIR powers, as it will allow the FCA to draw on the expertise and powers of the OFT, which will be able to decide whether a formal MIR to the Competition Commission, or enforcement action under the Competition Act 1998 would be more appropriate. On receipt of an appropriate referral the OFT may decide to make a MIR almost immediately and without the need for their own market study.

4.31 The ability to draw on the expertise of the OFT is likely to be particularly important in its early years when the FCA will be adjusting to its new responsibilities. Over time, as the FCA builds competition expertise and a track record of dealing with competition problems it will be important to review the current arrangements. Therefore, in line with the recommendation of the TSC, the Government proposes to review the issue of whether the FCA should have access to specific competition powers in five years time, once the FCA has bedded in to its new role.

4.32 It will also be important that the FCA's competition mandate and powers operate within an appropriate framework of scrutiny and accountability. The regime for scrutiny of the competition effects of the regulatory regime proposed in the White Paper will continue to apply to both the PRA and the FCA. In addition, the FCA will be regularly held to account for the way in which it has advanced its competition objective and discharged its competition duty through new provision requiring it to report on this in its annual report.

Box 4.B: Price Regulation

The detail of the FCA's approach to competition will not be the prescribed in primary legislation and the FSA has carried out a separate consultation on the FSA's regulatory approach. Typical competition problems in the markets for financial services relate to characteristics such as:

- high value transactions that are not repeated;
- products which may reveal their quality many years hence (e.g. long term investments);
- asymmetries of information;
- the inherent complexity of some products; and
- anti-competitive sale practices such as tying and bundling.

However in the light of the FSA's discussion of price intervention in their consultation on the FCA's regulatory approach[5] some respondents have sought clarification of whether the FCA will be a price regulator. The Government confirms that the FCA will not prescribe prices in the manner of some utilities regulators. In the absence of natural monopolies or similar conditions, such an approach would not be proportionate or consistent with its competition remit.

Nonetheless the FCA should be looking at comparative prices, amongst other things, as possible indicators of where competition is flawed and consumer detriment may arise as a result. We expect the FCA will take a keener and more informed interest in questions of value for money than the FSA has done in the past. One example of the type of intervention the FCA might consider would be to intervene to prevent misleading price structures, where a low headline price (to attract new customers) is offset by high ancillary charges, for example by charging very high prices for changes to personal details or to cancel aspects of a certain product. The FSA has already begun to take a similar approach to addressing consumer detriment, for example in its Consultation Paper "Mortgage Market Review: Responsible Lending" where it proposed to limit the number of times that firms could charge a fee for missed payments, and clarified rules around how arrears charges relate to costs. However such intervention is expected to be rare.

Markets and wholesale conduct

4.33 The Government is taking forward in the Bill the measures relating to infrastructure and markets regulation considered in the White Paper and preceding consultation documents. The FCA will therefore be responsible for regulating recognised investment exchanges (RIEs) under Part 18 of FSMA, as well as trading platforms e.g. multilateral trading facilities (MTFs) that are operated by authorised persons. The FCA will also be responsible for regulating wholesale market conduct, including drawing up the Code of Market Conduct and identifying market misconduct and taking appropriate action (for example, imposing penalties for market abuse in Part 8 of FSMA). As previously announced, the Bank of England will regulate recognised clearing houses (RCHs) under Part 18 of FSMA, and settlement systems under the Uncertificated Securities Regulations (made in exercise of powers conferred by the Companies Act 2006), alongside its existing responsibilities under Part 5 of the Banking Act 2009 for supervising recognised payment systems. The Bill will also apply the new provisions relating to holding companies (see Chapter 3)

[5] The Financial Conduct Authority, *Approach to Regulation* available on www.fsa.gov.uk

to holding companies of RIEs and RCHs, and extend the improved powers in relation to auditors of authorised persons to auditors of RIES and RCHs (see Chapter 5).

4.34 The FCA will continue as the UK competent authority for listing under Part 6 of FSMA. The Financial Services Bill will include the reforms to the listing regime discussed in the White Paper and preceding consultation documents with the exception of the proposal to extend the scope of the power in section 166 of FSMA (to require "skilled person reports") to cover persons subject to rules made under Part 6 powers. The Government accepts the views of many consultation respondents that it would not be appropriate for this power to be available in relation to issuers of listed securities, and has therefore removed it from the Bill.

4.35 The Government has decided, therefore, not to take forward the Joint Committee's recommendation that the PRA should be responsible for regulating all market infrastructure. Payment, settlement systems and central counterparties have in common that they have a primary role of managing and reducing systemic risk, making the Bank of England the appropriate regulator.PRA regulation would only be appropriate for recognised clearing houses that are central counterparties. It is more appropriate for trading infrastructure to be regulated by the FCA which will be responsible for regulating the conduct of authorised persons who use recognised investment exchanges or multilateral trading facilities to deal for their own account or the account of their customers.

4.36 The Bill also makes provision for a memorandum of understanding between the Bank, FCA and PRA in relation to the regulation of market infrastructure. One particularly important area of cooperation will be between the Bank and FCA on the regulation of RCHs and settlements systems. Much of the substance of regulation in this area will, in future, be determined in European legislation, such as the European Market Infrastructure Regulation (EMIR) and related technical standards. While it is intended that the Bank will be the competent authority for this regulation, the FCA will occupy the UK voting seat on the European Securities and Markets Authority (ESMA), which is responsible for developing the relevant technical standards. The Bank and FCA will therefore have to work closely on these matters. Furthermore, the FCA will have a strong interest in the Bank's responsibilities in this area as much of the trading infrastructure that the FCA regulates will rely on clearing and settlement infrastructure which the Bank regulates. To support cooperation in this area, the Bill extends the ability of the Bank to obtain information from RCHs which the Bank considers will assist the FCA to discharge its regulatory functions. Similar provision in relation to settlement systems will be made in the relevant secondary legislation.

Accountability, transparency, and engagement of the FCA

4.37 The Government proposed, in the draft Bill, to make a number of improvements to FCA accountability, including the provision for audit by the National Audit Office (NAO), and the accompanying ability to launch value for money (VFM) studies. These were widely welcomed, and the provisions are carried forward into the Bill.

4.38 The Joint Committee proposes that the draft Bill be amended to require the FCA to publish board and panel minutes and agendas, where possible and appropriate. While the Government endorses the Joint Committee's view that the governance of the FCA should be as transparent as possible and appropriate, it is of the view that operational issues relating to transparency should, in the first instance, be a matter for the FCA board. It should not be necessary to fix the detail of board procedure in legislation, and the Government notes the strong commitment to transparency made by witnesses to the Joint Committee speaking on the subject of FCA governance and accountability.

Engagement on mass detriment

4.39 In recent years, there have been a number of cases – of which the misselling of payment protection insurance (PPI) has been the most widespread and high profile – of action by firms operating in the financial sector resulting in detriment for a large number of consumers. One way to ensure such cases are dealt with effectively is to provide for a mechanism by which the regulator can be alerted to issues of mass detriment and be held accountable for its response.

4.40 In the White Paper, the Government consulted on specific proposals to help ensure that the FCA will take the lead in dealing with issues that are causing mass consumer detriment, allowing the FOS to focus on dealing with issues on a case-by-case basis. The proposal was that where mass detriment was already occurring, designated interested parties (such as consumer groups, firms, or the FOS itself) would be able to raise the issue with the FCA and require a response within 90 days. Such engagement will enable a faster and more decisive regulatory and market response.

4.41 The Joint Committee argues that this mass detriment mechanism is not broad enough for consumer issues to be brought to the attention of the FCA. It argues that designated consumer bodies should be able to make "super-complaints" to the FCA, as well as to the OFT (the super-complaints regime allows designated consumer groups to make a complaint to the OFT or relevant sectoral regulator and receive a response within 90 days where "any feature, or combination of features, of a market in the United Kingdom for goods or services is or appears to be significantly harming the interests of consumers"). This proposal was supported by a number of consultation respondents, notably consumer groups. The Government therefore accepts this proposal, and the Bill provides that consumer representatives will be able to make super-complaints to the FCA.

4.42 However, where mass detriment is already occurring, the prospect of the FOS having to deal with issues on a case-by-case basis can also have a significant impact on firms and on the FOS itself. In these circumstances, the FCA has a range of powers it can use to ensure mass detriment issues are dealt with more effectively, such as issuing new rules or guidance or using its powers at s404 of FSMA to deliver an industry wide redress scheme, or the adoption of a single-firm redress scheme. The Government therefore proposes that, in the far narrower range of circumstances where mass detriment is occurring, firms, and the FOS, should be able to refer issues of mass detriment to the FCA and require a response within 90 days. The FCA's response might, for example:

- announce plans to consult on an issue;
- set out a timetable for regulatory action which would allow the FOS to consider whether or not to place a hold or "stay" on complaints;
- explain how the FCA is already taking action to address an issue; or
- explain why it is not taking any action.

5 Regulatory processes and coordination

Coordination between the new regulators

5.1 Two of the major failings of the existing system of financial services regulation that came to light in the recent financial crisis were:

- regulatory "underlap", where none of the three bodies in the tripartite structure had both the responsibility and tools to take action against systemic financial instability; and
- the breadth of the FSA's remit across prudential and conduct of business regulation meant that it could not focus on financial stability.

5.2 The new regime set out in the Bill solves these issues by giving the responsibility and power to promote financial stability to the Bank of England, and in particular, the Financial Policy Committee (FPC) and the Prudential Regulation Authority (PRA). Alongside this fundamental reform, the Government is creating, in the Financial Conduct Authority (FCA) a separate dedicated regulator to focus on conduct of business and consumer protection.

5.3 The Government remains confident that the Bill provides a structure under which the regulators can pursue their distinct and separate objectives, fully developing and exercising their expertise without conflict or inappropriate overlap. For example the high threshold for the PRA veto enables the FCA to focus exclusively on delivering its objectives while providing a safeguard for the PRA to intervene where its expertise leads it to conclude that financial stability might be threatened.

5.4 Many firms will be regulated by both the PRA and FCA. Effective coordination between the PRA and FCA will be essential to ensure that the authorities can deliver their statutory objectives effectively. Previous consultation documents proposed a number of mechanisms to ensure effective coordination between the new regulators:

- cross-membership of boards between the PRA and FCA;
- a statutory duty on the PRA and FCA to coordinate the exercise of their functions; and
- an obligation to prepare a Memorandum of Understanding (MOU) setting out how the statutory duty will be delivered.

5.5 Additional mechanisms will ensure that the PRA and FCA will be held accountable for how effectively they have coordinated: a requirement for the MOU between the PRA and FCA to be reviewed annually and laid before Parliament; and a requirement for the PRA and FCA to include in their annual reports an account of how they have complied with the statutory duty to coordinate their actions over the year.

5.6 The Joint Committee welcomes the assurances provide by the FSA and others that duplication of information requests would be minimised, and recommended that although the "joint rule book" and "single point of contact" requested by some industry respondents may not be possible, the regulators should actively consider how to reduce regulatory burden. The

Committee recommended that “a draft of the Memorandum of Understanding on coordination between the PRA and FCA must be available when the Bill is introduced into Parliament”. A draft of this document has been published jointly by the Bank and FSA.

Regulatory processes

Approved persons

5.7 The Joint Committee also recommends a change to the provisions about approved persons. The draft Bill allowed the PRA to be solely responsible for approving individuals performing significant influence functions (SIFs) in firms regulated by both bodies, albeit in consultation with the FCA. However, the Joint Committee recommends that “The draft Bill should be amended so that the FCA will have to give its consent before the PRA approves any person holding significant influence in a dual-regulated firm.”[1] This point was echoed in a number of responses to the consultation.

5.8 The Government therefore agrees that the FCA should be required to give its consent over the approval of key individuals conducting SIFs in firms where supervision is shared between the PRA and FCA, and the Bill now makes provision for this. However, it is also essential that the involvement of both regulators does not lead to an approvals process that is overly burdensome for firms. The MOU between PRA and FCA therefore makes clear that there will be single administrative process for approvals.

Authorisation

5.9 The Government has made a small number of amendments to the authorisation regime, requiring that the regulators should consult each other prior to withdrawing a permission, but they do not need to obtain each other’s consent. The Government has also amended legislation to reflect that the authorities will be able to place an appropriate level of weight on the opinion of the overseas regulators of a non-EEA firm when assessing an application to authorise a non-EEA firm. This is in line with the FSA’s current practice, which will be adopted by the FCA and the PRA.

Appeals

5.10 In order to support the judgement-led approach of the new authorities, the draft Bill proposed changes to the arrangements concerning appeals. The Bill leaves the Upper Tribunal’s scope of review of supervisory decisions unchanged, but limits the course of action available to the Tribunal in the event it chooses not to uphold the relevant regulator’s decision. With the exception of disciplinary matters and those involving specific third party rights, the Tribunal will not be able to substitute its opinion for that of the regulator as to the regulatory action which should be taken by the regulator. The Tribunal will instead be required to remit the decision back to the regulator with such directions as it considers appropriate in relation to a range of findings. A number of consultation respondents objected strongly to this position. However, the Joint Committee agrees with the Government that this is an important part of ensuring that the regulators are free to exercise judgement in their supervisory approach, noting that “we believe that the PRA or FCA, as the regulators, will remain better placed to reach an informed judgment. Allowing the Tribunal to substitute its own opinion for that of the regulator would undermine the principle of judgement-based regulation.”[2] The Government is pleased that the Joint Committee endorses its approach on this issue, and the provisions on appeals set out in the draft Bill have been retained.

[1] *Report of the Joint Committee on the Draft Financial Services Bill*, paragraph 294.

[2] *Ibid*, paragraph 348

Disclosure

5.11 Within the new framework, disclosure of information will be a vital tool for ensuring market discipline and, with respect to the FCA in particular, for empowering consumers and encouraging effective competition. The Government recognises that disclosure can be a powerful regulatory tool.

5.12 Therefore, transparency and disclosure are enshrined in the new regulatory regime as two key principles of good regulation that apply to both the PRA and FCA. Consumers already have access to a great deal of information concerning the misconduct of firms – for example, FSMA requires the regulators to publish such details of decision and final notices as it considers appropriate. As discussed in the previous chapter, the Bill goes a step further and gives the regulators the power to publish the fact that a warning notice has been issued in respect of disciplinary action. This will address key concerns raised by consumer groups. And the Government is also giving the FCA a new power to require firms to withdraw misleading financial promotions, and publish the fact that is has done so, thereby tackling a potentially key source of consumer detriment and encouraging greater compliance through disclosure. In addition, in the future, the Financial Ombudsman Service (FOS) will be required to publish reports of its determinations, unless in its opinion this would be inappropriate. This will provide greater clarity for both firms and consumers.

5.13 The Joint Committee's report endorses the draft Bill's focus on transparency and disclosure and the progress made by the Government in respect of new powers. Building on the concerns expressed by some stakeholders, the Joint Committee expresses concern that existing provisions of FSMA concerning disclosure of confidential information in section 348 are too restrictive in terms of enabling non-disclose on the grounds of confidentiality. It therefore recommends that "neither regulator should be unnecessarily restricted from disclosing information. Section 348 should be amended to make it as unrestrictive as possible within the confines of EU law."[3]

5.14 This is a complex issue, requiring detailed analysis (and potentially consultation) for an appropriate resolution to be found. The Government committed to a review of Section 348 as part of the PLS process. This review is ongoing, and its conclusions and recommendations will be made available during the passage of the Bill.

Actuaries and auditors

5.15 As discussed in the February 2011 consultation document, actuaries and auditors are currently required by law to provide information to the FSA. The FSA also has powers to make rules imposing duties on actuaries and auditors to make reports to the regulator about aspects of firms' business. These powers are being carried forward so that they may be used by the PRA and FCA.

5.16 The Government has concluded that initially, powers to enforce rules and duties under FSMA will only be needed by the FCA. However, the Government will be able to extend these enforcement powers to the PRA by order, should it become necessary in the future.

5.17 The February consultation document proposed to clarify that the regulators would be able to disqualify individual professionals, irrespective of whether they were appointed as an individual or were representing their firm. However, the Government has concluded that this could result in an overlap with the role played by the FRC and professional bodies. Instead, the Bill will extend the sanctions that are available for breaches of other rules under FSMA (the ability to censure and to impose financial penalties) to enforcement in respect of actuaries and auditors.

[3] *Report of the Joint Committee on the Draft Financial Services Bill*, paragraph 330

Insolvency

5.18 As discussed in the February consultation document, both regulators will have access to the insolvency provisions in Part 24 of FSMA. The PRA and FCA will be able to petition for insolvency and otherwise participate in insolvency proceedings for the firms that they regulate.

Regulatory failure

5.19 As demonstrated by the recent report published by the FSA into the failure of RBS (see below), there are important accountability benefits in open and transparent analysis being conducted into failures of the regulatory system. The Joint Committee endorses the new duty, proposed by the Government in the White Paper and draft Bill, requiring regulators to conduct and report upon an investigation where failure has occurred. The Joint Committee notes that "it should be standard practice to publish a report after major regulatory failure." The new duty was also broadly welcomed by both industry and consumer groups.

5.20 Some stakeholders argued that the triggers for such an investigation should be made more objective. The Government welcomes the conclusion of the Joint Committee that such a change is not necessary, noting the existence of a backstop power for the Treasury to order an investigation if necessary. Nevertheless, in order to provide greater clarity for the public, the Government has amended the relevant provisions to include a requirement on the regulators to set out in a statement of practice how these triggers might be met. The Treasury will approve these statements before they are published.

5.21 While the Joint Committee welcomes the Treasury's backstop power of direction, it notes the importance of ensuring that in considering a direction, the Treasury must consider the potential impact of an investigation on the successful pursuit of ongoing regulatory activity – particularly enforcement activity against a firm, or employees of a firm, that has failed. The Committee also stressed that the regulator, when considering how to approach an inquiry and report under its own initiative, must consider these same issues. The Government notes the importance of these points, and has amended the relevant provisions accordingly in line with the Joint Committee's recommendation.

The FSA's report on RBS

5.22 On 12 December, the FSA published a comprehensive and illuminating report into how the Royal Bank of Scotland came to the brink of failure before it was rescued by a taxpayer bail-out. In addition to identifying a number of clear failures on the part of the regulators, and the management of RBS, the report recommends that a public debate be carried out in a number of important areas.

5.23 One of these is the question of whether the balance between risks and rewards faced by the senior management of banks need to be adjusted, given the particularly important role played by banks in the economy and society at large. Policy options that might be considered, include:

- stronger legal liability for the senior managers of failed banks; and
- automatic prohibitions on such individuals working in the financial sector in the future.

5.24 The Government recognises that some of these options would represent a radical change, and very careful consideration would need to be given before proceeding with them. Nevertheless, the Joint Committee recommends that this work be carried out, and therefore the Treasury and the FSA will publish a joint consultation document in the spring.

Compensation, consumer education and dispute resolution

5.25 The Financial Services Compensation Scheme (FSCS), the Financial Ombudsman Service (FOS) and the Money Advice Service (MAS) provide crucial functions that underpin consumer and market confidence in financial services. Reflecting the broad support from stakeholders for the arrangements proposed for these bodies and the absence of any substantive recommendations from the Joint Committee, the Government intends to make very few changes to the drafting in the draft Bill; providing for a model in which the FSCS, FOS and MAS are operationally independent of the regulators.

Financial Services Compensation Scheme

5.26 The provision of compensation is essential to both supporting consumer confidence and promoting stability through effective resolution. The Government is therefore committed to a single, independent, compensation scheme with the PRA making rules for deposit-taking and insurance businesses and the FCA making rules for all other types of financial activity covered by the scheme. These proposals have been broadly welcomed by respondents to consultation.

5.27 Specific reference to how FCA and PRA will coordinate their responsibilities for the FSCS is contained in the coordination MOU published by the Bank and FSA. The additional MOUs that the scheme manager must prepare with each regulator will be published during the passage of the Bill to aid in Parliamentary scrutiny.

Financial Ombudsman Service

5.28 The Government is committed to the FOS as an independent body to provide an alternative impartial route for resolving disputes between financial services firms and consumers. The Bill includes the provisions for the measures to improve the accountability and transparency of the FOS and its co-ordination with the FCA which were consulted upon in the White Paper. The MOU which states how the FCA and FOS will work together will be published during the passage of the Bill.

Money Advice Service

5.29 The Money Advice Service provides an invaluable role in addressing the information asymmetries between the financial services industry and their consumers. The MAS has a statutory function to "enhance the understanding and knowledge of members of the public of financial matters, and their ability to manage their own financial affairs". The Government has added clarity to this function in the Bill to include express provision for the coordination and provision of debt advice. The MAS is well placed, with national reach to provide debt advice as part of existing services. The Government has consulted on these plans and responses were received from a range of stakeholders who broadly supported the proposal to clarify MAS's consumer financial education function.

5.30 MAS will work closely with the FCA in delivering its objectives and the Bill provides for the MAS to have regard to the FCA's objectives and share relevant information. It also places a duty on the two bodies to co-operate. The MOU which states how the FCA and MAS will work together will be published during the passage of the Bill. The Government has also concluded that, to support the FCA's oversight of the MAS, the FCA should retain the FSA's power to order reviews of the economy, efficiency and effectiveness of the MAS's use of resources. This will be in addition to the power the NAO will have to launch value for money studies.

National Savings and Investments

5.31 Although not an issue related to financial regulation, the Government is using the Bill to bring forward small but important changes to help deliver financial savings in the operation of

National Savings and Investments (NS&I). The Treasury has agreed a long term strategy for NS&I that includes leveraging their partnership contract and the associated skills and capabilities that exist within NS&I.

5.32 The Bill makes provision to extend the functions of the Director of NS&I to be able to offer its services more widely across the public sector. This new function would enable NS&I to make the most of its modern operational infrastructure by offering payment-processing, account management and ancillary administrative services to government bodies on a commercial basis. By offering such services, NS&I will be able to deliver savings across Government, in line with the cross-Government Efficiency and Reform agenda. It will also help NS&I to meet its commitments under the 2010 Spending Review.

5.33 The powers of the Director of Savings do not currently extend to providing such services. There are no delegated powers that could be used to extend the powers of the Director of Savings to the required extent. Therefore, in order to allow NS&I to undertake such new business, primary legislation is required and this Bill provides a timely legislative vehicle.

6 European and international regulation

6.1 Financial services are, by their very nature, global. Markets for financial services do not operate in a national vacuum, and firms are interconnected with one another across international boundaries unlike any other form of business. This presents a number of challenges for governments and regulators, not just in judging the risks created by the complexities of the international financial system, but also in engaging with international bodies that have a direct impact on financial regulation.

6.2 A clear lesson from the financial crisis is the need for greater international coordination and cross-border cooperation between regulators and governments. The Government recognises that it is imperative to get both the domestic and international regulatory framework right for the future strength and stability of the UK, European, and global economies. Accordingly, the UK authorities have played, and will continue to play, a leadership role in all of the key global bodies including the G20, Financial Stability Board (FSB), International Monetary Fund (IMF) and the Basel Committee on Banking Supervision (BCBS), as well as in the European Union.

6.3 The Government welcomes the Joint Committee's focus on international issues and its recommendations in this area. Recent developments internationally only emphasise the importance to the UK financial sector, and the country more widely, in engaging effectively at an international level with the appropriate legislative and regulatory bodies.

6.4 By playing a full role in engaging with international regulatory bodies it is expected that the regulators will be able to exert influence to ensure that their discretion to use their judgement is not unduly adversely affected by international developments. As *The Bank of England*, *Prudential Regulation Authority: Our approach to banking supervision* states:

> "It is important that the EU policy framework leaves scope for supervisors to make informed judgements about risks posed, and action to be applied, within a clear overall policy framework. Such an approach is essential to ensure appropriate risk capture and action, and is thus necessary to ensure effective international action to preserve financial stability… By playing an active and constructive role in shaping the development of international regulatory standards, the PRA will seek to ensure that broader international developments support its judgement-based supervisory approach."[1]

6.5 *The Financial Conduct Authority: Approach to regulation* commits that:

> "The design of the FCA will need to be framed in an EU and international context. This is particularly important given the growing influence of EU legislation and standards on UK policy-making and supervisory practices. In both consumer protection and securities and markets issues, the FCA will therefore engage early and effectively in EU and international negotiations to influence the outcomes in ways that are consistent with its objectives and philosophy."[2]

[1] Available at www.bankofengland.co.uk and www.fsa.gov.uk

[2] Available at www.fsa.gov.uk

International engagement

Coordination Committee

6.6 The Joint Committee, in common with a number of respondents to previous consultations, have suggested that the FCA, PRA, Bank of England and HMT should establish a standing committee on international coordination to ensure that the UK's negotiating position with the international community on financial services matters is effective and consistent. Specifically, the Joint Committee recommended that the international coordination MOU should establish a committee "responsible for ensuring the UK authorities agree consistent objectives and exercise their functions in a way that is effective".

6.7 The Government had been open to the idea of such a Committee but previous discussions had led to the conclusion that the practical arrangements for ensuring that the UK's engagement with the international community is consistent and effective could be determined by the relevant bodies themselves. This position did not rule out establishing a standing committee if the relevant bodies had felt it expedient to do so.

6.8 Nevertheless, the Government accepts the Joint Committee's recommendation of an international regulatory committee to be included in the international organisations MOU. The Bill has been amended to require that the international organisations MOU establish this committee. The committee will report to the Chancellor, be chaired by the Treasury and include members from the FCA, PRA and Bank of England.

The PRA's international role

6.9 The Joint Committee highlights that the PRA should be on the international regulatory college of supervisors "for all major banks with significant branches in the UK". The FSA is a member of regulatory colleges for all major banks with significant branches or subsidiaries in the UK, and the PRA will take on such memberships. Regulatory colleges, in addition to providing highly valued means of knowledge sharing and cross-border supervision for large multi-national financial institutions, provide opportunities for constructive international cooperation in financial services regulation. Separate from regulatory colleges are core colleges, which tend to be included in Crisis Management Groups: these core colleges bring together the supervisors of the most significant subsidiaries globally. The FSA is a member of these where the UK subsidiary is significant enough within the group, and the PRA will take on these memberships. The PRA's in role in engaging in supervisory colleges internationally is highlighted in the PRA approach document:

> "The PRA will be an active participant in both supervisory colleges and the EBA, including through peer review of other countries' supervisory approaches."[3]

Reporting on international engagement

6.10 The Joint Committee recommends that the PRA should report on its work in engaging with international regulators. The Government agrees with this recommendation and has included provision in the Bill that the PRA should include a report of its international engagement in its annual report. The FCA will also be under such a duty, reflecting the importance the Government places on the effectiveness of the regulators' international engagement.

[3] *The Bank of England, Prudential Regulation Authority - Our approach to banking supervision* available on www.bankofengland.co.uk and www.fsa.gov.uk

European issues

Capital Requirements Directive 4 (CRD4)

6.11 The Joint Committee recommends that the UK "must continue to push for the removal of all restrictions on the ability of member states to raise their capital requirements above internationally agreed minima". It is vital that European legislation – the Capital Requirements Directive 4 – gives national regulators the discretion to go beyond the internationally agreed Basel III proposal when national circumstances require it in order to safeguard financial stability and reduce the risk of a potential call on taxpayer funds. The European Systemic Risk Board has also emphasised the need to ensure that national authorities are equipped with sufficient discretion to take macro-prudential action at a national level. The Government will continue to work to ensure that there is adequate flexibility in European legislation.

Judgement and the European rulebook

6.12 More broadly, but linked to their recommendation on capital requirements, the Joint Committee recommends a role for the proposed international regulatory committee in "ensuring that the European rulebook does not limit the necessary discretion of the UK supervisory authorities to achieve forward looking regulation". The Government agrees with the sentiment of this recommendation; the informed use of judgement by the new regulatory bodies is a key overriding tenet of these reforms to the regulatory system. This may well develop to be a key role for the Committee that will be established in the international organisations MOU, but does not require specifying in legislation.

Crisis management and the European rulebook

6.13 In a similar vein to the points on capital requirements and the impositions of the European rulebook, the Joint Committee were concerned that the FPC and PRA should not be constrained in acting in the event of a crisis due to restrictions imposed by European legislation. The Joint Committee recommends that the FPC and PRA should highlight where European legislation constrains their ability to respond to a financial crisis and report this to the Treasury and to the international regulatory committee proposed above.

6.14 The Government agrees that it is imperative that the UK authorities are able to address future financial crises in a manner that is appropriate to the unique characteristics of the UK financial services sector. In the current system it would be unimaginable for the regulator not to raise a constraint which potentially impacted on their ability to deal with financial crises with HMT in the normal course of fulfilling their role, to inform international engagement. The Government is committed that this situation will not change and agrees that the proposed international regulatory committee would be an appropriate forum for discussions in this area. As the international regulatory committee will be established in the international organisations MOU, it would not be appropriate to make provision for this in statute.

Compensation scheme cover

6.15 The Joint Committee recommends that the PRA and FCA should make it clear to the public that an EEA firm which has passported in to the UK is the responsibility of their home state and therefore deposits are not covered by the FSCS. The Government agrees with this recommendation, welcomes the work already carried out by the FSA in doing just this and would expect both the FCA and PRA to continue this work in the normal pursuance of their objectives.

A Government response to the Joint Committee

Introduction

A.1 The Joint Committee on the draft Financial Services Bill (the Joint Committee) was formed in July 2011, charged with the role of considering the draft Bill published by the Government in its White Paper of June 2011. The Joint Committee consisted of 12 members, six MPs and six peers, and was chaired by the Rt. Hon Peter Lilley, MP.[1] The Joint Committee completed its deliberations and published its report on 19 December.

A.2 The Government welcomes the report of the Joint Committee, and thanks the members of the Committee for their work. The analysis, advice and recommendations of the Committee have been invaluable in developing and taking forward the Government's reform programme for financial regulation, and the Government has made a significant number of amendments to the Financial Services Bill based on the Joint Committee's recommendations.

A.3 This Annex sets out each of the Joint Committee's recommendations in full, alongside the Government's response.

Recommendations and responses

A.4 This section presents the Joint Committee's recommendations in turn, grouped by subject matter, followed by the Government's response. The text of each recommendation is presented in indented italic text, for ease of identification. The paragraph numbers in brackets refer to those in the Joint Committee's Report.

General recommendations

> *Successful regulation depends more on the regulatory culture, focus and philosophy than on structure. (Paragraph 16).*
>
> *To be successful the reforms will have to change the regulatory culture and philosophy. It is through a change in culture and philosophy that the relevant authorities can best ensure both financial stability and good conduct of business. A key aspect of the cultural change needed will be a shift towards forward looking supervision. This will require staff with appropriate experience, approach and attitudes. A change in culture is not something that legislation can guarantee but legislation can influence the culture of a regulator by:*
>
> 1. *setting objectives,*
> 2. *allocating and aligning powers and responsibilities,*
> 3. *establishing appropriate systems of accountability.*

1 The other members of the Committee were: Baroness Drake, Lord McFall, Lord Maples, Lord Newby, Lord Skidelsky , Baroness Wheatcroft, Nicholas Brown MP (Newcastle upon Tyne East), David Laws MP (Yeovil), David Mowat MP (Warrington South), George Mudie MP (Leeds East) and David Ruffley MP (Bury St Edmunds)

Without significant changes to clarify objectives, allocate appropriate powers and create proper accountability the Bill as currently drafted will not guarantee a change in regulatory culture. This report makes recommendations to address these weaknesses. (Paragraph 24)

A.5 As highlighted throughout the body of this document, the Government agrees with Joint Committee's emphasis on the importance of regulatory culture at the PRA and FCA. As the Government has made clear in the previous consultation documents, the box-ticking approach to financial regulation in the run-up to the financial crisis failed. The new regulators must be empowered to use their judgement to examine firm's business models and determine their viability, not just in the present, but with a view to future risks.

A.6 The Joint Committee has made many constructive observations relating to the approach of the regulators, and the need to entrench a judgement-led approach. The Government particularly welcomes the Joint Committee's recommendations to introduce a duty for the PRA's to supervise, and to review the threshold conditions that firms must satisfy in order to remain authorised. As described in more detail below, the Government has made amendments to implement these proposals.

Recommendations on statutory objectives

The FPC's objective

We recommend the Government reconsider the drafting of clause 3 (new Bank of England Act 1998 clause 9C(6)) to make clear the importance of monitoring the global exposure of UK banks. (Paragraph 32)

The reference in the FPC's objective to monitoring "systemic risks attributable to structural features of financial markets or to the distribution of risk within the financial sector" is presumably intended to place a duty on the FPC to consider the interconnected nature of the market—this duty should be made more explicit. (Paragraph 33).

A.7 The Government believes that the language in the draft Bill already covered the particular types of risk identified by the Joint Committee. However, the Government recognises the importance of being as clear as possible in defining key issues when legislating to provide for the statutory objective of a new body with significant macroeconomic responsibilities. Therefore, in line with the Joint Committee's recommendations, the Bill has been amended to make this absolutely clear.

Defining financial stability

Preventing excessive or inadequate growth of credit will be an important part of the way that the FPC meets its objective. However, it will also need flexibility to consider other factors which bear on the stability of the financial system. Moreover, it would in our view be premature to attempt to set quantitative targets for credit growth before the FPC has experience of developing and applying macro-prudential tools. So we do not recommend setting a credit based objective for the FPC. (Paragraph 40)

A.8 The Government notes that the Joint Committee has endorsed its view that an objective focused more closely on the sustainable supply of credit would not be workable or appropriate.

Financial stability and economic growth

The Government is right to require the FPC to consider the impact of its decisions on growth. But the Bill's current drafting is too strong and restrictive. The FPC is not authorised to take any actions to promote stability if it is likely to have a significant adverse effect on the financial sector's contribution to growth in the medium or long

term. The Bill should be redrafted so that like the MPC, the FPC must have regard to the Government's growth and other economic objectives subject to meeting its primary responsibility of attaining financial stability. (Paragraph 44)

A.9 The FPC's objective will require it to contribute to the Bank's financial stability objective to "protect and enhance the financial system of the United Kingdom". Action to increase the resilience and stability of the financial system must, however, be proportionate. While the recent financial crisis has demonstrated the significant negative impact that macro-prudential risks crystallising in the financial system can impose on the economy, disproportionate regulation could be just as damaging.

A.10 When the Chancellor gave evidence to the Joint Committee he argued that the Government should not seek the "stability of the graveyard"[2] in strengthening the system for protecting financial stability. In other words, the FPC should not be able to pursue stability to the point where the financial sector can no longer support the real economy. The FPC must, therefore, strike a balance between making the financial sector safer overall without compromising economic growth in the long term. This is why the FPC's objective features a stronger growth element than that of the MPC.

A.11 The current formulation of the FPC objective achieves the right balance between financial stability and economic growth. While the objective requires the FPC to consider the impact of its action on growth, it clearly allows – and indeed requires – the FPC to take action to mitigate systemic risk (for example, an asset price bubble). By taking effective and timely action (in the example above, to "lean against" unsustainable credit growth), the FPC will be protecting long-term economic growth. Allowing such a bubble to build and then burst would likely have serious negative implications for growth in the medium or long term.

The role of the Treasury in interpreting the financial stability objective

The draft Bill should be amended so that the Treasury, not the FPC, have the final say about the remit of the FPC. We would normally expect the Treasury and the FPC to come to an agreement about the remit and therefore we would not expect the Treasury to have to override the FPC on a regular basis. If the FPC has any objections to the annual remit issued by the Treasury it should make these public and alert the House of Commons Treasury Committee. Notwithstanding that the Treasury may suggest matters that the FPC should regard as relevant to the Committee's understanding of the Bank's financial stability objective the Bank of England will remain responsible for the entirety of that objective. (Paragraph 49)

A.12 The Government notes this recommendation and has made appropriate amendments to the Bill, as discussed in detail in chapter 2. The Government acknowledges the need for the FPC to be properly accountable to democratic institutions, but believes that this cannot be achieved if its institutional responsibilities are diluted. Macro-prudential judgements are such that the FPC may need to make unpopular decisions – for example, to limit the availability of credit to address an unsustainable asset bubble. It is vital that such decisions can be taken independently of political influence. However, the Government agrees with the Joint Committee's assertion that where the FPC does not agree with the Treasury's recommendations, it should make its concerns public. The Bill has been amended accordingly to require the FPC to respond publicly to the Treasury's remit, setting out how it intends to comply with the recommendations and, where appropriate, setting out its reasons why it does not intent to act in accordance with the remit.[3]

[2] The Chancellor's statement can be found in the record of the oral evidence to the Joint Committee on the draft Financial Services Bill, which is available from www.parliament.uk

[3] New section 9D of Bank of England Act, as inserted by clause 3 of the Bill

Indicators of financial stability

> *The FPC should begin work towards developing indicators of financial stability in dialogue with the Treasury. They should be published and the FPC should report against them. The set of indicators should be flexible and subject to regular review. (Paragraph 54)*

A.13 The Government believes that openness and transparency are important to secure public understanding of macro-prudential policy. The Bank has made clear in its response to the TSC's report into Bank accountability[4] that the FPC will regularly publish, and report against, indicators of financial stability.

Financial stability and recourse to public funds

> *We agree with the Chancellor that avoiding where possible the need for taxpayers' money to support or rescue parts of the financial services industry is a key element of financial stability. There will of course always be a possibility that public funds are called on to preserve stability but part of the objective of the FPC should be to minimise the likelihood of this happening. The FPC's objective should be amended to require it to "reduce the likelihood of recourse to public funds". (Paragraph 58)*

A.14 The Government agrees with the Joint Committee that the protection of public funds should be a core priority for the new regulatory system. In fulfilling its objective to protect and enhance financial stability, the FPC will be responsible for reducing the likelihood of serious threats to stability that might have the potential to put public funds at risk. However, the FPC will not have a role in crisis management and will therefore not be involved in decisions made when there is a material risk to public funds, much less in specific decisions about the use of public funds to resolve a particular risk. The Government believes that the proposed specific "public funds" objective for the FPC would therefore not be appropriate.

Possible conflict between the MPC and the FPC

> *We do not expect any serious conflicts between the MPC and FPC but they may arise. Careful co-ordination and communication should minimise the risks as should the evolution of the FPC's interpretation of its objectives. In the rare occasions when the two committees come into conflict the Governor should inform the Court – or the equivalent body if it is reformed – and the Chancellor, to explain how the conflict will be handled. Even if there is a difference of opinion the two committees must remain independently responsible for their own levers. (Paragraph 70)*

A.15 The instruments through which monetary policy and macro-prudential regulation are pursued will likely interact with each other in influencing macroeconomic outcomes. So while the decisions of one Committee will inevitably have an effect on the deliberations and decisions of the other, they will each be responsible for their own levers. The Government notes that this is an approach endorsed by the Joint Committee. The Government agrees with the Joint Committee that coordination and communication between the MPC and FPC will be very important.

A.16 There will be significant executive cross-membership between the MPC and the FPC – the Governor, two deputy governors and the executive director responsible for markets will sit on both committees. This will ensure that the interactions between each separate remit are fully considered and taken into account. Shared membership should ensure consistent policy and there is no need to legislate for specific mechanisms.

4 Bank of England, *Response from the Court of the Bank to the recommendations made by the Treasury Committee and Joint Committee on the Draft Financial Services Bill on the Accountability of the Bank oF England*, January 2012, paragraph 5.Available from www.bankofengland.co.uk

A.17 Fundamentally, given the Bank's broad overview of the financial sector and the close link between monetary stability and systemic regulation, the Government believes that combining responsibility for the two areas within the Bank, but in separate Committees, will strengthen the Bank's pursuit of both objectives.

Organisational status of the FPC

The governance arrangements in the draft Bill—where the FPC is a committee of the Court and the MPC is a committee of the Bank—risk giving the impression that one body is more important than the other. The FPC should be made a committee of the Bank. (Paragraph 74)

A.18 The Government notes the Joints Committee's recommendation. It has been argued, including by the Bank's senior management when giving evidence to the TSC, that the FPC should remain under the oversight of Court in order to allow better coordination of the Banks' various financial stability activities. The Government notes the recent response of the Court of the Bank on this matter and will consider the status of the FPC further.

The PRA's objective

In order to align its objectives with its own activities and with international best practice, the Bill should explicitly give the PRA a microprudential objective alongside its concern with avoiding risks to the whole system. When supervising PRA regulated persons, the primary objective should remain to reduce risks to the stability of the UK financial system. The secondary objective should be to reduce potential costs of failure to the Financial Services Compensation Scheme, taxpayer funds and customers. Neither objective requires the PRA to be a zero failure regulator. The second objective will mean ensuring firms comply with rules on for example, capital adequacy, solvency and liquidity that will reduce but not eliminate the likelihood of failure. (Paragraph 78)

A.19 The Government acknowledges that are some attractions to reframing the PRA's objective in terms of prudential outcomes, as the Committee has suggested. However, specifying particular desired outcomes creates difficulties. For example, the extent to which the failure of a firm results in a call on public funds will depend to an extent on the actions of the government of the day, for example in taking a decision to nationalise or recapitalise a failing institution. It is also potentially problematic to highlight some outcomes over others. In some circumstances, the failure of a significant firm followed by a large FSCS payout may the best way of protecting depositors and taxpayers while maintaining market discipline. The secondary objective suggested by the Joint Committee could, in such circumstance, lead to a lack of clarity over the regulator's remit.

A.20 On balance, therefore, the Government believes that it is more appropriate to frame the PRA's objective more broadly, requiring the PRA to focus on the regulation of the safety and soundness of individual firms, so as to improve financial stability.

Competition in the PRA objective

Competition within the financial sector is an important part of developing a stronger, more diverse system. The actions of the PRA have the potential to affect the costs of individual firms or of particular types of institution, and affect the barriers to entry and expansion in the market. While the need to protect and promote competition in the sector should not dictate the actions of the PRA, nor detract from the clear role of the OFT in this area, we believe it is a factor that ought to be considered in the course of PRA decision making. We invite the Treasury to consider how best this duty could be included in the Bill. (Paragraph 83)

A.21 Financial stability, supported by a rigorous and effective regulatory framework, provides a strong platform for the financial services industry's sustainable growth and success. Central to the Government's model is that regulatory remits need to be more focused and less diffuse if the failings of the current model are not to be replicated.

A.22 The Government recognises, of course, that competition is an important feature of a healthy financial sector that is able to meet the needs of those who consume the services it provides. The FCA will be the regulatory authority responsible for promoting this outcome, and as discussed elsewhere, the Government accepts the Joint Committee's recommendations to strengthen the FCA's remit in this regard. The Government's view, therefore, is that the combined effect of competition scrutiny powers (as applied to the PRA and FCA) and the FCA's objective will be appropriate mechanisms for recognising and safeguarding the importance of competition in the new arrangements.

The PRA's insurance objective

> *There is legal uncertainty regarding the definition of the "reasonable expectations" of policyholders. Using a phrase of this kind makes it difficult for the PRA to be clear on the meaning of its duties, and near to impossible for consumers and Parliament to hold the PRA to account for its actions. The phrase has been shown to be problematic in the past: it is unwise for the Treasury to revive it in new legislation and thereby risk the same difficulties recurring. The PRA should be responsible for ensuring that with-profits consumers are treated fairly, but the Treasury must find a way to redraft the Bill to achieve this end without using the problematic phrase "reasonable expectations". The PRA should be given an explicit duty to consult the FCA, as the consumer expert, on matters affecting with-profits consumers. (Paragraph 90)*

A.23 The Government notes this recommendation and has made appropriate amendments to the Bill.

The FCA's objective

> *The FCA's strategic objective should be amended to focus on promoting fair, efficient and transparent financial services markets that work well for users. This would better reflect the Treasury's intended purpose for the FCA, which is to ensure that business across financial services and markets is conducted in a way that advances the interests of all users and participants. (Paragraph 99)*

> *We recommend that the FCA should have a clearer role in promoting competition. To this end the FCA's operational objective of "promoting efficiency and choice" should be replaced by "promoting competition, efficiency and choice for the benefit of consumers". This will give the FCA a clear mandate in the area of competition and a clear responsibility for taking forward some of the ICB's recommendations aimed at making it easier for customers to move between retail banks and compare products. (Paragraph 103)*

A.24 The Government notes these recommendations and has made appropriate amendments to the Bill to clarify the FCA's strategic objective, and replace its "efficiency and choice" operational objective with one that focuses on promoting effective competition in the interests of consumers, as described in detail in chapter 4.

The definition of consumers

> *Given that the draft Bill requires the FCA to tailor its approach to different types of consumer we believe the definition of "consumer" should remain broad and not be restricted to a narrower category. (Paragraph 111)*

A.25 The Government notes that the Committee endorses its view that the definition of consumer should remain broad. The definition used in the draft bill reflects the various participants in the financial system which the FCA may seek to protect by virtue of an exercise of its general functions – this definition must be broad enough to ensure that these powers are not inappropriately constrained. The Government feels that the operational objectives make clear that there should not be a one size fits all approach, and that the regulator must differentiate between different types of consumers in determining what constitutes an appropriate degree of protection.

Balancing the responsibilities of consumers and firms

> *We recommend that the consumer responsibility principle be complemented by an amendment to the draft Bill to place a clear responsibility on firms to act honestly, fairly and professionally in the best interests of their customers. The FCA should be empowered to hold firms to account for this and ensure companies address conflicts of interest and the needs that consumers may have for advice and information that is timely, accurate, intelligible to them and appropriately presented. (Paragraph 126)*
>
> *Clearly, the actions firms should be expected to take will depend on context and circumstances. For example, the way information is presented to retail consumers is likely to be different from that appropriate for a professional investor. (Paragraph 128)*

A.26 The Government notes this recommendation and has made appropriate amendments to the Bill, as detailed in chapter 4. In sum, the Government is making two changes to the consumer protection objective. First, the Government is adding a new "have regard" so that in deciding what degree of protection is appropriate the FCA will be required to have regard to the general principle that those providing regulated financial services should be expected to provide a level of care appropriate to the consumer involved or transaction being undertaken. Second, the Government is replacing the current have regard covering in general terms the need for accurate information with one setting out explicitly consumers' need for advice and information that is accurate, timely and fit for purpose. In addition, the Government has also amended the senior management responsibility principle to which the new regulators will have 'have regard' to when discharging their general functions. The new wording requires the regulators to have regard to "the responsibilities of the senior management of persons subject to requirements imposed by or under this Act, including those affecting consumers, in relation to compliance with those requirements". This reflects the fact that the senior management of regulated firms are responsible for securing compliance with the regulatory framework, including requirements that affect consumers.

Recommendations on responsibilities and powers

Crisis management

> *It is vital that legislation makes proper provision for handling crises (including the ongoing need for the lender of last resort function) and resolving bank failures—including possible restructuring of banks to make them more resoluble. (Paragraph 10)*
>
> *The powers and responsibilities of the Bank of England and the Treasury during a crisis are key. They should be carefully reviewed in light of the concerns we have raised. A duty for these bodies to co-ordinate in a crisis should be on the face of the Bill. The definition of the term "material risk" should be subject to parliamentary approval and not left to a Memorandum of Understanding. The Bill should also make it clear that there are no circumstances where it is permissible for the Bank not to notify the Treasury as soon as material risk to public funds becomes clear. (Paragraph 140)*

A.27 The Government agrees with the Joint Committee that crisis management is a very important issue, and that it should be covered by appropriate statutory provision. More specifically, the Government agrees that a statutory duty on the Bank (including the PRA) and Treasury to coordinate activity in a crisis would be a helpful clarification, and as such has amended the Bill accordingly.

A.28 The Government can confirm that the drafting in the Bill does not provide any discretion for the Bank over whether or not to notify the Treasury once a material risk to public funds has clearly arisen. The draft crisis management MOU at Annex E sets out in detail the factors the Bank will consider when deciding whether it is necessary to make a notification of a risk to public funds. However, the MOU does not give a strict definition of what "material risk" means, as it would be difficult, if not counterintuitive, to attempt to provide a formulaic test for something that is ultimately a matter of judgement. Attempting to codify such a decision in a strict statutory test would be counter to the general thrust of changing the culture of the regulatory system to place a greater emphasis on expertise and judgement – an approach which the Joint Committee has elsewhere stated it supports.

A.29 Given this, the Government has chosen not to attempt a formal definition of "material risk" and has instead taken the approach of detailing the process by which the judgement of materiality will be made. Given this focus on process, the Government considers that the crisis management MOU, rather than the primary legislation itself, is the most suitable place for this material to be included.

> *The Bill should be amended so as automatically to give the Chancellor power to direct the Bank after a formal warning of a material risk to public funds. At this stage ultimate responsibility rests with the Chancellor. (Paragraph 143)*

A.30 The Government notes this recommendation and has made appropriate amendments to the Bill to provide the Chancellor with a new power of direction, as detailed in chapter 2.

Powers and responsibilities of the FPC

Powers to identify and monitor systemic risks

> *We are sympathetic to the need for the FPC to have powers to collect information from those outside the regulatory perimeter. In fact the FPC will normally be able to obtain the information it needs through the PRA but sometimes this might cause delay. The FPC should be given a reserve power if it thinks that requesting the information directly through the PRA could cause delay or have adverse consequences. (Paragraph 148)*

A.31 The Government notes this recommendation and has made appropriate amendments to the Bill to reduce the potential for delay when the FPC recommends that it is necessary for information be gathered by the PRA from firms or classes of firms to which the PRA does not yet have access.

Operation of the FPC's power of direction

> *Where the FPC is to be given the power to direct the PRA and FCA to implement a macro-prudential tool it should also be given the power to direct the regulators as to the timing and means of implementing that tool. The FPC should use this power where the timing and means of implementation are likely to have a significant impact on the effectiveness of the tool. If these circumstances do not exist the decisions about timing and means are better left to the regulators—the PRA and FCA—who hold the expert knowledge. (Paragraph 161)*

A.32 The Government does not believe this change is necessary. In addition to the power to direct the PRA and FCA to implement macro-prudential decisions, the Bill provides powers for

the FPC to make specific recommendations on timing and means of implementation of the macro-prudential tools. The PRA and FCA must comply with such recommendations unless they have very strong reasons not to, which they must explain publicly in the event that they decide not to comply. The Government believes that the PRA and FCA will hold the expert knowledge required to make the micro-prudential judgements to ensure that the timing and method of implementation proposed by the FPC does not cause any unintended consequences, including to the stability of individual firms.

Power for the FPC to set UK macro-prudential rules

> *We welcome the language in the proposed Capital Requirements Directive IV that appears to allow member state authorities to take into account "structural variables and the exposure of the banking sector to any other risk factors related to risks to financial stability". Nevertheless, the Government must continue to push for the removal of all restrictions on the ability of member states to raise their capital requirements above internationally agreed minima. Such freedom to impose higher capital requirements is essential given the large size of Britain's banking sector relative to its economy. (Paragraph 172)*

> *The FPC and the PRA should consider carefully what actions they will take with regard to capitalisation and liquidity requirements in the event of another crisis and must consider to what extent they are currently constrained by European regulation and how far this represents a threat to the UK's ability to respond to any financial crisis. Where they assess that they are constrained by European regulation they should report this to the Treasury and to the committee that we recommend as being responsible for co-ordinating international representation on these type of issues. (Paragraph 175)*

A.33 The Government agrees that it is vital that European legislation gives national regulators the discretion to go beyond the internationally agreed Basel III proposal when national circumstances require it in order to safeguard financial stability and reduce the risk of a potential call on taxpayer funds. The European Systemic Risk Board has also emphasised the need to ensure that national authorities are equipped with sufficient discretion to take macro-prudential action at a national level. The Government will continue to work to ensure that there is adequate flexibility in European legislation. The Government also agrees that the international coordination committee and the MOU which establishes it will provide the principal forum in which to discuss these matters.

European rulebook negatively impacting on use of judgement

A.34 More broadly, but linked to their recommendation on capital requirements, the Joint Committee recommended a role for the proposed international regulatory committee in "ensuring that the European rulebook does not limit the necessary discretion of the UK supervisory authorities to achieve forward looking regulation". The Government agrees with the sentiment of this recommendation; the informed use of judgement by the new regulatory bodies is a key overriding tenet of these reforms to the regulatory system. This may well develop to be a key role for the Committee that will be established in the international organisations MOU, but does not require specifying in legislation.

Powers and responsibilities of the PRA

Powers in respect of firms headquartered outside the UK

> *For all major banks with significant branches in the UK the PRA should be on the college of supervisors for that bank. (Paragraph 178)*

A.35 The FSA is a member of regulatory colleges for all major banks with significant branches or subsidiaries in the UK, and the PRA will take on such memberships. Regulatory colleges, in

addition to providing highly valued means of knowledge sharing and cross-border supervision for large multi-national financial institutions, provide opportunities for constructive international cooperation in financial services regulation. Separate from regulatory colleges are core colleges, which tend to be included in Crisis Management Groups: these core colleges bring together the supervisors of the most significant subsidiaries globally. The FSA is a member of these where the UK subsidiary is significant enough within the group, and the PRA will take on these memberships.

> *Even though the PRA may, under CRD IV, gain limited powers to oversee the UK operations of EEA firms these will remain ultimately the responsibility of their home state regulator. The PRA and the FCA should seek to ensure that the public understand when a banking group is not subject to UK prudential regulation. Where deposits are not covered by the Financial Services Compensation Scheme the regulators should require banks to make this clear with prominent warnings in branches and on websites. The regulators should work with consumer groups to plan how best to get this message heard and understood. (Paragraph 180)*

A.36 The Government agrees with this recommendation, and welcomes the work already carried out by the FSA in this area. The Government would expect both the FCA and PRA to continue this work in the normal pursuance of their objectives.

Reporting on international coordination

> *The PRA will be under a duty to co-ordinate with international regulators. This is an immensely important duty given the international dimension of many of the firms whose failure could impact on the stability of the UK financial system. In order that the PRA can be effectively held to account for its duty to co-ordinate with international regulators we recommend a further duty to report on its work in this area. (Paragraph 182)*

A.37 The Government notes this recommendation and has made appropriate amendments to the Bill.

Empowering the PRA to conduct judgement-led supervision

> *Forward looking supervision is a desirable aim. Mechanical enforcement of rules should not be the objective of the regulators. We agree with the Bank of England that more needs to be done to ensure the PRA has the legal power to supervise using forward looking judgement. As a first step the Bill should be amended to place a duty on the PRA to supervise firms. The Treasury should then consider how to enshrine in the legislation the concept of forward looking supervision. In particular, the threshold conditions which set out what firms must do to become and remain authorised should be carefully reviewed to ensure that they embody all the things that the PRA may wish to consider in a forward looking regime. (Paragraph 196)*
>
> *There has been concern and uncertainty about what forward looking supervision might mean for firms. Once established, the new regulators should provide clarity on this issue. A less predictable approach means that regulators will have greater discretion and it is therefore important that attention is paid to the proportionality principle. (Paragraph 197)*

A.38 The Government agrees with Joint Committee that forward-looking, judgement-led supervision will be a key improvement resulting from its new framework. The Government notes, in particular, the recommendation that the PRA be given a formal duty to supervise firms, and has made appropriate amendments to the Bill. With respect to threshold conditions, the Government has noted carefully the Committee’s suggestions in this area, including its concerns that fundamental change should be subject to detailed consultation. The Government will

conduct a comprehensive review of the threshold conditions and bring forward changes in due course, as detailed in chapter 3 of this document.

A.39 With respect to communication by the new regulators with firms, the Government is encouraged by the work that has already been carried out in this area with the joint publication of approach documents for the PRA and FCA by the Bank of England and FSA. The approach documents have already started to provide firms with a clear idea of what will be expected of them and this will be articulated further in the coming months.

Designation of PRA scope

> *The PRA's regulatory perimeter should be broader. We should expect firms of the significance of MF Global, and firms engaging in rehypothecation of client money and assets, to be supervised by the PRA. (Paragraph 209)*

A.40 The Government, the Bank, and the FSA will continue to consider the question of PRA scope, including issues around rehypothecation of client assets. There is also a role for the interim Financial Policy Committee, which has a mandate to advise the Government on issues relating to financial stability and the regulatory perimeter. No change has been made to the provisions of the Bill, as the legal framework already provides sufficient flexibility for changes to be made through secondary legislation – including the Regulated Activities Order, and the Order to be made under new section 22A (designation of activities requiring prudential regulation by the PRA).

> *We are persuaded that there is cause for concern in the area of regulation of holding companies, and recommend that the Treasury examine how it can provide the PRA with more comprehensive powers to ensure a consistent regulatory approach. (Paragraph 211)*

A.41 The Government notes this recommendation and has made appropriate amendments to the Bill. As detailed in chapter 3, the Government has broadened the powers over holding companies provided to the PRA in the draft Bill. The Government also notes the need for change to the regime for regulation of holding companies – many of which exist to provide corporate structures governing the operation of global financial conglomerates – to be agreed internationally, across jurisdictions. The Government is engaging proactively with the emerging European legislation in this area, including the Financial Conglomerates Directive, and the new crisis management framework.

> *It is right that the designation of PRA regulated activities is left to secondary legislation. The financial landscape develops quickly and any definition fixed in primary legislation could soon become redundant or inadequate. The secondary legislation approach will allow a quicker response if the regulatory perimeter needs to be changed in order to accommodate a new area of risk. Nevertheless, given that the initial designation of PRA regulated activities is a key factor in understanding the intentions and scope of the Bill, a draft of the Order must be available when the Bill is introduced into parliament. (Paragraph 213)*

A.42 The Government notes that the Joint Committee endorses its approach in this area. A draft of the Order to be made under section 22A (designation of activities requiring prudential regulation by the PRA) of the Bill is published on the Treasury website, as recommended by the Joint Committee.

> *The procedures for orders designating PRA activities should be amended to provide for an enhanced affirmative procedure in non-urgent cases, retaining the made affirmative procedure for urgent cases only. We appreciate that there will be instances where fast action is required, but it is not appropriate for the 28-day procedure to be applied as a*

matter of routine. The enhanced affirmative procedure should be modelled on that contained in Section 11 of the Public Bodies Act. (Paragraph 217)

A.43 The Government notes this recommendation and has made appropriate amendments to the Bill. The Government recognises that additional Parliamentary scrutiny of the designation order would be desirable, and has therefore amended the procedure to the affirmative.

The role of the PRA in markets regulation

For consistency of regulation, there is a strong rationale for keeping regulation of market infrastructure together. Given the PRA's role in regulating prudentially significant firms, we recommend that the regulation of market infrastructure should sit within the PRA. As is the case for other PRA-regulated firms, the FCA will have an important role in regulating market infrastructure with the respect to conduct issues, and it is important that the legislation makes this clear. Appropriate coordination mechanisms between the two regulators will be required. (Paragraph 231)

A.44 The Government's proposals have always been clear that the Bank of England (not the PRA) should be responsible for regulating clearing and settlement infrastructure (e.g. settlement systems and recognised clearing houses) while the FCA would regulate trading infrastructure (e.g. recognised investment exchanges and multilateral trading facilities). This is consistent with the Bank of England's existing responsibility for regulating systemically important recognised payment systems.

A.45 It would not be appropriate for the PRA to regulate all market infrastructure. Only recognised clearing houses that are central counterparties have the kind of financial exposures (for both capital and liquidity) that PRA-authorised firms have. Settlement systems do not have that kind of exposure, and their technological similarities with payment systems support the co-location of regulatory responsibilities in the Bank of England. The close links between the Bank of England and the PRA will ensure that the Bank has access to appropriate expertise for regulating the financial requirements of central counterparties.

A.46 It is more appropriate for trading infrastructure to be regulated by the FCA which will be responsible for regulating the conduct of authorised persons who use recognised investment exchanges or multilateral trading facilities to deal for their own account or the account of their customers.

We are concerned by the gap in resolution arrangements for market infrastructure firms that may be of systemic importance. The Treasury should take action to ensure that this gap is closed. (Paragraph 233)

A.47 The Government agrees that resolution arrangements of market infrastructure firms need to be investigated. However, this is a global issue and must be addressed as such. Work on this is under way internationally; the Committee on Payment and Settlement Systems (CPSS) and the Technical Committee of the International Organization of Securities Commissions (IOSCO) are currently hosting a working group (which includes the UK and is FSA-chaired) looking at central counterparty resolution powers.

Information from auditors

The PRA will be better able to identify risks building up in individual firms if it established an effective working relationship with bank auditors. The draft Bill should be amended to place a statutory duty on the PRA to meet regularly with bank auditors. The Treasury should consider whether any complementary duties can and should be placed on auditors for example to draw certain risks to the attention of regulators. (Paragraph 236)

A.48 The PRA should be free to determine its own approach to assessing the prudential integrity of the firms that it regulates – the Government does not wish to prescribe operational matters in legislation. The Bank and FSA have stated that the PRA will engage closely with auditors, and the PRA and FCA will have powers to make rules imposing duties on auditors.

Quality of information held by firms

> *The Bill should be amended to place a duty on the Bank of England (or its subsidiary the PRA) to develop information standards for the UK financial services industry and to report regularly on progress in improving these information standards in order to support financial stability. (Paragraph 243)*

A.49 The PRA (and the FCA) will have the ability to make rules requiring firms to hold information in a particular way, as the FSA does now. The FSA has already made some such rules - for example the single customer view rules, which require banks to hold information in a form that enables rapid FSCS payout. Similarly, recovery and resolution plan rules require firms to hold information that would assist in resolving their business.

A.50 The Joint Committee report notes that the Office for Financial Research has "responsibility for monitoring of systemic financial risks and, in order to undertake this task, has been given powers for the setting of data standards for the industry." But the UK's regulatory system will be structured differently to the US system. The FPC will monitor systemic risk – and the PRA and FCA will both be under a duty to provide the FPC with the information it needs to do so. Given this, and the fact that both regulators will be able to make rules of the sort recommended by the Joint Committee, the Government does not believe it would be necessary to legislate for such a duty.

Powers and responsibilities of the FCA

Consumer credit

> *We welcome the Government's decision to look at whether consumer credit should be moved to the FCA. Consumer credit products may pose different problems to other financial products, and it is important that the way in which they are regulated is proportionate, taking into account costs to firms and potential benefits to consumers. However, given the potential for consumer detriment in the case of some types of credit products, there are significant benefits in transferring consumer credit to the FCA, to ensure clarity of responsibilities, and to ensure that the FCA is better able to identify and deal with consumer issues across the financial services market. (Paragraph 250)*

A.51 The Government notes this recommendation, and can confirm that powers will be included in the Financial Services Bill to enable the transfer of responsibility for consumer credit regulation from the OFT to the FCA. However, the Government recognises that such a transfer would involve a significant change for many firms not currently authorised by the FSA, and the importance of ensuring that FCA regulation takes account of the distinct and diverse nature of the consumer credit market. The Government will, therefore, only exercise the powers in the Bill when it has identified a FSMA-based model that delivers proportionate regulation for the different segments of the consumer credit market. The exercise of these powers would also be subject to full consultation and impact assessment, and approval by both Houses of Parliament.

Early publication of disciplinary action

> *We recommend that the requirement to consult before disclosing the fact that a warning notice has been issued should be removed from the draft Bill. However, we do think it important that the FCA has the discretion to weigh the relevant factors and decide which set of interests listed in the Bill (fairness, potential to be prejudicial and potential for detriment to financial stability) are best served by disclosing or not disclosing that a*

warning notice has been issued. We also think that the FCA should be required to publish guidance as to how it will exercise its discretion in respect of disclosing that a warning notice has been issued. This will provide some degree of certainty to firms over how the FCA will treat different cases. (Paragraph 258)

A.52 The Government notes that opinion on this power has been divided; while industry has broadly opposed the power or called for further safeguards, the FSA and some consumer groups have strongly supported the power, and have called for the need to consult to be removed. The Joint Committee has endorsed this latter position. The Government believes that its current proposal strikes the right balance between making the power usable and providing appropriate safeguards for those affected. The Government also notes that the power as drafted ensures procedural fairness. The Government has therefore not made any changes to this power.

Trusted consumer products

A system of identifying and certifying simple, low cost financial products is an attractive idea. This is not a role that the regulator should take on but it is something the voluntary sector itself may be well placed to do. The FCA should be prepared to help the voluntary sector in these endeavours by providing information on products and their costs. (Paragraph 263)

A.53 The Government agrees that the identification and certification of simple financial products is not necessarily a role for the regulator. A Steering Group chaired by Carol Sergeant, former head of risk management at Lloyds TSB and MD of the FSA, has been tasked by the Government to deliver a report to Ministers by July 2012 on how a suite of simple financial products could be introduced by the industry. The Group is comprised of industry and consumer representatives, the Treasury and the FSA will have observer status on the Group.

Competition powers

The Government should review its decision on the FCA's competition powers. The FCA should be given concurrent powers alongside the OFT to make market investigation references to the CC. The FCA will need greater competition powers to achieve its recommended objective than is currently set out in the draft Bill. (Paragraph 279)

We also recommend that designated consumer bodies should be able to make super-complaints to the FCA, as well as the OFT. (Paragraph 280)

A.54 The Government has concluded that no change is required to the mechanism provided for in the draft Bill, which allows the FCA to make a referral to the Office of Fair Trading rather than the Competition Commission. Instead it will accept the recommendation of the TSC that the issue be revisited once the FCA has bedded in, as detailed in chapter 4.

PRA and FCA duty to co-ordinate

The PRA and FCA must co-ordinate as far as possible to minimise the burden on dual-regulated firms. We welcome the assurances that information given to one regulator will be shared with the other so that the same information will not have to be given twice. While a joint rule book and a single point of contact may not be possible, the two bodies should consider other methods of reducing the burden. A draft of the Memorandum of Understanding on co-ordination between the PRA and FCA must be available when the Bill is introduced into parliament. (Paragraph 291)

A.55 Effective coordination between the PRA and FCA will be essential to ensure that they can deliver their statutory objectives in an effective and timely manner. A draft of the coordination MOU has been published by the Bank and FSA, and sets out clear, detailed mechanisms for coordination between the two regulators.

The draft Bill should be amended so that the FCA will have to give its consent before the PRA approves any persons holding significant influence in a dual-regulated firm. (Paragraph 294)

A.56 The Government notes this recommendation and has made appropriate amendments to the Bill.

Influencing EU and international decisions

We strongly support proposals for an international regulatory committee. To be really useful it would need to go wider than just representatives of the FCA and PRA. We suggest that the international co-ordination Memorandum of Understanding establishes a committee responsible for ensuring the UK authorities agree consistent objectives and exercise their functions in a way that is effective. This committee should report to the Chancellor and include representatives of the PRA, the FCA, the Bank and the Treasury. The Treasury should chair this committee. (Paragraph 305)

A.57 The Government notes this recommendation and has made appropriate amendments to the Bill and the draft international organisations MOU (included at Annex F).

The new committee which we proposed be established to agree objectives and maximise the UK's influence in EU and international negotiations should have as an objective ensuring that the European rulebook does not limit the necessary discretion of the UK supervisory authorities to achieve forward looking regulation. (Paragraph 198)

A.58 The Government agrees with the sentiment of this recommendation; the informed use of judgement by the new regulatory bodies is a key overriding tenet of these reforms to the regulatory system. This may well develop into a key role for this new Committee, but it does not require specifying in legislation.

Responsibility for considering the ethics and remuneration structures of firms

The Government should consider the FSA's recommendations on changing the remuneration arrangements for executives and non-executive directions, or introducing a concept of 'strict liability' of executives and Board members for the adverse consequences of poor decisions, in order to ensure that bank executives and Boards strike a different balance between risk and return. Amendments could be brought forward to this Bill. (Paragraph 225)

A.59 The Government will consider the FSA's recommendations in this area carefully. As detailed in chapter 5, the Government and the FSA will publish a joint consultation document in the spring, discussing options for further action in this area.

Attracting the right staff

The PRA and the FCA will need to attract staff with the appropriate approach and experience if the required cultural change is to be realised. There is considerable debate, which we cannot resolve, about how this can be achieved within the financial constraints of public sector bodies. The PRA and the FCA should publish practical plans that explain how they will ensure that they have staff with suitable skills and how they will develop careers for financial regulators in the public service. They should report against progress in this area in their annual reports. (Paragraph 201)

A.60 The Government agrees with the Joint Committee and a number of respondents to the consultation that the calibre of staff will be absolutely critical in ensuring that the shift change to a judgement-led approach is achieved. However, ultimately it will be an operational decision for the regulators to ensure they have the necessary staff in place to meet their objectives and

for them to decide on how to report on this. Autonomy on operational matters (such as staffing) is an essential safeguard on the independence of the regulators.

Accountability, transparency and engagement

Governance of the Bank

> *The evidence we received in the course of our inquiry indicated that the House of Commons Treasury Committee was right to conclude that the governance structures within the Bank need considerable strengthening. Our recommendations about the role of the FPC add weight to this. We support the idea that the Court should be replaced by a Supervisory Board with expert members some of whom should have experience in prudential policy. The new Supervisory Board would be empowered to scrutinise work of its sub-committees and conduct retrospective reviews of decisions taken by the FPC. The reforms in the draft Bill give the Bank significant new powers in macro- and micro-prudential policy. These powers must be paired with reforms to ensure that clear accountability processes are in place. In addition we recommend that the Chairman of the Supervisory Board should be consulted over the appointment of the Governor. (Paragraph 309)*

A.61 The Government recognises that the proposed new structure for financial regulation places a great deal of addition responsibility within the Bank of England. This has the potential to stretch the Bank of England's current governance structures and capacity of senior management. Both the TSC and the Joint Committee, as well as respondents to the June 2011 public consultation have made a number of suggestions aimed at strengthening the governance of the Bank.

A.62 The Government agrees with the TSC that the current situation, whereby the Governor is subject to reappointment for a second five-year term, creates a risk of "instability and at least the perception of political interference in the Bank". As the Chancellor made clear in his evidence to the TSC in July 2011, the Government believes that the independence of the Governor of the Bank of England is vital. The Government has therefore amended the legislation to move the Governor to a single eight-year term, as recommended by the TSC.[5]

A.63 The Bank has published its own response to the TSC's recommendations[6]. The Government welcomes the positive and constructive set of proposals which the Bank has brought forward in this area and will consider the Bank's response carefully before deciding whether to bring forward further legislative changes in this area.

Scrutiny of macro-prudential tools

> *The macro-prudential tools to be used by the FPC are of considerable importance. Some of the tools being considered will have a direct effect on the economic circumstances of constituents. Parliament must have an opportunity properly to scrutinise these powers. On the other hand there must be flexibility to grant the FPC new tools quickly in rare and urgent circumstances. In non-urgent cases we recommend that the tools be subject to an enhanced affirmative procedure similar to that set out in Section 11 of the Public Bodies Act 2011. This would provide for consideration by the relevant select committees in both Houses and where appropriate would place a duty on the Treasury to consider those committees' recommendations before laying the final instrument. (Paragraph 315)*

[5] *Accountability of the Bank of England,* paragraph 143.

[6] Available from www.bankofengland.co.uk

A.64 The Government agrees that proper Parliamentary scrutiny of prospective macro-prudential tools is important. The Bill already provides for macro-prudential tools to be subject to the affirmative procedure giving Parliament an appropriate level of scrutiny. In addition, the Government will consult publicly on its proposals for the FPC's initial set of policy tools. The Government believes that the enhanced affirmative procedure would not be appropriate for the FPC's toolkit, as even in non-urgent cases, enhanced affirmative procedure could cause excessive delay in updating and amending the FPC's powers.

> *All statutory instruments aimed at granting macro-prudential tools to the FPC should contain a sunset clause of one parliament. This will allow ongoing parliamentary scrutiny of the FPC's toolkit. (Paragraph 316)*

A.65 The Government agrees that the FPC's toolkit should be subject to Parliamentary scrutiny and as outlined above, secondary legislation will outline the detail of macro-prudential tools. Some tools may well be of use for a limited period of time, in which case the Treasury can create temporary tools that can be used for a fixed period. And if the FPC or the Government believe that a tool is no longer necessary or appropriate, the Treasury could easily remove it from the toolkit via secondary legislation. However, the Government believes that automatic sun-setting all macro-prudential tools would create unacceptable levels of uncertainty around the FPC's toolkit. In addition, given Parliamentary recesses and the high levels of activity at the beginning of a new Parliament, any delay in renewing the FPC's toolkit would risk the FPC being left without key tools when it needs to use them.

Membership of the FPC

> *FPC membership must include experts from across the financial services industry including insurance and the wider economy. The draft Bill should be amended so that there are a majority of non-executives on the FPC. The interpretation of the FPC code of conduct should not prevent individuals with current and recent industry experience from sitting on the FPC but the FPC should develop clear protocols for dealing with conflicts of interest as they arise. (Paragraph 325)*

A.66 The proposed model for the FPC follows as closely as possible that of the MPC, which has worked effectively. The MPC and FPC have a similar balance of Bank executives and external members. The FPC will include, as well as Bank executives, the CEO of the FCA, and four external members. The FPC also includes a non-voting Treasury member. The Government believes that this creates an appropriate balance between Bank expertise and external challenge.

A.67 The Government notes that independent members with extensive industry experience sit on both FPC and Court, including Michael Cohrs and Robert Jenkins.

Accountability and engagement of the PRA and the FCA

Transparency

> *We recommend that the draft Bill be amended to require the FCA to publish Board & Panel minutes and agendas, where possible and appropriate. Where the FCA board has considered an issue of public policy the minutes should set out clearly the arguments for and against the policy. (Paragraph 328)*

A.68 The Government notes these recommendations, but believes that this should be a matter for the regulator and does not require legislation.

> *We look forward to the outcome of the Treasury's review on section 348 of the Financial Services and Markets Act. This section should not be retained as currently drafted. Neither regulator should be unnecessarily restricted from disclosing information. Section*

348 should be amended to make it as unrestrictive as is possible within the confines of EU law. (Paragraph 330)

A.69 The Government committed to a review of section s348 as part of the PLS process. This review is still ongoing, but its conclusions and recommendations will be made available during the passage of the Bill.

Engaging with the industry and consumers

While we consider that it is vital for the PRA to consult with practitioners, and as far as necessary, consumers, we believe it is right that the PRA should not be obliged by legislation to establish panels on the same model as the FCA. In particular, we are concerned that an obligation to create such panels could lead to regulatory capture. However, in the absence of panels it is even more important for the PRA to demonstrate that it is undertaking fair and adequate consultation. We are concerned that there is not yet clarity on how the PRA intends to go about this. We recommend that details of the proposed consultation arrangements are made available for consideration alongside scrutiny of the Bill in Parliament. The PRA should, in addition to its duty to publish details of consultation arrangements, also have a duty to report annually on its consultation activities. (Paragraph 336)

A.70 The Government notes this recommendation and has made appropriate amendments to the Bill to ensure that the PRA reports on its consultation activities in its annual report. The Bank of England and FSA will publish details of the proposed consultation arrangements during the Bill's passage, as recommended.

The PRA Board must have a balance of expertise reflecting the sectors regulated by the PRA. The draft Bill should make particular provision for at least one member of the Board to have specialist expertise in the area of insurance. The distinct nature of the insurance role of the PRA has been explicitly recognised through an entire separate objective—it only follows that the prescribed membership of the Board should reflect this responsibility. (Paragraph 338)

A.71 The Government agrees with the committee that the PRA Board should contain a balance of individuals with the right knowledge and expertise, who can robustly challenge the PRA's strategy to ensure that it is delivering its statutory objective of promoting the safety and soundness of firms. But the Government does not believe that it would be appropriate to suggest that the PRA board should in some way be representative the interests of industry. The PRA will be independent of those it regulates, and must be seen to be independent. There must be no suggestion of regulatory capture.

Dealing with complaints

Given the shift in regulatory architecture and culture, it is vitally important for the new regulatory bodies to have effective, independent complaint systems. The arrangements in the draft Bill do not provide for a sufficiently independent system at the PRA. We believe that the PRA should, mirroring arrangements under the current system, have an independent complaints commissioner whose appointment must be confirmed by the Treasury. In order to ensure that complaints concerning co-ordination between the PRA and FCA are properly handled and resolved, we recommend a single complaints commissioner and system covering both the FCA and the PRA. (Paragraph 343)

A.72 The Government notes this recommendation and has made appropriate amendments to the Bill.

Appealing regulatory decisions

> *We acknowledge the concerns that in certain cases the Upper Tribunal will be confined to referring contested decisions back to the regulators, rather than substituting its own opinion. However, we believe that the PRA or FCA, as the regulators, will remain better placed to reach an informed judgement. Allowing the Tribunal to substitute its own opinion for that of the regulator would undermine the principle of judgement-based regulation. (Paragraph 348)*

A.73 The Government notes that the Joint Committee endorses its position on this issue. The provisions of the draft Bill are therefore retained.

Reports on regulatory failure

> *It should standard practice to publish a report after major regulatory failure. (Paragraph 349)*

A.74 The Government agrees, and has legislated to ensure that this will be the case in future. If a significant regulatory failure occurs, the PRA or FCA will required to submit a report to the Treasury, which will be laid before Parliament. The Bill sets out how such investigations will be triggered. The Treasury will also have the power to direct the regulators to carry out a report.

> *There are some advantages to have an objective set of triggers for regulatory failure inquiries, to ensure clarity and increase accountability. However, these would be very difficult to define. It is important to note that even if the FCA or PRA does not think the threshold for an inquiry has been met, the Treasury will, under the proposals, be able to direct the regulators to undertake an inquiry. Given this, we do not think that the Bill needs to contain more specific objective triggers. (Paragraph 358)*

A.75 The Government welcomes this conclusion. In order to provide greater clarity for the public, it has amended the relevant provisions to include a requirement on the regulators to set out in a statement of practice how these triggers might be met.

> *The Treasury should be required to consider impacts on other regulatory activity, including enforcement activity, when making directions to the regulator on the conduct of investigations into regulatory failure. We also recommend that the regulator should be required to consider the impacts on other regulatory activity, including enforcement activity, when deciding how to conduct a regulatory failure investigation. (Paragraph 362)*

A.76 The Government notes these recommendations and has amended the relevant provisions accordingly.

Independent Commission on Banking

> *The ICB recommendations on ring-fencing and higher capital requirements are extremely important. Parliament must consider the substance and get the detail right in the legislation that enacts the recommendations. We urge the Treasury to confirm that legislation will be subject to pre-legislative scrutiny in parliament. The legislation enacting the ICB recommendations on ring-fencing should be brought forward during the 2012–13 Session in order to give banks a clear framework to work to. The ring-fence should be implemented as soon as possible. There is a good case for allowing time to rebuild capital requirement adequacy. (Paragraph 8)*

A.77 As the Chancellor made clear following the publication of the *Government's response to the Independent Commission on Banking* on 19 December 2011, the Government will consider the case for pre-legislative scrutiny. The Government believes that it is vital to ensure that the

legislation is right, and for that reason will consult widely with the industry and other stakeholders on the overall statutory framework, and on the technical details of the ring-fence. The ICB itself undertook two rounds of consultation, and any rules that the future Prudential Regulation Authority (PRA issues will also require a consultative process. Parliament will also have an opportunity to debate these fully as part of the legislative process.

A.78 The Government has already committed to completing primary and secondary legislation related to the ring-fence by the end of this Parliament (in May 2015), and banks will be expected to be compliant as soon as practically possible thereafter. The Government will work with the banks to develop a reasonable transition timetable.

A.79 The Government agrees with the ICB's timetable that the final, non-structural recommendations relating to loss-absorbency should be completed by the beginning of 2019, in line with the Basel III timetable.

The impact of ICB recommendations on the PRA's responsibilities

The ICB recommendations are key to the work of the regulators established by the draft Financial Services Bill. For example, without the ICB reforms it will be harder for the PRA to meet its objective of minimising the impact of firm failure. The legislation enacting the ICB recommendations on ring-fencing should be introduced into parliament during the 2012–13 Session in order to give banks a clear framework to work to. The ring-fence should be implemented speedily. By contrast there is a good case for allowing banks to build up capital over time. Furthermore, the Government should think carefully about imposing on banks headquartered in the UK capital requirements relating to their overseas subsidiaries over and above that agreed by the international college of regulators. (Paragraph 185)

It should be for Parliament to define the ring-fence for retail banking. The definition may need adjusting from time to time and therefore should not be enshrined in primary legislation. Instead it should be set out in secondary legislation so it can be more easily reviewed and adjusted. It should not be left to the Bank or the regulators to define the ring-fence. (Paragraph 187)

A.80 The Government has already committed to completing primary and secondary legislation related to the ring fence by the end of this Parliament in May 2015 and banks will be expected to be compliant as soon as practically possible thereafter. The Government will work with the banks to develop a reasonable transition timetable. The Government agrees with the ICB's timetable that the final, non-structural recommendations relating to loss-absorbency should be completed by the beginning of 2019, in line with the Basel III timetable.

A.81 The ring fence will be defined in primary and secondary legislation, and so will be subject to full Parliamentary scrutiny.

B Government response to the Treasury Select Committee

Introduction

B.1 The Government welcomes the report of the Treasury Select Committee (TSC) into accountability of the Bank of England, published on 8 November 2011, and thanks the Committee for its work in this important area.[1] Chapter 2 of this document sets out in detail the Government's overall approach to the matters covered in the TSC's report: the role and powers of the FPC, crisis management, and the governance of the Bank. The Government's response to the individual recommendations and conclusions of the TSC is set out below. Paragraph numbers refer to the TSC's report.

B.2 The Government is not, at this time, minded to pursue the more radical changes to Bank of England governance recommended by the TSC, including the replacement of Court with a supervisory board. In general, the Government considers that the governance of the Bank should primarily be a matter for the Bank itself. The Government notes that the Court of the Bank of England responded to the Committee's report on 17 January and welcomes the positive and constructive set of proposals which Court has brought forward.[2] Court's response proposes the creation of an Oversight Committee for financial stability, made up entirely of non-executive members of Court. Court suggests that the oversight committee's remit should cover the entirety of the Bank's financial stability activities and members should have access to the meetings and papers of the Bank's policymaking committees, including the FPC. The oversight committee would also be able to commission periodic reviews of policymaking performance from expert external authorities. The response also proposes publishing records of future Court meetings.

B.3 The Government will consider Court's response carefully in considering whether further changes to the governance of the Bank are needed.

The Court of the Bank of England

Name of the governing body

> *To reflect the shift of emphasis in its role, we recommend that the governing body of the Bank (Court) change its name to the "Supervisory Board of the Bank of England". References below to the Board of the Bank of England in this report use this term. Whatever name is ultimately chosen, we strongly recommend that the term "Court" is abolished. (Paragraph 41)*

B.4 The Government recognises the views of the TSC but also notes the risks raised in Court's response, in particular with regards to the potential for confusion if Court were to be re-named as a "Supervisory Board". The Government does not intend to change the name of Court at this time.

[1] Available from www.parliament.uk

[2] Available from www.bankofengland.co.uk

Responsibility for resource allocation

> *We recommend that when the Supervisory Board considers the annual budget, it should be responsible for coming to an explicit view about both the level of, and changes to the allocation of, resources for all areas of activity, including the macro-prudential and monetary areas of work. It should provide public explanations of those decisions. (Paragraph 44)*

B.5 The Government agrees that Court's responsibility for the annual budget and the allocation of resources is important, and notes the Court's positive response to this recommendation.

Membership: skills and experience, size, balance and conflicts

> *The new responsibilities of the Bank will require its governing body to have an enhanced mix of skills. The Bank will have responsibility for macro and micro-prudential regulation and financial stability. As well as management skills, the new Supervisory Board needs sufficient expertise in macro-economics and finance to enable it to perform its expanded oversight role effectively. We therefore recommend that, in addition to experience in running large organisations and financial institutions, membership of the new Supervisory Board have expertise in prudential policy. (Paragraph 50)*

> *We draw attention to the increased importance of the role of the Chairman of the new Supervisory Board. We recommend that the Chairman in the future have considerable experience of prudential or financial issues. (Paragraph 52)*

B.6 The Government agrees that prudential expertise will be an important asset for the future work of the Court. This will be taken into consideration as part of the process for future Court appointments.

> *The current arrangements are that non-executives are in the majority on the Court and that the Chairman of the Court is external. These should remain in place. We propose, in addition, that the new Supervisory Board should be reduced to a size which allows a diversity of views and expertise but is small enough to be an efficient decision-making body. Although the Court has recently been reduced in size, it is still too large. We recommend that the new Supervisory Board be reduced from a membership of twelve to one of eight, comprising the Governor, the two Deputy Governors, an external Chairman, and four other external members. (Paragraph 54)*

B.7 The Government recognises the importance of having an efficient decision-making body, but also notes the views of Court that, given the new responsibilities of the Bank, there would be risks in further reducing the number of Non-Executive Directors. The Government agrees with Court's view that it would be inappropriate to reduce the size of the Court at this time in light of the Bank's increasing responsibilities.

> *The membership of the new Supervisory Board of the Bank of England must consist of eminent and professionally experienced individuals. The interpretation of what constitutes a conflict of interest needs to be assessed on a case-by-case basis when external members of the Board are appointed. When a conflict arises in relation to a member of the Board, the rest of the Board, led by the Chairman, should exercise its judgement as to how to deal with it, as is standard practice on the boards of major public companies. (Paragraph 62)*

B.8 The Government notes the points made by Court in its response with regard to its responsibilities in this area.

Accountability of the governing body

> *It is important that those overseeing financial stability are publicly accountable for their performance. We will invite members of the new Supervisory Board before the Treasury Committee regularly in the future and we will seek to ensure that its members remain committed and effective in fulfilling their role. We recommend that the new Supervisory Board's minutes be published to a timetable similar to that of the MPC, subject to any specific concerns of confidentiality which the Chairman of the Supervisory Board should raise with the Chairman of the Treasury Committee. (Paragraph 67)*

B.9 The Government agrees that transparency and accountability to Parliament are of paramount importance and notes the points made by Court with regard to this matter, including its proposal to publish a record of future Court meetings. The Government welcomes this commitment.

Staff support

> *We propose that the staff support for the new Supervisory Board be strengthened. It requires a dedicated, and high quality staff containing the skills and experience needed to fulfil its oversight functions. We expect that many staff would be drawn from the Bank, as one stage in their career. While serving the Supervisory Board they would be accountable to the Chairman of the Board, including for performance management purposes. External staff should be considered, at the discretion of the Board. (Paragraph 71)*

B.10 The Government welcomes the Bank's commitment to provide the necessary resources in order for Court to discharge its functions effectively.

Role of the governing body

> *We recommend that the new Supervisory Board conduct ex-post reviews of the Bank's performance in the prudential and monetary policy fields normally not less than a year after the period to be reviewed. This would be consistent with avoiding second guessing at the time of the policy decision. The reviews should among other things enable lessons for the future to be learnt. They should strengthen the Bank's collective memory. There should be no presumption that the commissioning of a review implied that the episode or function in question had been badly managed: successes and failures should be reviewed alike. It would be a matter for the Board itself to determine when and how such reviews would be conducted, and into which issues. (Paragraph 81)*
>
> *There should be the presumption that ex-post reviews would be published, except where confidentiality needed to be maintained, in which case it might be desirable for either a redacted version to be published or for publication to be delayed. On such occasions, the Chairman of the Treasury Committee should be shown an unredacted version of the findings with an explanation of the reasons for non-publication. The date of publication should then be reviewed periodically until such a time as full publication would not endanger confidentiality or financial stability. (Paragraph 82)*
>
> *In addition to the present monthly reports to the Board on monetary policy and similar papers on prudential matters and actions, we recommend that Board members be authorised to see all of the papers considered by the MPC and FPC, to ensure informed monitoring of processes and management is possible by the Supervisory Board. (Paragraph 84)*
>
> *We recommend that the new Supervisory Board be responsible for responding to requests to the Bank for factual information from the Treasury Committee and the Treasury. It should also monitor the regular disclosure and publication of statistics and information relevant to the monetary, financial stability and prudential fields, though*

such decisions should, in the first instance, be a matter for the Bank executives. (Paragraph 88)

B.11 The Government is committed to transparency and Parliamentary accountability, and welcomes the views of the TSC, and Court's positive response, in this regard.

B.12 Court's model proposes the creation of an oversight committee for financial stability, made up entirely of non-executive members of Court. The oversight committee's remit would cover the entirety of the Bank's financial stability activities and members would have access to the meetings and papers of the Bank's policy-making committees, including the FPC. In addition to conducting its own scrutiny of the processes and information used by the Bank and its committees to reach and implement their policy decisions, the oversight committee would also be expected to commission periodic or ad-hoc retrospective reviews of policy-making and implementation performance from expert external authorities – such as the International Monetary Fund (IMF).

B.13 On 23 January the TSC published a response to Court's proposals[3], in which it notes the importance of internal policy reviews, in addition to external assessments. The Chancellor has therefore agreed with the Governor and the Chair of Court that the oversight body will also be expected to commission retrospective internal reviews from the Bank's policymakers of policy-making and implementation performance – for example from the FPC, or from other parts of the Bank with responsibilities relevant to financial stability, such as infrastructure regulation or bank resolution. The oversight body will be responsible for setting the terms of reference of the reviews and ensuring that they are conducted properly and effectively, for publishing their findings and for ensuring that the conclusions are followed up.

The Financial Policy Committee

Membership

We recommend that the Bank change its emphasis so that the appointment of industry practitioners becomes easier. This will put more onus on the committees, led by their chairmen, themselves to deal with any conflicts of interest as they arise. In order to do so they should follow best practice of private sector boards. (Paragraph 91)

B.14 The Government notes that independent members with extensive industry experience sit on both Court and the FPC, including Michael Cohrs and Robert Jenkins. However, the Government supports the Bank's intention to look again at this issue and would welcome any steps the Bank might make to help expand the potential pool of candidates for these roles.

The expertise and independence of external MPC and FPC members are of the highest importance. Their appointment requires greater accountability to Parliament. We recommend that the Treasury enable the appointment hearings we hold with the selected external candidates for the MPC and FPC to take place before their appointment to these committees. (Paragraph 93)

B.15 The Government recognises that it is of the utmost importance that strong candidates are found to sit as externals members of the Bank's policy committee. However, the market sensitive nature of MPC and FPC appointments make them unsuitable for pre-appointment hearings. Appointments to these committees are already subject to pre-commencement hearings by the TSC, and the Government hopes that this will continue.

The avoidance of groupthink is the responsibility of the Bank of England, and therefore should be monitored by the new Supervisory Board of the Bank. This Board will be well

[3] Treasury Select Committee, *Accountability of the Bank of England: Response from the Court of the Bank,* January 2012

placed to conduct reviews of committee processes and build relationships with the members of committees. (Paragraph 102)

B.16 The Government agrees that the external members of policy committees must provide strong challenge to avoid groupthink. The Government notes the Court's response on this issue.

We repeat our previous recommendation that a better balance between internal and external members of the FPC and MPC be found. We propose that the ratio of internal to external members move from 5:4 to 4:5. We would expect that external members will not always agree with the internal Bank executives, but we believe that there should be room for such creative tension. Whatever the precise numbers, the external members of both the FPC and MPC should be in the majority. (Paragraph 103)

B.17 The Government believes that the current membership arrangements of the Bank's policy committees are appropriate and provide the best balance between Bank expertise and external challenge.

We recommend that the Chairman of the new Supervisory Board sit as a silent observer on all of the Bank's committees, a role which could be delegated by the Chairman to other members of the board. Since appearing before us, the current Chairman of Court, Sir David Lees, has told us that he can see the advantages of such a recommendation and agreed that it could be made to work in practice, with elements of discretion as to which meetings are attended and flexibility over which member of Court sits as the observer. A Board presence on Bank Committees will enable the Board better to handle many of the problems outlined above. It will become aware of, for example, potential conflicts of policy between the committees, potential problems of groupthink, and will be able better to monitor the implementation of the respective codes of conduct. (Paragraph 132)

B.18 The Government agrees that being involved in deliberations in this way would improve the Court's ability to review the decisions of the Bank's policy committees, thereby strengthening oversight and accountability. The Government notes that the Court has responded positively to this recommendation in its response.

Availability of information

The Court already has meetings with individual members on the adequacy of information and any concerns about governance matters. As part of its process and management overview function, the new Supervisory Board must ensure not only that internal and external members (and the Treasury observers) of the Bank's committees have the information they need, but also seek confirmation that all members feel free to express their views and do not perceive themselves constrained by groupthink or by the dominance of internal Bank members. (Paragraph 104)

B.19 The Government agrees that access to adequate information and the freedom to express their opinions are vital for external committee members of the policy committees to carry out their responsibilities effectively. The Government notes Court's response.

Role of Treasury in setting FPC's remit

In order to maintain the independence of the Bank, we support the ability of the FPC to reject any guidance which it regards as inappropriate. However, the ability for the Treasury to influence the interpretation of the financial stability objective is an important one, given the present lack of a definition of financial stability, and therefore if the FPC rejects guidance it should have the opportunity to explain its reasoning in writing to both the Treasury and the Treasury Committee. (Paragraph 113)

B.20 As noted in chapter 2, the Government agrees that where the FPC does not agree with the Treasury's recommendations, it should make its concerns public and explain why it does not

intend to act in accordance with those recommendations. The Bill has therefore been amended to require the FPC to respond publicly to the Treasury's remit, setting out how it intends to comply with the recommendations and, where appropriate, setting out its reasons why it does not intent to act in accordance with the remit.

> *We recommend that HMT give guidance under Clause 3 of the draft Bill to the Bank of England to adopt indicators for gauging financial stability. The selected range of indicators must be flexible and under constant challenge and review, not only by Parliament, Government and the Bank of England, but also by others such as financial industry practitioners, the media, academia and the public. The indicators should be published so that the performance in maintaining financial stability may be monitored and so that it can be held accountable for that performance. The FPC should report against these criteria at regular intervals. (Paragraph 114)*

B.21 The Government believes that openness and transparency are important to secure public understanding of macro-prudential policy. The Bank has made clear in its response to the TSC's report into Bank accountability[4] that the FPC will regularly publish, and report against, indicators of financial stability. The Bank and FSA published a joint paper on 20 December 2011 that discussed potential indicators for gauging financial stability. If necessary, as part of its annual remit to the FPC the Treasury will be able to make recommendations about additional indicators that it feels the FPC should consider.

Financial stability and protecting public funds

> *20. Clause 2 of the draft Bill should be amended so that the reference to the stability of the UK financial system takes account of the Chancellor's proviso about not requiring the support of taxpayers' money. The use of public funds will usually represent a failure by the regulatory authority to identify problems early enough. We recommend that the clause also place a duty on the Bank of England to minimise, as far as possible, the use of public funds. (Paragraph 115)*

B.22 The Government agrees with the Committee that the protection of public funds should be a core priority for the new regulatory system. In fulfilling its objective to protect and enhance financial stability, the Bank will be responsible for reducing the likelihood of serious threats to stability that might have the potential to put public funds at risk. Where the Bank considers that there is a material risk that a specific situation would threaten public funds, it is under a statutory duty to notify the Chancellor. This reflects the Government's ultimate responsibility to protect public funds. Given the importance of maintaining clarity of responsibilities and of underlining the Chancellor's sole responsibility for taking decisions around the use of public money, it would not be appropriate to give the Bank an explicit duty to protect public funds.

Status of the FPC

> *There is some concern that the position of the FPC within the Bank may appear anomalous with regard to the MPC. We request the Governor to review the status of the two institutions and we may return to this matter in further work. (Paragraph 116)*

B.23 The Government notes the Committee's observations, and also notes that the Joint Committee has made a specific recommendation that the FPC be established as a committee of the Bank. It has been argued, including by the Bank's senior management when giving evidence to the TSC, that the FPC should remain under the oversight of Court in order to allow better coordination of the Bank's various financial stability activities. The Government also notes the response of the Court on this matter and will consider the status of the FPC further.

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[4] *Response from the Court of the Bank to the recommendations made by the Treasury Committee and Joint Committee on the Draft Financial Services Bill on the Accountability of the Bank of England*, paragraph 5

Scrutiny and accountability

> *The macro-prudential measures set out in secondary legislation will be of great importance and potential scope, and will give the FPC great powers. Parliamentary control and scrutiny of these measures are vital before such powers are granted. As the legislation stands, their approval by the House of Commons requires only a 90 minute debate in a General Committee and a decision without debate in the House. We recommend that the Government amend the draft legislation to require that debates on orders prescribing macro-prudential measures be held on the floor of the House and not be subject to the 90 minute restriction. Furthermore, the House would benefit from prior scrutiny of such orders by this Committee. We recommend that the Government provide us with the proposed text of the draft orders at least two months before they are laid before the House in order to allow us to report to the House on their merits. (Paragraph 119)*

B.24 The Government believes that Parliamentary scrutiny of prospective macro-prudential tools is important. However, it is for Parliament itself to decide the length of, and venues for, its debates. The Statutory Instruments that will establish the FPC's tools will be subject to affirmative procedure. The Government will also consult publicly on its proposals for the FPC's initial set of policy tools.

> *The Bank is a democratically accountable institution and it is inevitable that Parliament will wish to express views and, on occasion, concerns about its decisions. Our recommendation that the new Supervisory Board have the authority to conduct retrospective reviews of the macro-prudential performance of the Bank should, if operating successfully, provide the tools for proper scrutiny. However, the Bank will need to explain its decisions more fully to Parliament than has been the case on occasion with some regulators, for example the Financial Services Authority. If these measures we propose prove inadequate, we will have to return to this issue. (Paragraph 120)*

B.25 The Government notes the findings of the Treasury Committee and the Court's proposed response to address these matters.

Conflicts between FPC and MPC

> *We recommend the introduction of a statutory duty for the Governor to raise such a conflict with the new Supervisory Board (or its Chairman) if it occurs or is suspected. The Chairman's role should be to ensure proper consideration and that correct process is followed, not to challenge policy. The Governor should, in addition, explain how he proposes to handle it, including by means of a public statement. We recommend that the legislation should provide for a joint meeting of the MPC and the FPC to take place if that is deemed by the Governor, after discussion with the Chairman of the Supervisory Board, to be the best way to resolve a significant conflict. The existence of the arrangement for notifying the Chairman is likely to diminish the need for its use. (Paragraph 129)*

B.26 The FPC and MPC will complement each other's policy aims and so are unlikely to come into conflict. The positive impacts of this match will be enhanced by the significant degree of cross membership between the two committees. Nevertheless, in order to provide for all eventualities, the Government has added provisions to the Financial Services Bill that will enable a joint meeting between the two committees if they believe it appropriate.

Transparency

> *We recommend that the minutes of meetings of the Financial Operations Committee (FOC) be published within two weeks, or, if publication would threaten financial stability, as soon as it is safe to do so. If publication of minutes is delayed, the Chancellor of the Exchequer*

and the Chairman of the Treasury Committee should be informed of the delay, and told of the nature of the discussion and the decisions reached. (Paragraph 136)

B.27 The Government notes the Committee's recommendation. This is an operational matter for the Bank.

The Bank of England's mandate

27. The mandate of the Bank of England is of the highest importance, but has not been a focus of the Committee in this inquiry. The new powers that the Bank has been given will allow it to take steps to meet its financial stability objective. But these powers could also potentially allow it to act to achieve wider economic objectives. Whether these new powers should also mean that the Bank should have an amended mandate, for example to promote sustainable growth, is something that we may wish to return to in a subsequent inquiry given the likely public debate about this important issue. (Paragraph 138)

B.28 The Government notes these observations and will consider, in due course, any recommendations made by the Committee in this area.

Office of the Governor of the Bank of England

Term and appointment

We recommend that the draft Financial Services Bill amend the Bank of England Act to state that the Governor may serve a single, non-renewable term of eight years. (Paragraph 143)

B.29 The Government agrees that the Governor's term should be changed to a single, eight-year term and the Bill contains a new provision to implement this change.

The Chancellor argued that because the OBR performs what is essentially an auditing function for the Government, and the Bank of England carries out executive functions, the two institutions are materially different. He used this distinction to argue that the Treasury Committee's power of veto over the appointment or dismissal of the leaders of the OBR should not apply to the position of the Governor of the Bank. We are not persuaded by this line of argument. The power of veto with respect to the OBR was given to ensure the independence and accountability of that body. The Governor of the Bank's independence from Government is crucial for his or her credibility. Given the vast responsibilities of the Governor, the case for this Committee to have a power of veto over the appointment or dismissal of the Governor is even stronger than it is with respect to the OBR. We therefore recommend that, in order to safeguard his or her independence, the Treasury Committee is given a statutory power of veto over the appointment and dismissal of the Governor of the Bank of England. (Paragraph 148)

B.30 The Government believes the independence of the Governor of the Bank of England is vital, and is confident that this independence is safeguarded via existing mechanisms, such as his appointment by the Queen. The Bank of England and the Office for Budget Responsibility perform materially different roles. The Bank of England undertakes policy actions that directly affect markets and, as such, appointments to the Bank's executive or policy committees are market sensitive. This market sensitivity makes these roles unsuitable for pre-appointment vetting. The Government hopes that the TSC will continue to hold pre-commencement hearings for the members of the Bank's policy committees, which include the Governor and Deputy Governors.

Crisis management and the role of the Chancellor

"Material risk"

> *We strongly recommend that the definition of what constitutes a "material risk" for the purposes of clause 42 of the draft Bill be contained in the forthcoming legislation. This definition should also take account of the fact that major liquidity operations by the Bank require Treasury approval—the material risk of these too must require notification to the Treasury. (Paragraph 165)*

B.31 The draft crisis management MOU at Annex E sets out in detail the factors the Bank will consider when deciding whether it is necessary to make a notification of a risk to public funds. However, the MOU does not give a strict definition of what "material risk" means, as it would be difficult, if not counterintuitive, to attempt to provide a formulaic test for something that is ultimately a matter of judgement. Attempting to codify such a decision in a strict statutory test would be counter to the general thrust of changing the culture of the regulatory system to place a greater emphasis on expertise and judgement.

B.32 Given this, the Government has chosen not to attempt a formal definition of "material risk" and has instead taken the approach of detailing the process by which the judgement of materiality will be made. Given this focus on process, the Government considers that the crisis management MOU, rather than the primary legislation itself, is the most suitable place for this material to be included.

Operation of the crisis management framework

> *We are concerned that the formal notification of a material risk to public funds may still not give the Chancellor enough time to consider other policy options. The Treasury needs to know as early as reasonably possible when it might receive a notification. We therefore recommend that the forthcoming legislation also require the Bank to give the Chancellor an early warning of the possibility that a notification of a material risk to public funds may need to be given, and full information about the circumstances. We further recommend that the Draft Bill be amended so that this early warning triggers a discretionary power for the Chancellor to be able to direct the Bank if he or she so chooses. The Bank should be required to provide such an early warning to the Chancellor as soon as the FPC becomes aware of a possibility of a material risk to public funds. Subsequently, until either the possibility has disappeared or a formal notification has indeed been made, the Bank should be required to keep the Chancellor fully informed. (Paragraph 166)*

> *To ensure proper accountability to Parliament, the responsibility of the Chancellor for all decisions involving public funds or liabilities in a time of crisis should be stated in the draft Bill. A crisis should be deemed to have begun from the moment when the Bank formally notifies the Chancellor of a material risk to public funds. (Paragraph 167)*

> *We recommend that the Chancellor be given statutory responsibility for a crisis after the formal notification by the Bank of a material risk to public funds. This should automatically trigger a discrete power for the Chancellor to direct the Bank, separate from the general power under the 1946 Act. The Chancellor might choose not to direct the Bank in such a crisis, but once the notification of material risk had been given, the Chancellor should be regarded as fully responsible and accountable to Parliament for its handling. Any use by the Chancellor of the power of direction should be made public unless the Chancellor considers it against the public interest to disclose it. Notification of such an event should be made to the Chairman of the Treasury Committee. (Paragraph 169)*

If the Chancellor chose not to direct the Bank after a notification of a material risk to public funds had been made by the Bank, this would represent a delegation of the function of operational decision making to the Governor, but with the Chancellor remaining responsible and accountable for the decisions made. The Chancellor's assumption of responsibility and his power to direct the Bank are consequences of his responsibility for public funds and liabilities, and his accountability to Parliament for them. The Bill should therefore specify that the period of the Chancellor's sole responsibility expires when the Chancellor decides that the risk to public funds has ended. Its termination should be made public. (Paragraph 170)

Decisions to issue either the early warning that we have recommended, or the formal notification set out in the draft Bill, should be a matter for the executives of the Bank. In both cases, prompt communication with the Treasury will be vital in order to give the Chancellor time adequately to consider options. We therefore recommend that the Court should have a duty to monitor the fulfilment of these warning and notification requirements. (Paragraph 172)

The proposals we have made give the Chancellor power to direct the Bank when there is a material risk to public funds. We have further recommended that he or she have a discretionary power to direct the Bank following early warning from the Bank that such a material risk is a possibility. It may be that Chancellors will decide not to use that discretionary power after an early warning, but the fact that he or she would have the statutory ability to assume that power would create a clear line of accountability for decisions taken through the Chancellor to Parliament. A Chancellor can be expected to take responsibility in times of turbulence. We regard it as essential that the Chancellor should have this discretionary power to allow him or her to be responsible to Parliament for decisions that may lead to a claim on the public purse. (Paragraph 176)

B.33 The Government recognises the TSC's concerns that the crisis management arrangements set out in the Bill may need strengthening in order to ensure clear lines of responsibility and accountability for the use of public funds and ensure that in all cases the Chancellor has the ability to fulfil his ultimate responsibility for protecting taxpayer money. As set out in Chapter 2 in more detail, the Government therefore accepts the TSC's recommendation that the Chancellor should be provided with a discretionary power to direct the Bank where public funds are at risk.

B.34 The Government believes that the duty on the Governor to notify the Chancellor of risks to public funds is designed in such a way that it will be triggered early enough in the process that an additional early warning system is not necessary. The draft MOU makes clear that there must be "no surprises" for either institution, and spells out mechanisms by which the Treasury can ask the Bank to consider whether the notification threshold of material risk has been reached.

B.35 In general, the Government agrees with the TSC's characterisation of the sole and overriding responsibility of the Chancellor for all decisions involving public funds or liabilities and believes that the new power of direction will make this clear without the need for further legislative provision.

The role of the Chancellor in the FPC

A broader enduring discretionary power could be considered. However, given the powers for the Chancellor that we have recommended, it is not clear what further would be gained by giving the Chancellor an enduring discretionary power to chair the FPC. In normal times we would expect any such power to be delegated to the Governor, and the lion's share of the occasions when he or she would be likely to wish to chair the Committee are covered by the recommendations we have made. However, there could be occasions when the Chancellor might wish to take responsibility for decisions by the

FPC of great economic or public importance where public funds were not potentially at risk. Since that the powers of the FPC are novel, this is something on which, given the likely public discussion, we and Parliament may wish to express a view. (Paragraph 177)

B.36 The Government is clear that the FPC is and should remain independent of undue political influence. Given that the FPC has no role in crisis management and does not take decisions involving public funds, it is right that the Chancellor's power of direction does not cover the policy decisions taken by the FPC. Similarly, the Government agrees with the Committee that it would not be appropriate to put in place arrangements to allow the Chancellor to chair the FPC in crisis situations.

Summary of responses to consultation

C.1 The Government's White Paper, *A new approach to financial regulation: the blueprint for reform* was published on 16 June 2011. The consultation period closed on 8 September and over 100 responses were received. This annex identifies the key themes emerging from the responses to the consultation and summarises responses to each of the consultation questions.

Summary of key themes

Stakeholder engagement

C.2 Respondents were appreciative of the Treasury's willingness to engage with stakeholders and welcomed the progress that had been made through previous iterations of consultation over the last year.

Timetable

C.3 Several respondents highlighted the fact that the Bill timetable is ambitious but many acknowledged that the Government needs to make changes quickly to reduce the period of uncertainty.

Bank of England and Financial Policy Committee

C.4 Respondents were broadly supportive of the proposals for the Financial Policy Committee (FPC), but there were comments on:

- the balance of expertise on the Committee and the ratio of independent members to Bank executives;
- the FPC's objective;
- the accountability and transparency of the FPC; and
- how the FPC would use its macro-prudential tools.

Prudential Regulation Authority

Objectives

C.5 Respondents were supportive of the revised general objective for the Prudential Regulation Authority (PRA). However, some noted that it appears to be framed in terms of addressing a micro issue (safety and soundness of firms) by focusing on a macro one (wider financial stability). Some argued that the objective is "UK focused". Respondents generally supported the principle that the PRA should not be required to ensure that no firm should fail.

C.6 Respondents also supported the new insurance objective. However some noted that the reference to protecting "future policyholders" could prove to be ambiguous.

Governance

C.7 Some respondents suggested refinements to the PRA's proposed governance arrangements to be more consistent with corporate best practice. A number of suggestions were made for changes to the governance arrangements.

Approach

C.8 Respondents generally supported the move to "judgement-led" regulation. However, some questioned how possible it will be to take this approach, given the increasingly prescriptive nature of EU directives. Respondents emphasised the importance of recruiting and retaining high quality, experienced staff in order to deliver effective judgement-led regulation.

Industry representation and engagement

C.9 Industry and consumer groups argued that the PRA should retain elements of the FSA's existing panel structure, and some argued for an overarching panel structure covering both regulators. Some respondents suggested changes to the PRA's proposed complaints procedure.

Financial Conduct Authority

Approach and powers

C.10 There was widespread support for a tougher and more proactive approach to conduct regulation under the Financial Conduct Authority (FCA), with both industry and consumer groups recognising that earlier intervention is necessary to improve outcomes for consumers of financial services and thereby to engender greater confidence in the UK's financial services and markets.

C.11 Consultation respondents generally welcomed the FCA's new product intervention power, although some industry respondents argued that the safeguards in place around its exercise should be enhanced.

Mass detriment

C.12 Most consumer groups and many firms and industry groups supported the proposals for better coordinating the response to cases of mass consumer detriment. Those who did not positively welcome them did not object in principle. A number of detailed points were made about who nominated parties would be, consultation requirements, response times and the link to the super-complaints process in the Enterprise Act.

Coordination and regulatory processes

C.13 Respondents were strongly in favour of the duty to coordinate and Memorandum of Understanding (MOU), but wanted the MOU to be the subject of consultation.

C.14 Respondents welcomed the new requirement on the regulators to report on the effectiveness of their coordination. Some respondents suggested that there should be a role for the consumer and practitioner panels in monitoring and commenting on this issue.

C.15 There was support for the PRA veto from a range of respondents (including some representatives of consumers). A number of respondents emphasised the importance of ensuring that the FCA's status is not undermined.

C.16 Respondents emphasised the importance of operational coordination and a number called for a single point of contact for regulatory processes.

Regulatory processes

C.17 Respondents' two main areas of comment (which ran through many of the comments about individual processes) were that shared processes should be properly coordinated, and provide certainty of process; and that it should be possible for firms to challenge the regulators' decision-making. More particularly:

- respondents expressed broad support for the detail that has been published on the regulatory processes, including strong support for the new approach to authorisation;
- a number of respondents continued to emphasise the importance of coordinated rulemaking. A significant number argued that there should be a joint rulebook for dual-regulated firms;
- a number of respondents commented on the proposals for unregulated holding companies, in particular raising questions about scope, the effects on legal certainty for UK-based firms;
- respondents generally welcomed the new inquiries power as an important addition to PRA and FCA accountability and transparency arrangements; and
- regarding appeals, respondents welcomed the decision to retain the full merits model for all decisions. However, a significant minority expressed the opinion that to restrict the ability of the tribunal to substitute decisions to disciplinary matters was not appropriate.

Systemically important infrastructure and markets

C.18 Responses from Recognised Investment Exchanges and Recognised Clearing Houses made the point that the proposed changes to the regulatory regime for them may alter the regime's character and effect their position as front-line regulators of those using their services.

C.19 A wide range of respondents considered that it would not be appropriate to give the FCA the power to require listed issuers to arrange for a skilled person to prepare a report. Some respondents also considered that the FCA should have separate statutory objectives for listing.

Associated bodies

C.20 With respect to the Financial Ombudsman Service (FOS):

- the proposal for NAO audit and the requirement for an annual plan were widely welcomed by those who responded; and
- the new requirement on the FOS to publish reports on determinations except where the FOS thinks it inappropriate was broadly supported by consumer groups, but many of the firms and industry bodies who responded thought there should be greater safeguards for affected firms.

C.21 With respect to the Financial Services Compensation Scheme (FSCS):

- in general, respondents supported the proposals in the draft Bill. Joint responsibility for the regulators was welcomed as was the provision for NAO audit and the requirement for an annual plan;
- some sectors of industry continued to question the FSCS funding model and the cross-subsidy in particular.

Answers to specific consultation questions

Bank of England and FPC

Consultation question 1: Do you have any specific views on the proposals for the FPC as described in paragraphs 2.6 to 2.24 and in Chapters 3 and 4?

C.22 Respondents continued to express broad support for the need for a new macro-prudential authority. There was a consensus that the FPC will require a broad range of expertise, and that membership appointments should strive to achieve balance in this respect. Some respondents felt that specific expertise should always be represented on the Committee e.g. insurance and consumer issues. There were also some calls for changes the ratio of external members to Bank executives.

C.23 Many respondents welcomed the new growth element of the FPC's objective. It was suggested by some respondents from the banking sector that the FPC's objective should be recast as:

- "to maintain a stable and sustainable supply of finance to the economy, and
- subject to that, to support the economic policy of Her Majesty's Government, including its objectives for growth and employment."

C.24 They argued that this "credit-based" objective provided a more concrete concept than financial stability, providing an easier benchmark for accountability, and strengthened the growth element of the objective by phrasing it positively and removing discretion.

C.25 The importance of transparency and accountability was stressed by a great number of respondents. It was suggested that the FPC should mirror the arrangements of the MPC as closely as possible, including: promotion to a committee of the Bank, rather than a sub-committee of Court; and direct reporting to Government and the TSC. Some respondents from industry questioned the appropriateness of Court as the main channel for accountability. Respondents mentioned the concentration of responsibility in the Governor as requiring enhanced accountability.

C.26 Many respondents queried the macro-prudential toolkit that the FPC will have. They stressed the untested nature of many of the potential tools. A number of respondents suggested that the FPC should always produce policy statements setting out how the tools work in practise and what situations the FPC would use them in. Many also noted that the toolkit should be consulted on before the Government passes secondary legislation to establish the toolkit. Some respondents felt that the FPC should be required to undertake Cost Benefit Analysis and Economic Impact Assessments before using macro-prudential tools.

Consultation question 2: Do you have any specific views on the proposals for the Bank of England's regulation of RCHs, settlement and payment systems as described in paragraphs 2.32 to 2.40 and in Chapters 3 and 4?

C.27 Respondents generally supported the proposals. Some respondents underlined the importance of adequate arrangements for coordination or cooperation with the FCA either because, as markets regulator the FCA would have an important interest in post-trade activities such as clearing and settlement or because the FCA would represent the UK in the European Securities and Markets Authority (ESMA) which will be responsible for EU-level interests in clearing and settlement regulation, including formulating the detailed EU technical standards for regulating central counterparty clearing houses.

C.28 A small number of respondents suggested that there should be adequate consideration of consumer interests in payment system regulation. (For comments on proposals for changes to the regulatory regime for RCHs, see responses to Question 11.)

Consultation question 3: Do you have any comments on:

- *the proposed crisis management arrangements; and*
- *the proposals for minor and technical changes to the Special Resolution Regime*

as described in paragraphs 2.41 to 2.44 and in Chapters 3 and 4?

C.29 Respondents stressed the importance of establishing effective crisis management procedures. Many respondents held off providing detailed comments until the publication of the draft MOU. Some industry respondents suggested that the Bank should be required to notify HMT in the event that activation of the SRR was likely to occur rather than for a risk to public funds.

C.30 A number of respondents suggested a role for the FCA in crisis management. Some argued that recovery and resolution policy-making should be shared equally by the FCA, PRA and the Bank, because of the FCA's role in relation to client assets.

C.31 Very few respondents commented specifically on the proposed technical change to the SRR. Those who did were supportive. Respondents from industry argued that that the reverse transfer power from a Private Sector Purchaser needs reconsidering to address the situation where a property had subsequently been transferred and no longer was owned by the original transferee.

C.32 A number of industry respondents argued that the Government should review the impact of transferring the SRR trigger to the PRA, as giving the role of triggering the SRR to a subsidiary of the Bank removes a safeguard. The Treasury was urged to engage with the Banking Liaison Panel (the "BLP", set up to provide advice to the Treasury on the operation of the SRR) to ensure that appropriate safeguards are introduced to prevent both supervisory forbearance and unnecessarily early implementation of the SRR. It was also suggested that the legislation should address the potential conflict of interest between the PRA in regulator role and the Bank's operation of the SRR, particularly in relation to the role of Governor.

Prudential Regulation Authority

Consultation question 4: Do you have any comments on the objectives and scope of the PRA, as described in paragraphs 2.46 to 2.61 and in Chapters 3 and 4?

Objectives

C.33 Respondents were generally supportive of the PRA's revised general objective, although most did not comment in detail. Some noted that it focuses on the firms it regulates rather than the financial stability of the wider financial system, and supported the proposal to give the PRA a power to issue guidance on objectives.

C.34 There was some suggestion that the definition of "PRA-authorised person" referred to in the objective should be refined: it currently includes incoming EEA firms establishing branches in, or providing cross-border services into, the UK. Some respondents noted that expectations about the regulator's powers in respect of these firms should be realistic.

C.35 On the other hand, some respondents argued that the proposals as a whole do not give enough weight to the international dimension of financial services and financial services regulation. Some suggested that the objectives are too UK-focused.

C.36 Respondents who commented generally supported the principle that the PRA should not be required to ensure that no firm should fail, and supported the statement to this effect in the legislation. It was noted that, in light of the PRA's proposed approach, the effectiveness of the

FSCS will be critical. On the other hand, some respondents argued that the PRA objectives should include appropriate and proportionate supervision designed to prevent firms' failure.

Principles of regulation

C.37 The principles to which the PRA must "have regard" were broadly welcomed by the majority of those who commented on them. There were a number of comments relating to specific principles that should be dropped or new principles that should be added for one or both of the regulators. Some industry respondents stated their strong support for the principles as drafted.

C.38 The absence of competitiveness of the UK as a regulatory principle was raised by a large number of respondents from industry. Some respondents argued specifically that it should apply to the PRA, although the majority wanted both regulators to have regard to competitiveness.

C.39 Consumer groups suggested changes to the principle of consumer responsibility. One consumer body stated that this should be accepted alongside the principle that firms have a fiduciary duty to their customers and another argued that the notion of consumer responsibility is already established in common law.

C.40 Industry respondents particularly welcomed the principle of proportionality and stated that its proper application would strengthen the regulatory regime.

Insurance companies

C.41 There was strong support from respondents for the new insurance objective, including from insurance companies and their representatives.

C.42 Some respondents suggested that the PRA's responsibility for insurance may lead to challenges in terms of coordination between the FCA and PRA if the PRA seeks to assert responsibility for a matter on the basis of the objective. These issues were felt to be more acute in relation to regulation of "with profits" business (see below).

C.43 Some respondents commented on the drafting of the objective. There was concern from industry that the inclusion of the term "future policyholders" in the insurance objective is not practical. A number of respondents queried whether the insurance objective would be consistent with full implementation of Solvency II.

C.44 Some queried whether the legislation should specify how matters would be resolved if there are conflicts between the general objective and the insurance objective. Others requested more detail of how the insurance objective will work in practice.

Investment firms

C.45 Respondents continue to agree with the principle that the PRA will regulate systemically-important investment firms. Respondents sought clarity about the designation process including over procedural safeguards and consultation requirements before the PRA exercises its designation power.

C.46 Respondents also sought clarity on the criteria for designation and emphasised that the designation criteria should be transparent and applied and implemented consistently. Suggestions included that there should be explicit policy criteria linked to the systemic impacts, that investment bank designation should be in primary legislation and that systemically significant investment firms should be identified on a case-by-case basis by the PRA and FCA, with the FPC as arbiter if there is a difference of opinion. Some proposed that the draft criteria should also be subject to consultation.

C.47 Some respondents suggested that the additions to the PRA objective (the acknowledgement of the importance of diversity and the new insurance objective) may lead to a lack of focus on investment firms, and that objectives for other sectors, such as investment firms, could be added.

C.48 There were queries raised about the practicalities of transition from being an FCA-only firm to being a "dual-regulated" firm and how the process of transition from being an FCA-regulated to dual-regulated firm could be made as harmonious as possible

C.49 There was interest about how consistency in approach between the PRA and FCA will be ensured and it was noted that prudential regulation in the crossover firms must not diverge over time. One approach suggested was to enshrine the boundary between PRA/FCA supervision of investment firms in the coordination MOU. The potential difference in approaches could become particularly pronounced between a stand-alone FCA-authorised firm and an FCA-authorised firm which is part of a group which has the PRA as its consolidated supervisor.

Regulation of "with profits" insurers

C.50 Respondents broadly supported the PRA being given responsibility for "with profits" regulation. They emphasised the importance of having skilled and knowledgeable senior management at the PRA, and that there will need to be close coordination with the FCA. However, some raised issues over technical detail. There was some scepticism about use of the term "policyholder reasonable expectations" (PRE) and a number of technical challenges in defining the split in "with profits" regulation were raised, suggesting for example that the Government should consider whether the PRA-FCA split is parallel to the home-host split of responsibilities under Solvency II.

Captive insurers

C.51 A number of respondents noted that it is a common arrangement for asset managers to have an insurer in their group solely for the purpose of writing unit-linked reinsurance contracts. They were uncertain as to whether these would now be brought within the scope of PRA regulation. One respondent suggested that such captive insurers should be regulated solely by the FCA.

Lloyd's of London

C.52 Respondents who commented generally welcomed the PRA regulating Lloyd's of London and Lloyd's members, but argued that there may be an increase in efficiency if it regulated members' agents too.

Consultation question 5: Do you have any comments on the detailed arrangements for the PRA described in paragraphs 2.62 to 2.78 and in Chapters 3 and 4?

Governance and operational independence

C.53 Some respondents suggested that the PRA's governance arrangements could be altered and argued that the PRA should also seek to observe the principles and relevant parts of the UK Corporate Governance Code. It was suggested that the significant overlapping memberships within the Bank of England group could create conflicts of interest, and an independent review of the proposals may be of benefit.

C.54 A number of respondents emphasised the importance of an operationally independent PRA and suggested firewalls and "conflict management procedures" for the Governor, for example in relation to the triggering of the special resolution regime (SRR).

C.55 The comments about the extent of the PRA's operational independence (and the ability of the PRA NEDs to provide a robust challenge function) fed into a broad set of observations about

the concentration of power in the Bank of England, and in particular with the Governor of the Bank of England.

C.56 A number of respondents argued that further thought should be given to ministerial oversight in the appointment and composition of the board. Others argued that there should be a statutory requirement that the regulators' boards and FPC should reflect a sectoral composition of the UK financial sector as a whole. Some respondents from the insurance sector argued specifically that the board should contain insurance expertise.

C.57 Some industry respondents argued that the PRA's Annual General Meeting should be retained. Respondents generally welcomed the clarification that the NAO will be able to conduct value for money studies.

"Judgement-led" regulation

C.58 Respondents generally supported the move to "judgement-led" regulation. However, a significant number of respondents questioned how possible it will be to take a "judgement-led" approach, given the prescriptive approach of EU directives, particularly CRD4. It was also stressed that "judgement-led" regulation should not lead to UK super-equivalence.

C.59 Others emphasised that if the move to judgement-led regulation is to be effective, it will be important to recruit and retain high quality and expert staff. It was also highlighted that the "judgement-led" approach should still be "evidence based".

C.60 Many respondents suggested a guidance power for the PRA. Some suggested that the lack of statutory guidance framework means that the PRA will be entitled to choose whether or not to make its views public on particular areas, that it could make it harder for firms to understand PRA expectations and potentially reduce legal certainty for firms.

Prompt intervention framework

C.61 Most respondents did not comment specifically on the proposed prompt intervention framework (PIF). Those that did supported the proposal, but highlighted that a "downward spiral" may occur if firms' stage in the PIF is made public.

Complaints

C.62 Some respondents argued that there should be a single complaints commissioner covering the PRA and FCA, appointed and removed by HMT. Crucially, they felt, this would enable complaints to be made relating to coordination issues between the PRA and the FCA.

Panels

C.63 A significant number of respondents argued that the PRA should retain elements of the FSA's existing panel structure. In particular, there was support for the retention of the Practitioner Panel. A number of consumer groups argued that the consumer panel should be retained.

C.64 Some respondents were reassured by the more general requirement for the PRA to "put in place arrangements" for consulting industry. However, a number suggested that this is not specific enough, and consumer groups were concerned that this does not allow for the consultation of consumers.

C.65 Some respondents argued that it would be more effective to have a panel covering both the PRA and FCA, to monitor the effectiveness of coordination.

Cost benefit analysis

C.66 Some respondents were supportive of the Government's proposal to continue requiring CBAs even where rules are mandated by Europe. However, others reiterated the view expressed in responses to the previous consultation document that consultation on European rules is unnecessary.

C.67 A number of respondents suggested that the CBA requirements in the draft legislation should require an "estimate" of likely costs and benefits, rather than an "analysis".

Financial Conduct Authority

Consultation question 6: Do you have any views on the FCA's objectives – including its competition remit - as set out in paragraphs 2.80 to 2.90 and in Chapters 3 and 4?

C.68 There was a very broad spectrum of responses on the question of FCA objectives, with many respondents from both industry and consumer bodies supportive, but others suggesting changes might be made to both the wording of the objectives and their structure or relative positioning.

C.69 Many respondents welcomed the structure of the objectives – for example, one noted that the "structure of a single strategic objective and three operational objectives is narrow enough to be clear, but broad enough to be flexible". Some respondents, asked for greater clarity on the relative hierarchy of strategic and operational objectives, and duties and principles. A small number of respondents also suggested that there could be tension between objectives, particularly between the consumer protection and efficiency and choice objective.

C.70 Industry respondents were in general very supportive of the strategic objective, and thought that "protecting and enhancing confidence" was an appropriate strategic objective. Some consumer groups disagreed, stating that they thought the strategic objective should focus on securing better consumer outcomes instead to ensure that it would not be interpreted in such a way as to stop the regulator taking decisive action against firms, particularly in the short term, if this would risk undermining confidence.

C.71 There were a variety of comments on the operational objectives, with many respondents welcoming the drafting of the three objectives and the way they required the FCA to balance them and strike tradeoffs where necessary.

Efficiency and choice

C.72 Both consumer and industry respondents welcomed the new efficiency and choice objective. While its inclusion did not receive any negative feedback, respondents did, however, ask for greater clarity as to what was meant by efficiency and choice. Some respondents, asked for there to be elaborations or have regards for the efficiency and choice objective in a manner similar to the other two operational objectives. They stressed that it was important to clarify what was meant by "choice", as studies have shown that too much undifferentiated and confusing choice can actually have a negative impact on consumers. Others asked for the addition of access and effective competition, amongst others.

Consumer protection

C.73 The consumer protection objective received widespread support from all stakeholders, and the majority also supported the "have regards" that the FCA is required to consider in pursuit of this objective. A number of respondents, mostly from consumer groups, suggested changes to some aspects of the drafting, including:

- consumer groups welcomed the have regard that relates to consumers' needs for information, but suggest that the drafting should be expanded so that the

information need not only be "accurate", but also timely, intelligible to them and appropriately presented;

- most consumer groups questioned the inclusion of the principle that consumers should take responsibility for their decisions; and
- one consumer group argued that the consumer responsibility principle, which they were broadly supportive of, should be complemented by a fiduciary duty on firms, which would be stronger than the common law principles that apply.

C.74 In addition, a significant number of respondents, mainly from consumer groups but including a small number of industry representatives, raised issues with the breadth of the definition of consumer used in the Bill. These respondents argued the definition was too broad and that the inclusion of retail consumers alongside large corporate entities could dilute the FCA's focus.

Market integrity

C.75 The market integrity objective was generally welcomed by industry and other respondents alike, with the elaborations on the objective considered particularly helpful.

Competition duty

C.76 Almost all respondents supported the proposal to have the FCA play a role in competition. Some respondents queried whether the proposed model of the efficiency and choice objective complemented with the competition duty was adequate. There was a near consensus view among industry that a role in competition for the FCA should not entail price regulation or for it to act as an economic regulator.

Consultation question 7: Do you have any views on the proactive regulatory approach of the FCA, detailed in paragraphs 2.91 to 2.110 and in Chapters 3 and 4?

C.77 There was widespread support for a more proactive approach to conduct regulation, with a clear focus on consumer outcomes.

C.78 A number of respondents noted that this new approach needs to be supported with staff that have the relevant experience and expertise to make high quality judgements. Several industry respondents said that the FCA should adopt a constructive and cooperative approach with firms, with some noting that early and regular contact with firms would facilitate a more proactive approach to regulation. Some responses from industry said that the FCA needs to provide an appropriate level of support to help firms, particularly smaller firms, to meet their regulatory obligations. It was also suggested that less relationship-management supervision could result in less practical knowledge of the industry and its clients.

Product intervention power

C.79 Consultation respondents generally welcomed the new power for the FCA to intervene quickly and decisively where it considers that a product or product feature is likely to cause significant consumer detriment.

C.80 Consumer representatives were particularly supportive of the new product intervention power. Industry respondents noted that the power must be appropriately safeguarded to ensure it is used in an appropriate and targeted way. Some raised issues with its broad scope and the relatively low threshold for intervention.

C.81 The existing safeguards around the power's use received broad support (particularly the requirement for the FCA to publish a statement of policy governing on the making of temporary product intervention rules and the provision that the FCA cannot "renew" temporary such rules).

Some industry respondents argued that the safeguards could be enhanced. For example, it was suggested that the Bill could specify that the power may only be used in circumstances where there is a real and demonstrable risk of significant consumer detriment.

C.82 There was strong support for the Government's decision not to apply the power to the FCA's market integrity objective, and the statement that the new power is unlikely to be appropriate in relation to professional or wholesale customers. There was also widespread support for the statements that product intervention should be a complement to (and not a substitute for) regulation of the sales process, and that the new power does not represent a shift towards product pre-approval. Nevertheless, some respondents noted that the FCA will need to manage the risk that consumers may interpret a lack of intervention as a form of tacit product approval or endorsement.

C.83 A number of industry respondents said that the FCA would need to strike the right balance between protecting consumers and not stifling product innovation and consumer choice, although other respondents contended that the trade-off was not a clear one, as greater choice and innovation do not always lead to positive consumer outcomes if they serve to create confusion. It was also noted that the application of the Regulatory Principles to the FCA's use of the power should ensure that consumer choice and competition are not adversely affected.

C.84 A key theme among industry respondents was how the new product intervention power will operate in the EU context. Respondents asked for clarity on the territorial scope of product intervention rules, and whether they would be compatible with the maximum harmonisation approach in draft directives. Several queried whether banned products could be marketed into the UK from other jurisdictions. A number of respondents noted that product banning powers are also being discussed as part of the MiFID review, and asked for more detail on how the FCA and ESA's banning powers would interact.

Financial promotions power

C.85 The proposals for the financial promotions power were supported by the majority of consultation respondents. It was particularly welcomed by consumer groups, who were in favour of seeing clear and public action being taken against misleading financial promotions, and noted that this would bring greater clarity to consumers also on when and on what grounds the regulator took action. However, they did note that information was only useful if it was provided in a way that was useful to consumers and urged the regulator to consider this in developing its policy on the proposal.

C.86 While industry were broadly positive about the power, it was clear that some industry respondents did not fully understand the purpose of the power. Some queried the need for the power, saying that the regulator can already take action in relation to misleading financial promotions, and does so on a regular basis with firms complying willingly with any requests. While it is correct that the regulator can already take action, this misses the core purpose of the power, which is to ensure that the regulator can *make public* the fact that it has required a financial promotion to be withdrawn.

C.87 On the drafting of the clause itself, respondents generally thought the power was well designed and welcomed the safeguards, including the ability for firms to make representations. However, several industry respondents commented on new section 137P(11), which places a duty on the regulator to publish information about a direction even it is revoked. Firms thought that this may result in negative publicity for them, even though the regulator did not in this case find the promotion misleading. Placing a duty on the regulator to publish what it had found, whether or not a promotion had to be withdrawn, is designed to increase accountability on the regulator itself (it needs to acknowledge where it got it wrong) and aide firms, as they would be able to see what the regulator considered acceptable alongside those promotions it did not.

Firms also didn't note that the regulator has discretion over what it publishes, and will only publish information that it considers appropriate.

Early publication of disciplinary action

C.88 Responses to proposals on the early disclosure of the fact that a warning notice has been issued in respect of a disciplinary action were mixed, with consumer groups very much in favour of such a move, but industry, trade bodies and law firms raising issues. This ranged from those absolutely opposed to the idea on principle to those who felt that the power would be acceptable if subject to further safeguards.

C.89 More specific comments on the power included:

- that the power goes against natural justice;
- that it will not fulfil the purpose it was designed for of increasing transparency for consumers, flagging unacceptable behaviours to firms, and increasing regulatory accountability on enforcement success rates;
- that as a quid pro quo, the regulator's statutory immunity should be removed given the potentially damaging impact its actions might have on a firm or individual;
- to limit the use of the power to only those circumstances where its use is necessary to prevent immediate and significant consumer detriment, and there are no alternative means of achieving the same result;
- that there should be clear guidance on the power as part of the enforcement manual, including on how the regulators propose to apply it (consistency and transparency over regulatory decision-making;
- that the publication of information about a warning notice should clearly state that this constitutes the start of the enforcement process and that rights of dispute have not been exhausted, and explain what is happening in language that a retail customer can understand; and
- that the power will fundamentally alter the nature of the enforcement process, and change the cooperate relationship between firms and the regulator.

Mass detriment

Consultation question 8: What are your views on the proposal to allow nominated parties to refer to the FCA issues that may be causing mass detriment?

C.90 Many respondents both on consumer side and on the industry side specifically welcomed or agreed with the general proposals. Some industry respondents had reservations about the need for such arrangements, while others preferred to reserve judgement until the identity of the nominated parties was clear. Consumer groups generally thought it appropriate that consumer representatives should be nominated parties.

C.91 There was a mixed response to the suggestion the FOS might be a nominated party. Some industry representatives supported a role for the FOS, as did some groups on the consumer side. On the other hand, some industry respondents thought this role could compromise or downgrade the status of the FOS respectively.

C.92 The majority of respondents thought it was important that there be clearly defined criteria for nominated parties, often on the grounds that this would help avoid vexatious complaints.

Consultation question 9: What are your views on the proposal to require the FCA to set out its decision on whether a particular issue or product may be causing mass detriment and preferred

course of action, and in the case of referrals from nominated parties, to do so within a set period of time?

C.93 Industry groups emphasised the need for time to consult industry, to be able challenge the report, and the need for clarity about the evidence required, the factors the FCA would take into account and the process it would follow. One respondent suggested that any deadlines should not be mandatory but should be in the nature of a guideline.

C.94 Some consumer groups thought the FCA should be subject to duties further to the duty to respond, such as a duty to resolve the problem as far as reasonably practical; or a duty to investigate and act if there is reasonable evidence of consumer detriment. Another thought it was important that the FCA take robust action to ensure consumer redress schemes were put in place.

Competition approach and powers

Consultation question 10: Do you have any comments on the competition proposals for the FCA set out in paragraphs 2.111 to 2.119 and in Chapters 3 and 4?

C.95 Some industry respondents welcomed the proposed power for the FCA to refer competition matters to the OFT. However some firms did not see why the FCA would want to use this power and cede control to the OFT and another felt that the Government should await the outcome of the Government's proposals for the current competition regime. A number of respondents took the opportunity to propose the FCA should be able to receive super complaints distinct from the question of mass detriment.

C.96 Consumer groups supported the power, while making recommendations about its modification and use. Few respondents had detailed comments on the regime (which applies to all the regulators).

Market regulation

Consultation question 11: Do you have any views on the proposals for markets regulation by the FCA, described in paragraphs 2.120 to 2.123 and in Chapters 3 and 4?

C.97 Respondents generally supported the proposals to retain the distinct regime for regulating recognised investment exchanges (RIEs) and clearing houses (RCHs). However, some affected by the proposals felt that the proposed changes to the regulatory regime for RIEs and RCHs were perhaps unnecessary and that they would amount to a significant change in the character of the regime which could undermine their position as regulators of the markets they serve, potentially reducing the distinction between recognised bodies and investment firms.

C.98 Respondents also supported retaining the UK Listing Authority as part of the FCA but there were suggestions that the FCA listing function should continue to have its own statutory objectives, particularly incorporating international competitiveness.

C.99 Many respondents also raised the specific proposal to give the FCA a power to require listed issuers and others subject to listing rules to appoint a skilled person to prepare a report. While this power was seen as an appropriate option for the regulation of financial services firms, it was not seen to be so for overseeing issuers which were not regulated financial services firms. The potential costs to issuers, especially smaller issuers, when the power is exercised were queried.

Governance and accountability

Consultation question 12: Do you have any comments on the governance, accountability and transparency arrangements proposed for the FCA, as described in paragraphs 2.124 to 2.132 and in Chapters 3 and 4?

C.100 There was broad support for the proposals. The importance of transparency was emphasised by both consumer and industry respondents.

C.101 A few respondents commented on the composition of the FCA's board. Suggestions included that the majority of non-execs on the board should have a consumer background or that industry representation was of great importance. Some industry respondents sought greater clarity about the appointment process for and definition non-executive directors, and one stated that they should have more of a public role.

C.102 The provision for NAO audit and accompanying power to launch VFM studies were welcomed by a broad spectrum of respondents. A few respondents had more detailed comment about accountability to Government and to Parliament including exploring whether greater resources could be allocated to the TSC while noting that the FCA still needs to be independent from Parliament.

C.103 The new inquiries and investigations power in relation to both the PRA and FCA was universally welcomed as a key addition to the accountability and transparency arrangements under the new regulatory structure. Many respondents argued for revisions to the definition of the triggers for the power, either in statute or through public statements from regulators. Respondents also suggested clarity about what the outcome of an inquiry would be, for example what action would be expected of a regulator. Industry respondents noted that the power should be caveated by the inclusion of reference to the need to keep confidential information confidential.

Regulatory coordination

Consultation question 13: Do you have any comments on the general coordination arrangements for the PRA and FCA described in paragraphs 2.138 to 2.149 and in Chapters 3 and 4?

C.104 Many respondents were reassured by the coordination measures set out in the draft Bill. Stakeholders broadly supported all of the proposed general coordination mechanisms. A number welcomed the new requirement for the PRA and FCA to include in their annual reports an account of how they have coordinated. While others specifically welcomed the statutory duty to coordinate and obligations regarding the existence and content of the MOU.

C.105 Industry respondents continued to emphasise the need for cost increases to be minimised, and that regulation should be proportionate and consistent. Respondents were reassured by the mechanisms that are now in place to ensure effective coordination, but maintained calls for a "single point of contact" for regulatory processes. Some firms argued for a legislative requirement to urge regulators to consider a single point of contact where possible.

MOU

C.106 The MOU was welcomed by most respondents with one industry respondent stating their view that an MOU is the most appropriate tool for coordination on regulatory processes.

C.107 A majority of stakeholders (and in particular the industry trade bodies) expressed support for early publication of a draft MOU and other documentation from the Bank and FSA about how the PRA and FCA will coordinate.

C.108 The majority of respondents argued that there should be consultation with industry about drawing up the draft MOU, and a large number of industry respondents argued that there should be consultation whenever there are significant revisions to it. A number of respondents thought that the legislation could mandate the contents of the MOU, rather than merely specifying a list of things it "may include".

Duty to coordinate

C.109 Respondents strongly supported the general duty to coordinate, and a number drew particular attention to the fact that a key purpose of the general duty to coordinate is to drive a culture that minimises unnecessary overlap and duplication.

C.110 Respondents were broadly content with the way that the duty is framed in legislation. Some suggested that the threshold for coordination could be seen as unclear and queried how one regulator will determine that its action will affect the other. They suggested that the draft legislation appears to imply that coordination should be undertaken only if it doesn't burden the regulator.

Accountability for effective coordination

C.111 A number of respondents welcomed the requirement for the regulators to assess how well they have coordinated and report on this in their annual report. Some respondents suggested that there should be a role for the Panels in monitoring and commenting on the effectiveness of coordination and that the Practitioner Panel could assist in providing further confidence in coordination.

PRA veto

C.112 Consultation respondents had differing views on the issue of the PRA veto. One consumer group was reasonably reassured that the PRA veto is intended to be used only in very exceptional circumstances, although they noted that day-to-day tensions should be resolved in a way that does not undermine consumer protection. Another consumer group accepted the need for the veto but suggested that the use of the veto should trigger an inquiry into regulatory failure. Other consumer bodies restated their reservations.

C.113 Industry respondents remained more in favour of the veto, although there was some divergence over how readily it should be deployed with some suggesting that that there should be a "high threshold", while others suggested that exercise of the veto should be mandatory where the criteria are met.

C.114 Some representatives of firms who will be regulated by the FCA only highlighted that the veto should not erode the status of the FCA. Some respondents argued that further thought should be given to the scope of the veto, and the procedure for using it.

Supervisory coordination with the Bank

C.115 Supervisory coordination with the Bank of England was not a major concern for most respondents. However, one respondent argued that the FCA will need market intelligence, which could be gathered in the market intelligence unit at the Bank of England. One trade body suggested that, given the Bank of England's responsibility for payment systems, there should also be an MOU between the Bank and the FCA. There were some suggestions that the Bank of England should be involved in the proposed MOU between the PRA and the FCA.

International coordination and engagement with the ESAs

C.116 Most respondents emphasised the importance of engaging effectively with Europe and in a timely manner. The arrangements for international coordination and engagement with ESAs were generally welcomed. However, a number of respondents believed that more effective coordination (both domestically, and for the purposes of influencing Europe) could be delivered by having a formal committee bringing all of the authorities together. This is discussed in more detail below.

C.117 Some respondents requested further clarity on how the arrangements for engaging with Europe would work. Some welcomed the discussion of international coordination in the FSA's

paper on the future approach of the FCA, while others wanted greater clarification on how the authorities will coordinate on an EU level.

C.118 Some responses from industry suggested that the regulators should consult industry on the international coordination MOU.

Regulatory processes

Consultation question 14: Do you have any views on the detail of specific regulatory processes involving the PRA and FCA, as described in paragraphs 2.150 to 2.195 and in Chapters 3 and 4?

Authorisation

C.119 Authorisation remained a key issue for industry respondents. Respondents overwhelmingly welcomed the new approach. A number noted that having a single regulator responsible for the process is similar to the "single point of contact" that respondents have requested for other regulatory processes. However some respondents continued to suggest that it should be the FCA to lead the process for all firms.

C.120 Most respondents continued to emphasise the importance of having a quick and efficient process. Some respondents recommended a review of the Regulated Activities Order and FSA register.

Approved persons

C.121 Most respondents welcomed the changes to the approved persons process, however a number suggested further refinements. Most respondents agreed that the PRA and the FCA should have the power to designate SIFs, and issue statements and codes. But there were also some calls for further clarification on: measures to avoid overlap, and provisions to ensure that the PRA and FCA will consult each other in relation to applications for SIFs; to whom an application should be submitted; and how to ensure coordination in drafting of Codes etc to avoid conflicts.

C.122 Respondents emphasised the importance of getting the process right. There was support for the approved persons process being "dual-key", with one application and a joint interview.

Rule-making and rulebook

C.123 A number of respondents emphasised the importance of coordinated rule-making. There were some calls for the suggested "joint committee" (discussed above) to facilitate coordination of rule-making, and in particular over-arching high-level regulatory standards. A number of respondents reiterated the calls from the previous consultation for a single rulebook, that the current rulebook should be used as a starting point for the new rulebooks, and that some of the rulebooks (SYSC, PRIN) should be consistent across the bodies.

C.124 A number of respondents emphasised the importance of a joint rulebook for dual-regulated firms. However, some were against this, arguing that each authority will have differing expertise and a different focus.

Enforcement and appeals

C.125 Respondents generally expressed support for the proposed approach to enforcement for both the PRA (minimal enforcement given the nature of decisions to be made and the judgement-led approach) and the FCA (continuation of the credible deterrence strategy). Respondents limited their more specific comments to two areas, the proposed changes to the appeals mechanism, and the proposed reduction in the period of representation following the issuance of a warning notice.

C.126 The majority of respondents welcomed the decision to retain the full merits model for all decisions and not to proceed with an earlier proposal to restrict the grounds on which the Upper Tribunal can consider appeals to supervisory decisions. However, some were of the opinion that to restrict the ability of the Tribunal to substitute decisions to disciplinary matters was not appropriate.

C.127 There were some suggestions that the proposed approach to the Tribunal will be inefficient, and that the existing arrangements better satisfy ECHR requirements. It was also highlighted that the list of disciplinary actions, in other words those that remained subject to a full merits review, including the Tribunal's ability to substitute a decision, did not include a number of decisions traditionally considered "core enforcement"; specifically, decisions made under s384 (court order, restitution) and withdrawals of approval, prohibition, and disqualifications.

Passporting

C.128 Most respondents broadly supported the passporting proposals. However, a number of respondents suggested further clarity in relation to the actual application process and whether the FCA should deal with all notifications and supervision. One response from industry argued that host regulators should have a single point of contact in the UK regulatory framework and another supported the proposed approach to pass-porting but raised a number of questions around how far the PRA will be able to supervise incoming EEA firms.

Mutuals/diversity

C.129 Most respondents did not comment on the proposed approach to promoting diversity in the financial sector (which is particularly intended to support mutuals). The proposal attracted support from the majority that did comment. One trade body suggested that there should be a statement on mutuals in all cases while a mutual argued that the statement should include an assessment of the appropriateness of the rule by legal structure as well as cost of compliance.

Associated bodies

Consultation question 15: Do you have any comments on the proposals for the FSCS and FOS set out in paragraphs 2.196 to 2.204 and in Chapters 3 and 4?

FOS

C.130 The provision for NAO audit and requirement for an annual plan were welcomed by the generality of respondents. Few respondents had detailed comments on corporate governance.

C.131 Consumer groups welcomed the new requirement on the FOS to publish reports on its determinations. On the other hand, firms and industry groups thought it needed more safeguards, such as the right for firms to be consulted before publication or to remain anonymous in the reports. One trade body thought the issue should be a matter for public debate led by the FCA when it was established.

C.132 Consumer groups reiterated their support for the FOS, as did many industry groups, at least in part. However many of the firms and industry groups who responded took the opportunity to raise issues with the statutory "fair and reasonable" test and the consequence that FOS decisions can set precedents and create requirements which go beyond legal or regulatory requirements.

FSCS

C.133 Proposals for the FSCS contained in the White Paper and Bill were broadly welcomed by those who commented. Joint responsibility for the FSCS for the two regulators was welcomed as were the provisions for NAO audit and the production of an annual plan.

C.134 Some of those who supported the proposals stressed the importance of the detail contained in the MOUs and there was felt to room for greater clarity around which regulator would make rules for each sub-scheme. Some respondents accepted that further changes to the FSCS may be dependent on developments in Europe.

C.135 Some industry respondents suggested that the FSCS should be accountable to a creditors' committee.

C.136 Some specific comments from industry and industry groups focused on the FSCS funding model and made suggestions for change. These respondents accepted that the FSA's funding review of the FSCS is currently ongoing.

D Impact assessment

D.1 The following pages contain the impact assessment for the proposals contained within this document.

Title: A new approach to financial regulation **IA No:** **Lead department or agency:** HM Treasury **Other departments or agencies:**	# Impact Assessment (IA) **Date:** 26/01/2012 **Stage:** Final **Source of intervention:** Domestic **Type of measure:** Primary legislation **Contact for enquiries**: financial.reform@hmtreasury.gsi.gov.uk

Summary: Intervention and Options

RPC Opinion: Not applicable

Cost of Preferred (or more likely) Option				
Total Net Present Value	**Business Net Present Value**	**Net cost to business per year** (EANCB on 2009 prices)	**In scope of One-In, One-Out?**	**Measure qualifies as**
£630m	NA	NA	No	NA

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 substantial deterioration in public finances. The regulatory system cannot be restructured without primary legislation.

What are the policy objectives and the intended effects?

The objective is to reform the financial services regulatory system to avoid a repeat of the financial crisis. The legislation will create a Financial Policy Committee to take charge of macro-prudential regulation. The Bank of England will regulate settlement systems and central counterparty clearing houses. The PRA – a Bank of England subsidiary – will undertake the prudential regulation of deposit-takers, insurers and certain investment firms using a more judgement-based approach. The FCA will regulate conduct of business generally, market conduct, investment exchanges and listing. The FCA will also be responsible for consumer protection in financial services and for prudential regulation of non-PRA regulated firms.

What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)

Two options have been considered at this stage: "do nothing" (the base case option in which the proposed regulatory reforms would not be made) and the preferred two regulator model of the PRA and FCA. (This assessment does not re-examine the three regulator model considered in previous impact assessments.) The preferred option is justified by the reduction in the probability of a serious financial crisis ocuring in the UK. A serious financial crisis would lead to substantial losses in output. The benefits of the preferred option (equal to the change in the expected net present value of lost output) will outweigh the costs (which comprise the transitional costs for the authorities and for firms which will be regulated by the PRA and the FCA and the additional ongoing administrative costs for the authorities and the additional compliance costs for these firms.

Will the policy be reviewed? It will not be reviewed. **If applicable, set review date:** NA

Does implementation go beyond minimum EU requirements?			N/A		
Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base.	**Micro** No	**< 20** No	**Small** No	**Medium** No	**Large** No
What is the CO_2 equivalent change in greenhouse gas emissions? (Million tonnes CO_2 equivalent)			**Traded:** NA	**Non-traded:** NA	

I have read the Impact Assessment and I am satisfied that (a) it represents a fair and reasonable view of the expected costs, benefits and impact of the policy, and (b) that the benefits justify the costs.

Signed by the responsible SELECT SIGNATORY: Date: 26/01/2012

Summary: Analysis & Evidence

Policy Option 1

Description:

FULL ECONOMIC ASSESSMENT

Price Base Year 2011	PV Base Year 2011	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: 630	**High:** 10,660	**Best Estimate:** 630

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	180		25	**340**
High	275		75	**770**
Best Estimate	275		75	**770**

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

Development and implementation costs (spread over about 2 years) for existing public authorities and two new regulators; ongoing costs for two new regulators. Transitional and ongoing costs for: firms (deposit takers, insurers and certain investment firms) subject to prudential and conduct of business (COB) regulation. The estimates are not intended to be more precise than the discussion in the evidence base indicates.

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

There are no significant non-quantifiable costs.

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	0		See text	**1,400**
High	0		See text	**11,000**
Best Estimate	0		See text	**1,400**

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

Illustrative benefits only from reduction in frequency of severe financial crises in the UK - a benefit for the UK as a whole rather than for specific groups.

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

A reduction in frequency of major incidents of consumer detriment in provision of financial services in the UK and benefits for consumers arising from increased competition between financial services firms - benefits for UK consumers, regulated firms and the regulators. These benefits are likely to be significantly smaller than the monetised benefits.

Key assumptions/sensitivities/risks **Discount rate (%)** 3.5

The key assumptions are those made for benefits and for development, implementation and transitional costs for existing public authorities, new regulators and affected firms. The main specific risks are: (1) that the transitional costs could be underestimated; (2) that there could be significant additional compliance costs for firms subject to both prudential and COB regulation; and (3) that the benefit from the reduction in the frequency of severe financial crises is overestimated. The main overall risk is that the reforms make little or no difference to the incidence of financial crises.

BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			In scope of OIOO?	Measure qualifies as
Costs: N/A	**Benefits:** N/A	**Net:** N/A	No	NA

Evidence Base (for summary sheets)

Introduction

1. This assessment updates the consultation stage impact assessment published in June 2011 with the White paper *A new approach to financial regulation: the blueprint for reform* (Cm 8083). This section sets out the assumptions and analysis to support the assessment which have been refined where necessary to reflect comments made by consultees and further information from other stakeholders. It should be read in conjunction with the White Paper and previous consultation documents and largely follows the structure of the impact assessments in those documents.
2. This impact assessment does not include:
    a. an assessment of the clauses in the Bill enabling some or all consumer credit regulation to be transferred to the FCA. This proposal has already been the subject of a separate consultation including an impact assessment. The Government will only exercise these powers when it has identified a model of FCA regulation that is proportionate for the different segments of the market, including by looking a possible deregulatory options. Any decision to exercise these powers will be subject to further consultation, including a separate impact assessment;
    b. the three regulator option which was considered in previous impact assessments. This option included the creation of a third specialist regulator, focussing on wholesale markets and related issues. While there could be some additional benefits in this option arising from better targeted regulation of wholesale markets and efficiency gains from having a more specialised regulator of these markets, it is considered unlikely that these benefits could outweigh the higher transitional costs of establishing a third regulator and the additional ongoing costs of this regulator or the additional ongoing compliance costs for triple-regulated firms; and
    c. assessments of the minor measures included in the Bill to amend the Financial Services and Markets Act 2000, the Banking Act 2009 or other legislation. These changes will only affect the regulators or other authorities, make minor changes to existing regulatory arrangements (including to place on a statutory footing the regulation of persons who disseminate price-sensitive information on behalf of issuers), affect only a very small number of businesses or will be deregulatory. The costs or benefits will be small in absolute terms as well as small in relation to the main costs or benefits discussed in this assessment, and could not affect the overall choice of options.

Objective

3. 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.

Overview of costs and benefits

Benefits

4. The key assumption for this impact assessment is that creation of specialist financial regulators and the strengthening of the arrangements for coordination between the PRA and the Bank of England should result in a reduction in the frequency of severe financial crises in the UK, in addition to any such reduction that could be attributed to other measures (such as internationally agreed changes to regulatory requirements). If that assumption is correct, the benefits of the proposed reforms would be likely to be large but the actual quantification (discussed in detail below) can only be the result of the assumptions made, including those about economic growth and the impact of a single financial crisis. Since the severe financial crises are relatively infrequent (a reasonable assumption would be once every 20-25 years), it would probably not be possible to test the key assumptions for at least

30-40 years and even then, it would be difficult to isolate the effects of past regulatory reforms from other factors.

Costs

5. There will be both transitional costs to change the regulatory organisation and some additional ongoing costs. Some regulated firms may incur transitional costs in making arrangements to deal with two regulators rather than one and may also incur additional ongoing costs in dealing with two regulators on a regular basis. Public authorities (primarily the Bank of England and the FSA) will incur transitional costs in setting up the new regulators. The new regulators' ongoing costs in total may differ from the costs that the FSA would have incurred if the regulatory reforms were not implemented. As at present, regulators' costs will be recovered in fees or levies paid by regulated persons or by persons engaged in regulatory transactions apportioned, as they currently are, on the basis of size and other factors relevant to the type of business activity or concerned.

Costs for public authorities

6. These cost estimates have been provided by the Bank of England and the Financial Services Authority (FSA) and relate principally to the creation of the PRA, its integration with the Bank and subsequent operations, and the transformation of the FSA into the FCA. The cost estimates have been updated as estimating improves and must be seen as the latest available "snapshot" of an ongoing process. The cost estimates cover the transfer of about a third of the FSA's regulatory staff to the Bank and the transitional costs of making the FSA into the FCA. There are relatively small costs to the Bank in setting up the FPC.
7. The Bank's approach to creating the PRA is founded on an expectation that costs of prudential regulation will fall in the medium term. This will flow from improved quality of system support (flowing from the extension of Bank's more economical and secure IT framework to the new subsidiary), from eliminating duplication between the PRA and the Bank, and also from tight control of costs.
8. In the short run, however, the transition will involve significant expense to the Bank on premises and IT. Establishment of the PRA as part of the Bank involves substantially more than just splitting the FSA into two parts and putting one part under a Bank governance structure. The Bank's view is that to deliver the objectives of judgment-based regulation, integrated with the Bank's analytical capacity, the PRA will need to be physically located in or very close to the Bank, and given the likely staff numbers involved, a new building will be required. The Bank is also clear that in order to contain costs in the long run it would not wish to share in the existing IT systems at the FSA, which have relatively high running costs. So in order to reach a position in which it can both ensure integration and exercise a proper control over future costs, the Bank will need to invest in the transition.
9. The transitional costs therefore include the costs of preparing for and undertaking the transfer to the Bank of relevant FSA staff; acquiring and fitting out suitable accommodation for the PRA close to the Bank; delivery of Bank corporate IT to the PRA, with associated networks and data centres; giving PRA access to selected FSA regulatory data and applications pending development of PRA-specific systems; and programme management and business change.
10. The FSA legal entity will become the FCA and retain the staff and systems not transferring to the PRA. As with the PRA, there will be some IT system development work, although the FSA would obviously have been incurring IT expenditure in order to make improvements or upgrades to its systems. Such expenditure should not be seen as part of the cost of transition. However, there will be costs in restacking the FSA's main site as the PRA staff move out and space becomes available for re-letting; and some HR and training costs. There will also be legal and programme management expenses.
11. The Bank and the FSA are committed to ensuring that the transitional costs are minimised and controlled, and to achieving long-run cost savings to offset the transition costs.

Costs for regulated firms

12. The Government has sought views on the transitional and ongoing costs for all types of regulated person in previous consultations. A small number of responses on these matters were received and the comments made have been taken into account in the assumptions made for the transitional and ongoing costs that firms would incur in making changes to their internal systems and processes.

Description of options considered

"Do nothing" option

13. This option is the base case for this impact assessment. As the name implies, in this option the FSA would remain responsible for both the conduct of business regulation and the prudential regulation of all regulated financial services firms and carry out its other activities as now. The roles and responsibilities of other organisations would also continue as before.

14. "Do nothing" does not mean "no change in the regulatory environment". It only means that the reforms to the regulatory structure and organisation discussed in this consultation document would not be made. Other changes to the regulatory environment will continue to happen. These may include the implementation of changes to EU law or changes to domestic regulatory practice including the continuation of current FSA regulatory initiatives by the FCA or the PRA. Future changes to FCA or PRA rules will be subject to cost benefit analysis in essentially the same way as proposed changes to FSA rules currently are.

Preferred option – two regulator model

15. In this model:

- a **Financial Policy Committee** in the Bank of England will 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;
- the **PRA**(a subsidiary of the Bank of England) will have responsibility for the prudential regulation of deposit-takers, insurers and certain investment firms;
- the **FCA** will have responsibility for:
  - supervision (including prudential supervision) of all firms not regulated by the PRA, including most investment firms;
  - consumer protection in financial services (including through a stronger role in competition matters);
  - regulating conduct in financial services generally, including in relation to firms authorised and supervised by the PRA;
  - regulating market conduct, including taking action to impose civil penalties for market abuse and pursuing criminal prosecutions;
  - regulating investment exchanges and providers of trading facilities;
  - primary market regulation (including listing).

Analysis of costs and benefits

Introduction

16. As explained above, the "do nothing" option provides the base case for this impact assessment and it is assumed that other changes to the regulatory environment – changes which would happen irrespective of changes to the regulatory structure or organisation - would increase or decrease the costs and benefits of each option by the same amounts on the same dates. The net present value (NPV) of each option would therefore be increased or decreased by the same amount and the ranking of the options and the differences between their NPVs would not be changed.

17. The costs and benefits of the "do nothing" option are therefore assumed to be zero and the costs and benefits of the preferred option are measured as differences from the amounts in the "do nothing" option. It would, of course, be double counting to treat something both as a cost (or benefit) of the "do nothing" option and as a benefit (or cost) in the preferred option.

Public authorities: transitional costs

18. The current estimate, taking account of the accommodation, IT and staff transfer expenses, the full cost to the Bank and the FSA of creating the PRA will be in the region of £115 million - £150 million. The range of transition costs has narrowed slightly as further design work has been completed and there is more certainty about staff and IT costs for setting up the PRA although the upper end of the range has not increased. Nevertheless, the margin in the estimates remains fairly wide reflecting remaining uncertainty over the likely scale and cost of the PRA's IT estate and of the acquisition of new premises. The residual cost of creating the FCA (excluding IT development undertaken as 'business as usual') is expected, as previously estimated, to be in the region of £15 million - £25 million. At this stage, therefore, the authorities are assuming that the costs of establishing the PRA and transforming the FSA into the FCA would be between £130 million and £175 million.

Public authorities: ongoing administrative costs

19. The ongoing additional costs of the reforms will be mainly resource costs incurred by the new regulators less the ongoing administrative costs that the FSA would continue to incur in the "do nothing" option.

Changes in supervisory practice etc.

20. The FSA has been taking steps to improve the rigour and credibility of its supervisory effort and the costs of this are reflected in the base case. The PRA is expected to take a more judgement-led style of prudential supervision which is likely to mean more intensive and demanding engagement between the regulator and the firms concerned. The Bank of England considers that these changes in supervisory practice will not result in higher ongoing costs for the PRA because of a more efficient approach to regulation and the ability to adopt more cost-effective IT solutions.
21. The FCA is also likely to make some changes to the operational model of the FSA in order to deliver improvements to consumer protection and market integrity. This reflects its role as a single, integrated conduct regulator with a more proactive approach to regulating conduct in financial services and financial markets and taking on a stronger role in competition matters. These changes will be in addition to changes already made by the FSA towards a more interventionist and pre-emptive approach to retail conduct regulation which are included in the base case.

Loss of economies of scale

22. Some loss of economies of scale due to duplication of fixed costs is inevitable but this is not expected to be significant for the FCA as it will remain a relatively large organisation. The PRA is likely to be a smaller organisation but it is expected to be able to share common services and overheads with the Bank of England.

Increased specialisation and efficiency gains

23. Increased specialisation may result in some efficiency gains. However, these are likely to be limited as the FSA is large enough to ensure that there is a critical mass of expertise in both areas relevant to the FCA and PRA. The FCA should also be large enough to support the specialisation needed for certain activities such as listing, infrastructure regulation and market conduct.

Other matters

24. There should be no significant additional ongoing costs in respect of functions transferred to the Bank of England or arising from the activities of the Financial Policy Committee (FPC).

Conclusion

25. It remains difficult to estimate the overall balance of the factors discussed above. The Bank expects there to be long-run cost savings in the PRA arising from a more efficient approach to operational support, and in particular IT provision. But it is less likely that such savings could be made in the FCA which will retain a broad set of responsibilities. Overall, therefore, this impact assessment assumes that the FCA's and PRA's combined ongoing running costs should not be materially different (in real terms) in aggregate from the current FSA budget of about £500 million and that the range for additional ongoing costs in would be between £0 and £25 million higher than the base case costs.

Regulated firms: transitional costs

26. The estimates of transitional costs for regulated firms have not been changed in this impact assessment. Previous assessments took account of the views of the small number of consultees who commented on this issue. However, considerable uncertainty must remain in relation to these estimates.

27. Most of the approximately 20,000 UK firms regulated under the Financial Services and Markets Act 2000 will be regulated solely by the FCA. These firms may face some transitional costs – for example updating websites and letterheads – but these costs seem unlikely to be important. All firms will need to replace stationery and update websites etc. on a regular basis and they will have had notice of the proposed change. The additional resources required specifically to take account of the transition from the FSA to FCA are, therefore, assumed to be negligible for the purposes of this assessment.

28. About 1,700 UK-authorised firms are likely to be prudentially supervised by the PRA while also subject to conduct of business regulation by the FCA ("dual-regulated firms"). These firms are more likely to have to make arrangements to deal with two regulators rather than one, including changes to IT systems and possibly to internal processes and organisation. There are also some groups containing both dual-regulated firms and FCA-only firms which may be affected in a similar way as dual-regulated firms.

29. Many dual-regulated firms will be large banks, insurance companies and investment banks and most groups which contain dual-regulated firms are likely to be large or to contain large firms of these types. These firms or groups seem more likely to incur transitional costs in setting up systems to deal with both regulators, largely a function of the size of the firm.

30. 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; many credit unions would be very small by any standard. Some investment firms regulated by the PRA may also be small firms although it is likely that they will be parts of groups that include a bank or insurance company. The transitional costs for these firms seem likely to be relatively less depending on the circumstances of the individual firm.

31. It is difficult, therefore, to estimate the transitional costs that dual-regulated firms will face. It would also be difficult to separate genuinely additional costs from expenditure that would have been incurred anyway. Unlike most regulatory changes which involve firms having to make specific changes to staffing, processes or systems used in their businesses in order to meet precise, identifiable regulatory requirements, the principal effect of the regulatory reforms considered here is that dual-regulated firms will have to deal with two regulators rather than one. The transitional costs for these firms are simply the costs of setting themselves up to be able to do this. These costs are likely to vary considerably depending on their size, individual circumstances and their existing internal organisations, systems and processes. The small number of respondents to previous consultations who commented on transitional costs mainly included large dual-regulated firms and they expected quite large transitional costs, partly reflecting experience with recent regulatory changes – although these would mainly include changes to regulatory requirements rather than to the regulatory organisation with which firms would have to deal. On the other hand, it seems unlikely that very small firms, which are not expected to have to make major adaptations to prepare for the PRA's more judgement-led approach to supervision, will incur significant transitional costs.

32. The Government sought views on the transitional for regulated persons in previous consultations and respondents' comments have been taken into account in the assumptions made for the transitional that firms are likely to incur in making changes to their internal systems and processes. However, the small number of responses received and the range of different sizes and circumstances of dual-regulated firms mean that it is not possible to produce more precise estimates of their transitional costs. The range of estimates is, therefore, unchanged at £50 million to £100 million.

Regulated firms: ongoing compliance costs

33. The estimates of ongoing compliance costs for regulated persons have not been changed in this impact assessment. Previous assessments took account of the comments received from a small number of consultees who commented on this issue. However, considerable uncertainty must remain in relation to these estimates.

34. Regulated firms and applicants for authorisation are only like to face significantly higher ongoing compliance costs if they have to deal with more than one regulator. The majority of FCA-only firms are unlikely, therefore, to face higher ongoing compliance costs. Some firms may be affected by the possible changes to the FCA operating model but that will depend on a range of factors and need not imply higher costs for firms; this is discussed in more detail in the section on benefits.

35. Dual-regulated firms (and applicants) will have to deal with two regulators and may need to respond to the changes in supervisory practice in the PRA. The impact on larger dual-regulated firms seems likely to be relatively greater than for smaller dual-regulated firms but the amount of the impact would depend to a significant extent on the circumstances of individual firms and their existing internal systems and processes. Respondents to previous consultations and those who commented on this issue in response to the June White paper have been concerned that dual-regulated firms would face significantly higher costs and that these would fall disproportionately on smaller dual-regulated firms. In practice, it seems unlikely that very small dual-regulated firms would face significantly higher ongoing compliance costs as changes in PRA supervisory practice will mainly affect larger firms as a result of the move towards more judgement-led supervision and greater emphasis on high-impact firms. The largest banks and insurance companies are probably best placed to adapt to a move to more judgement-based supervision and so may not face significantly higher compliance costs in comparison with the current position. However, it less clear what the effect would be on medium sized firms (which could include a broad range of smaller banks, building societies, insurers, friendly societies or proprietary trading firms) although a great deal could depend on the complexity of their businesses and their individual circumstances.

36. The Government sought views on the ongoing compliance costs for regulated persons in previous consultations and respondents' comments have been taken into account in the assumptions made for additional ongoing compliance costs that firms would incur. However, the small number of responses received and the fact that firms can be expected to adapt over time to the new regulatory arrangements mean that additional ongoing compliance costs cannot be precisely estimated. This impact assessment therefore keeps the assumptions about additional ongoing compliance costs of between £25 million and £50 million a year used in previous assessments.

Benefits

Improvements in prudential regulation

37. In principle, the gross benefits from improvements in prudential regulation can be estimated by calculating the change in the present value of the total expected welfare losses (represented by the reduction in output i.e. GDP) from financial crises due to the reduction in the frequency of financial crises. This is equivalent to estimating the change in the probability of a financial crisis occurring in a year multiplied by the very large loss (the present value of the reduction in GDP in that years and several subsequent years) which would result from the financial crisis, and then discounting these annual amounts and summing them.

38. It is then necessary to deduct the amount of any benefits which could be expected to arise in the base case, including (i) the effects of the increased rigour and credibility of the FSA supervisory effort and (ii) the net effect of any changes to relevant regulatory requirements which would happen in any case (e.g. in bank capital and liquidity requirements made to implement recommendations of the Basel Committee on Banking Supervision to strengthen global capital and liquidity rules) or of other reform measures such as those to implement the ICB recommendations.

39. Of course, all such estimates are entirely dependent upon the assumptions made while isolating the net effects of other reforms or measures would be very difficult. The present values of benefits should be regarded as purely illustrative.

40. The Basel Committee on Banking Supervision has published estimates of the annual economic benefits and costs of tighter regulatory standards, including estimates of the effect of higher capital requirements on the probability of systemic banking crises. Their estimates of the annual benefits of reducing the probability of a financial crisis by 1 percentage point (e.g. reducing the incidence of

financial crises from 4 per century to 3 per century) range from 0.19 per cent of output per year (assuming that financial crises have no permanent effect on output) to 1.58 per cent of output per year (assuming that financial crises have a large permanent effect on output).

41. The Basel Committee on Banking Supervision also considers that requiring banks to hold increased capital and liquidity will itself lead to significant reductions in the probability of financial crises and to significant net benefits in terms of reductions in output lost. It will always be difficult to assess how much of any benefits should be attributed to changes in capital and liquidity requirements rather than improvements in supervisory practice. The amount of capital and liquidity that a bank holds (and the amount of risk-weighted assets included in the denominator of a capital ratio calculation) can only be estimated on the basis of information from the bank's accounting systems and will depend on the quality of information in those systems. Clearly more intensive supervision could make a more important contribution to improving the stability of a bank if it led to the identification and correction of weaknesses in the bank's information systems. Increasing capital requirements would be more important for a bank which already had good systems.

42. It is impossible therefore to estimate the amount of any benefit that could be attributed to the preferred option but if it is assumed that the proposed regulatory reforms alone reduced the probability of a financial crisis by only 0.1 percentage points, this would generate an annual benefit of between 0.02 per cent and 0.16 per cent of output. On this basis, for **illustrative** purposes, the annual benefit for the UK of the proposed regulatory reforms would be between about £250 million and £2,000 million a year. (This is estimated by assuming UK output (gross value added at basic prices) in 2010 to be about £1,300 billion. The estimates would be higher if GDP at market prices was used.)

43. For the purposes of this impact assessment, it is assumed that these benefits would only accrue from 2014 to 2020, reflecting the 10 year cut-off for impact assessments. In practice, of course, the benefits should endure as long as the new regulatory structure is maintained. (The method of estimating the benefits implicitly assumes they are long-run effects; the effect of the reforms is essentially to increase the time between severe financial crises although the analysis accepts that much of this can be attributed to internationally agreed changes in regulatory requirements (which are in the base case).) On the assumptions made, these benefits should exceed any ongoing costs so the results of this assessment are not biased by working with the 10-year cut-off period.

Improvements in consumer protection

44. The benefits in terms of consumer protection from a more proactive approach with greater emphasis on transparency and disclosure, to regulating financial services and conduct can be estimated in essentially the same way by calculating the change in the NPV of the expected gains or losses for consumers, regulated firms and others (such as regulators) arising from adopting the new approach to consumer protection. This analysis will also be entirely dependent on the assumptions made.

45. There are potential resource benefits for consumers from a reduction in the frequency or severity of incidents of significant consumer detriment (e.g. major investment misselling cases). Consumers would not have to engage with firms, regulators or bodies such as the Financial Ombudsman Scheme (FOS) in order to obtain redress, or suffer any loss of interest because of the inevitable delay between suffering a loss and receiving compensation. They would also not suffer distress about potentially losing what may be large amounts of money or because of the uncertainty over whether they are able to obtain compensation; distress can be regarded as a resource loss for consumers although it is obviously more difficult to estimate.

46. The resource gains or losses for firms and regulatory bodies could also be large. Firms would not need to use resources to examine claims or complaints from customers or to deal with regulators or the FOS. Regulators, the FOS etc. and, if firms were in default and unable to pay claims, the Financial Services Compensation Scheme (FSCS) would not need to use resources to process claims. Both firms and regulators etc. can incur these costs whether or not the complaint is justified or compensation is payable. (Compensation paid or losses incurred because a customer is unable to obtain sufficient redress from a firm or from the FSCS (because the claim exceeds the limit in FSCS rules) are transfers rather than resource costs.)

47. There is no doubt that the quantifiable resource gains or losses involved could be large. The cost benefit analysis (CBA) included with an FSA consultation in 2009 on payment protection insurance (PPI) complaints indicates that there had been over 400,000 complaints since January 2005 about PPI while 63,000 cases were submitted to the FOS. The costs for firms and others in dealing with

these complaints can differ significantly depending on how they are to be handled. The same FSA CBA assumed administrative costs for firms of £200 per complaint but indicated that this was lower because firms only had to review rejected complaints.

48. It is impossible, therefore, to estimate the amount of any benefit which could be attributable to the preferred option rather than the base case. However, assuming that numbers of customers affected by any one incident was of the order of 100,000 and that the resource costs were £5,000, the resource costs of any one incident would be £500 million. While the precise answer would depend on the assumed frequency of such incidents and the change in the frequency attributed to an improved operating model, this calculation suggests that benefits could not be of the same order as the benefits from the improvements to prudential regulation discussed above and would almost certainly be substantially lower. No amount has therefore been included in the illustrative benefits of the preferred option.

49. The benefits from the FCA having a stronger role in competition matters are also very difficult to quantify. Most of the effect of the elimination of monopoly rents in the supply of real goods and services (which would include the provision of investment advice but not the provision of financial investments themselves) takes the form of a transfer from suppliers to consumers and so does not involve any resource cost or benefit. The benefits to consumers from the stronger FCA role in competition would therefore be found in any increase in the provision of financial services such as investment advice less the amount of any such benefits that might be expected to arise in the base case. There would also be some benefits in any reduction in resource costs incurred by other bodies such as the OFT. These benefits would be very difficult to estimate but there does not seem any reason for believing that they could be of the same order as the benefits from the improvements to prudential regulation. No amount has therefore been included in the illustrative benefits of the preferred option.

Assumptions, risks and sensitivities

50. The principal assumptions are those relating to the benefits of avoiding a financial crisis (see above) and about the costs for public authorities and regulated firms.

51. The key assumption is that establishing two specialist financial regulators and the strengthening of the arrangements for coordination between the PRA and the Bank of England should result in a reduction in the frequency of severe financial crises in the UK, in addition to any such reduction that could be attributed to other measures (such as internationally agreed changes to regulatory requirements). There is a risk that this assumption is not correct and that the benefits assumed in the impact assessment are overstated.

52. In addition, the amount of the benefits is clearly dependent on the detailed assumptions made (including by the Basel Committee of Banking Supervision in its work). This can be seen in the difference between the high and low estimates of the benefits which reflects different assumptions about whether there are permanent effects on output from a crisis. These estimates will always be very sensitive to changes in economic assumptions (for example, the long-run trend in economic growth).

53. In relation to costs, the main risks are that (1) 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) the ongoing costs for regulatory bodies and firms are materially underestimated.

Wider impacts

Statutory equality duties

54. The Government has considered the proposed reforms in relation to its public sector equality duties under the Sex Discrimination Act 1975, the Race Relations Act 1976, the Disability Discrimination Act 1995, section 75 of the Northern Ireland Act 1998 and the Equality Act 2010. It has concluded that no relevant issues arise. All UK residents would be affected to a greater or lesser extent by a financial crisis having a severe impact upon the UK economy.

Environmental, social and sustainable development impacts

55. The Government does not anticipate any impact upon greenhouse gases, wider environmental issues, health and well-being, human rights, the justice system, rural proofing and sustainable development. This assumes that the proposed reforms would not change the relationship between certain environmental phenomena and GDP.

Economic impacts

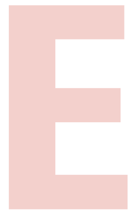
56. Apart from any effect arising from the stronger FCA role in competition matters, the principal effect on competition from financial services regulation is through the effect on barriers to entry into the industry. The Government does not envisage that the proposed reforms to regulatory structure will in themselves change the conditions which applicants have to satisfy to obtain authorisation from a regulator but there may be higher costs in obtaining authorisation for applicants to be dual-regulated firms as both the PRA and FCA will be involved in processing the application. The 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 possible increase in compliance costs for dual-regulated firms does not appear large enough on its own to induce a dual-regulated firm to relocate elsewhere in the EEA and use an EU 'passport' to provide services in the UK. (Many dual-regulated firms such as credit unions and building societies could not relocate to another EEA state; the additional compliance costs arising from dual regulation will be only one of many UK and non-UK factors which would be considered in the location decisions of the largest dual-regulated firms.) The Government does not consider, therefore, that the proposed reforms will have any significant adverse effect on competition.

57. Small firms which take deposits or effect or carry out contracts of insurance, and certain small investment firms will be regulated by the PRA and FCA. 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 FCA in succession to the FSA. They are not likely to be disproportionately affected by the proposed reforms. Micro-businesses are not exempt but most micro-businesses will be regulated solely by the FCA in succession to the FSA and so will not be significantly affected by the reforms. Some micro-businesses will be regulated by both the FCA and the PRA but it is unlikely that these firms will face significantly higher compliance costs as the anticipated changes to supervisory practice will mainly affect much larger systemically important firms.

Summary and preferred option (with description of implementation plan)

58. The Government therefore proposes to proceed with the preferred option.

59. 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 the end of 2012.



MOU on crisis management

Memorandum of Understanding on financial crisis management

1 This memorandum has been prepared and published in line with the provisions of Section [61] of the Financial Services Act [2012], (the Act) which requires HM Treasury (the 'Treasury') on the one hand, and the Bank of England and its subsidiary, the Prudential Regulation Authority (PRA), on the other, to prepare and maintain a memorandum of understanding on financial crisis management. This memorandum of understanding therefore establishes the framework for coordination of financial crisis management between the Treasury and the Bank of England and its subsidiary, the PRA. Within this memorandum, a reference to the 'Bank' refers to both the Bank of England and the PRA, except where the context otherwise requires or it is explicitly stated otherwise.

2 The Bank is responsible for protecting and enhancing the stability of the UK financial system. Through the PRA, the Bank will regulate deposit-takers, insurance companies and certain 'investment firms' to promote the stability of the UK financial system and ensure that when individual institutions fail, they do not pose a threat to the stability of the system as a whole. Stability, while important, is only one element of a successful financial sector and economy; and the possibility of failure of individual firms is a vital element of the competitive discipline imposed by efficient markets.

3 When the risk of instability or failure arises, it must be monitored and mitigated so as to minimise the impact on the financial system, and the economy, as a whole. Managing such risks when there is a material likelihood of crystallisation is the process referred to in this memorandum as 'financial crisis management'.

Responsibilities

4 The key principle of financial crisis management is to make clear who is in charge of what, and when. The Bank and the Treasury have clear and separate responsibilities. The Bank has primary operational responsibility for financial crisis management. The Chancellor and the Treasury have sole responsibility for any decision involving public funds. When the Bank has formally notified the Treasury of a material risk to public funds, and either there is a serious threat to financial stability, or public funds are already committed by the Treasury to resolve or reduce such a serious threat and it would be in the public interest to do so, the Chancellor may use powers to direct the Bank.

5 The Bank has primary operational responsibility for financial crisis management. Its responsibilities in a financial crisis stem from:

- the PRA's monitoring and mitigating of risks to the safety and soundness of individual firms – including through the Proactive Intervention Framework (PIF), which makes clear how and when the PRA will escalate its engagement as risks in relation to a firm increase;

- its oversight of payment systems, settlement systems and clearing houses, which are systemically important to the financial system, including its power to close an inter bank payment system.
- offering, as the central bank, liquidity insurance to the financial system on terms that safeguards the Bank's capital, as described in the Bank's published frameworks;
- the provision, when authorised by the Treasury, of Emergency Liquidity Assistance (ELA - defined as support operations outside the Bank's published frameworks) to firms that are at risk but are judged to be solvent;
- the Bank's powers under the Special Resolution Regime (SRR), as set out in Parts 1 to 3 of the Banking Act 2009; and
- the Bank's obligation, under Section [54(1)] of the [2012] Act, to notify the Treasury of a material risk to public funds arising from a potential crisis.

6 The Chancellor and the Treasury have sole responsibility for any decision on whether and how to use public funds, including:

- authorising any proposal by the Bank to provide ELA to one or more individual firms in a support operation that goes beyond the Bank's published frameworks;
- authorising the use of any stabilisation power which would have implications for public funds, including in respect of a firm to which financial assistance has already been extended by the Treasury; and
- the exercise of the Temporary Public Ownership stabilisation option in relation to a bank or a bank holding company in accordance with the relevant provisions of the Banking Act 2009.

7 The Chancellor and the Treasury are also responsible for:

- keeping Parliament and the public informed of action taken to manage a crisis; and
- ensuring that actions considered or taken are assessed for compliance with the UK's international obligations.

Notification by the Bank of a risk to public funds

8 Operational responsibility for mitigating and managing risks to financial stability rests with the Bank. Where the Bank is able to manage a financial crisis without public funds being put at risk, it will have autonomy in exercising its responsibilities, in line with the relevant statutory provisions. The Bank will keep the Treasury informed of such actions and their outcomes in a manner proportionate to the severity of the situation.

9 When the Bank, however, considers there to be a material risk of circumstances arising in which public funds would be at risk, close co-ordination is required to ensure that the Bank and the Treasury are able to fulfil their individual responsibilities effectively. Both the Bank and the Treasury have particular responsibilities to ensure this co-ordination is effective.

10 The Bank has a statutory duty under Section [54(1)] of the [2012] Act to notify the Treasury immediately when there is a material risk of circumstances arising in which public funds would be put at risk.

11 The [2012] Act establishes that these circumstances are those in which:

- the Treasury[1] might reasonably be expected to regard it as appropriate to provide financial assistance to or in respect of a financial institution;
- the Treasury[2], the Bank or the PRA might reasonably be expected to regard it as appropriate to exercise any of their respective powers under the SRR and the Treasury might reasonably be expected to regard it as appropriate to incur expenditure in connection with the exercise of those powers; or
- the scheme manager of the Financial Services Compensation Scheme might reasonably be expected to request financial assistance from the Treasury (including via the National Loans Fund) for the purpose of that scheme.

12 In addition, where the Bank proposes to make ELA available to one or more financial institutions it will notify the Treasury and seek the Treasury's approval.

13 In determining whether a notification of a risk to public funds is needed in respect of an individual firm, the starting point for the assessment will be the published generic risk "stages" identified in the PRA's PIF. However, the PIF stages will not be used as a formulaic test. Notification may be required at earlier or later stages of the PIF, depending on the probability, nature and severity of the risk to public funds. The same will apply to assessment of non firm-specific or systemic risks: the precise notification threshold will depend on a range of factors relating to the nature and probability of the risk to public funds.

14 The assessment will not, however, depend on the amount of public funds at risk. The principle that the Chancellor and the Treasury are responsible for any decision involving public funds, regardless of the amount concerned, is absolute.

15 Notification will be made in sufficient time for the Treasury to make a fully informed decision about the potential use of public funds. This will include sufficient time to allow the Treasury to commission the Bank to develop alternative mitigation options. If in doubt, the Bank will tend towards notification.

16 If the Treasury independently identifies an issue which it believes may result in a threat to financial stability or a risk to public funds, it may ask the Bank to assess whether this issue requires a notification.

17 When the Bank notifies the Treasury under Section [54(1)], the Bank will, as soon as possible thereafter and on a timetable agreed with the Treasury, provide:

- an explanation of the risk to public funds;
- identification of the options the Bank is considering to mitigate the risks to stability including, where relevant, resolution options under consideration;
- an assessment of the potential systemic or firm-level impact of each option; and
- identification of specific risks to public funds arising from any action being considered, including inaction.

18 The Bank and the Treasury will agree a suitable frequency for updates, reflecting the severity and immediacy of the risk to public funds given the specific crisis. The Bank will also notify the Treasury when a risk is deemed to have passed.

[1] Or the Secretary of State of another Government Department

[2] Or the Secretary of State of another Government Department

Financial crisis management

19 As noted above, where the Bank is able to manage risks to financial stability without public funds being put at risk, it will do so on an autonomous basis. Once a risk to public funds has been notified, the Bank will continue to lead the operational response, working closely with the Treasury to develop options to mitigate the risk.

20 During a potentially fast-moving crisis, it will become especially important to ensure close and effective coordination so as to maintain coherence in the overall crisis management process. At the heart of institutional coordination during a live crisis will be frequent contact between the Chancellor and the Governor. However, the Chancellor and the Governor may agree to establish ad hoc or standing committees at other levels to support this process.

21 The Treasury will provide the Bank with clear information on particular issues of interest or concern to the Treasury which relate to resolving the crisis in the public interest. If requested by the Bank, this will include the Treasury's view on the type and the level of public funding commitments that, consistent with the 2009 Act, it is likely to authorise. This information will be provided in sufficient time to assist the Bank in developing and implementing resolution options. It will not, however, constitute Treasury pre-approval of a specific public fund envelope within which the Bank may operate. Any decision with public funds implications will still require explicit Treasury authorisation. Within this framework, the Bank will be responsible for developing options for managing or resolving the risk to public funds consistent with its statutory responsibilities as the resolution authority. The Bank will provide the Treasury with information needed on the options for managing the situation, including on options commissioned by the Treasury. This will be provided in sufficient time to allow the Treasury to make a fully informed decision about any use of public funds.

22 The Bank will take account of the Treasury's need to use public funds in a way which meets standards of regularity and propriety and provides good value for money.

23 The Chancellor and Treasury Accounting Officer will take responsibility and ultimate control over all decisions involving the use of public funds. The Treasury will take decisions on the use of public funds in a timely manner, to allow the Bank (and any other agencies or authorities involved) to implement the chosen course of action, within the constraints imposed by legislation (including EU legislation).

24 The Treasury's involvement after notification will increase in proportion to the magnitude of the risk to public funds up to the point where, having consulted the Governor, the Chancellor is satisfied that there is a serious threat to financial stability, or that it would be in the public interest to do so, given public funds already committed to resolving the crisis. At this point, the Chancellor will have the ability, if necessary in the public interest, to exercise the power of direction provided for in the Act and set out below.

The Chancellor's power of direction over the Bank

25 The Bank has primary responsibility for financial stability and operational responsibility for managing financial crises. But consistent with the Treasury's overall responsibilities, the Chancellor may, in some circumstances during a financial crisis, use additional powers to direct the Bank. This is provided for in Section [57] of the Act, which allows the Chancellor to direct the Bank to:

- conduct special support operations for the financial system as whole, in operations going beyond the Bank's published frameworks;
- provide ELA in a support operation going beyond the Bank's published frameworks to one or more firms that are not judged by the Bank to be solvent and viable;
- provide ELA in a support operation going beyond the Bank's published frameworks to one or more firms on terms other than those proposed by the Bank; and
- implement a particular SRR stabilisation option.

26 Where the Chancellor directs the Bank to conduct a support operation, either to the financial system as a whole or to one or more individual firms, the Bank will act as the Treasury's agent. The Bank will set up a Special Purpose Vehicle (SPV), separate from the Bank's balance sheet, to effect the support operation. The Bank and the Vehicle will be indemnified by the Treasury. Where the Treasury has determined that the operation needs to be carried out covertly, the Bank will execute the operation in a way which best ensures that the existence of the operation does not become public.

27 The Treasury will decide whether the Vehicle shall be financed through the issuance of government securities, by a loan from the Bank with share capital provided by the Treasury or via another mechanism. When the Vehicle is financed by a loan from the Bank or would otherwise affect the Bank's balance sheet, the Bank will decide, consistent with its operational independence in monetary policy, whether and how to offset the resulting expansion of central bank reserves.

28 The 2009 Act contains a number of provisions covering the Treasury's role in the SRR where public funds are at risk. The Bank may not exercise a stabilisation power without the Treasury's consent, if the exercise would have implications for public funds. In addition, if the Treasury has provided financial assistance to resolve or reduce a serious threat to financial stability, the Bank may only exercise its stabilisation powers where recommended to do so by the Treasury on the grounds that such an exercise is necessary to protect the public interest.

29 In general terms, these provisions are sufficient to allow the Treasury to fulfil its role in protecting public funds when use of the SRR is being considered in a crisis. Notwithstanding this, the power of direction in the [2012] Act will cover the SRR to put beyond legal doubt the Chancellor's ability to require the Bank to take specific action when public funds are at risk. This is a backstop power, and it is not anticipated that its use will be considered in the majority of crisis situations.

30 As with directions involving liquidity, when the Chancellor directs the Bank to implement a specific option under the SRR, the Treasury will provide the Bank with indemnities covering any risks arising from actions it had taken under direction from the Treasury.

31 The power of direction may be exercised if and only if:

- the Bank has notified the Treasury of a material risk of circumstances arising in which public funds will be at risk in accordance with Section [54] of the Act; <u>and</u>
- the Chancellor, having consulted the Governor, is satisfied that the direction is either a necessary response to a serious threat to financial stability or, where

financial assistance has already been provided in respect of a firm to resolve or reduce such a serious threat, necessary to protect the public interest.

32 Upon a direction being given, that direction, along with any response the Bank may wish to make, will be laid immediately before Parliament. The only circumstance in which the direction would not be immediately laid before Parliament will be when such disclosure would reveal the existence of a support operation that the Treasury has decided needs to be covert in order to preserve financial stability. In that case, the Chancellor will notify the Chairs of the Treasury Select Committee and the Public Accounts Committee in confidence immediately. The direction and any Bank response will be laid before Parliament when the Treasury, having consulted the Bank, has decided that the need for confidentiality of the support operation has passed.

33 This power of direction is not available in relation to (1) supervisory decisions taken by the PRA or by the rest of the Bank in its regulation of systemic post-trade infrastructure; (2) policy decisions made by the MPC and FPC; or (3) changes to the Bank's published framework for providing liquidity support to the financial system.

Other aspects of co-ordination

Other organisations

34 In some cases, the Financial Conduct Authority, the Financial Services Compensation Scheme or other organisations may need to be involved in the monitoring and assessment of risks, or the planning and implementation of financial sector interventions. The Bank and Treasury will involve these organisations as necessary.

Compliance with international obligations

35 Action to manage a potential financial crisis may give rise to considerations of compliance with the UK's international obligations, particularly those arising from European law. The Government is legally responsible for ensuring that this compliance is achieved. The Bank and the Treasury will therefore coordinate activity to ensure that actions considered or taken are assessed for compliance with those international obligations.

36 In particular, use of the special resolution regime or other interventions in respect of failing firms may require the European Commission to be notified of, and approve, the measure on state aid grounds, whether or not public funds are deployed. The Treasury is responsible for developing the UK policy and framework for state aid in financial services. The Bank will develop options for intervention or resolution that are consistent with this framework, and will prepare initial State aid notifications in consultation with the Treasury. The formal State aid notification to the European Commission will be made by the Treasury acting on behalf of the UK Government. The Bank will support the Treasury in securing state aid approval when the issue has arisen from its actions.

Communicating with Parliament and the public

37 Treasury Ministers are responsible for keeping Parliament informed of action taken to manage a financial crisis – including action taken by the Bank without any public funds implications. The Bank will keep the Treasury informed to the degree needed for Ministers to fulfil this function.

38 The Bank and the Treasury will also work closely together to ensure that wider communication – including provision to the markets of information relating to

regulatory reporting events, and communication to the general public about the progress of a financial crisis and the steps being taken to manage them – is carried out effectively.

39 Within that, the Bank is responsible for communications to the market: about the use of its balance sheet; about measures concerning critical financial infrastructure arising from its oversight under the 2009 and [2012] Acts; through the PRA, about the PRA's regulation and supervision of individual firms; and about any measures taken by the Bank under the SRR, excepting any use of public money by the Treasury in association with those measures.

F

MOU on international organisations

Memorandum of Understanding: International Organisations

1 Many policy issues related to financial stability and financial regulation are now either wholly or largely determined at an international level. Reflecting this, the number of official international committees and ad hoc groups engaged on these issues has increased greatly. Often, similar or inter-related issues are discussed in several different fora (for example, in the Basel Committee on Banking Supervision (BCBS), the Financial Stability Board (FSB), EU Working Groups, European Supervisory Authorities (ESAs), European Systemic Risk Board and ECOFIN/EFC). Representation in these different fora is, however, spread across different authorities, notably the Treasury, the Bank of England (for its functions in relation to financial stability and as a regulator), the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA)[1]. This gives rise to an important challenge to ensure that, despite having different representation in different fora, the UK takes a coherent position internationally and a consistent line in discussions with international partners[2].

2 This MOU sets out a framework for consultation and cooperation amongst the relevant authorities to facilitate achievement of this objective, while respecting the individual responsibilities and competences of the different authorities and the requirement, where relevant, for personal or institutional independence and the constitutions of the international bodies themselves.

3 The Treasury is responsible for the overall institutional structure of financial regulation and the legislation which govern it, both domestic and international. Individual authorities have responsibilities and objectives under statute and may as part of that have responsibilities directly to international organisations. For example, while the Treasury has responsibility for negotiations of level one directives and regulations in the European Union, the PRA and FCA have been delegated responsibility, through the ESAs, for the development of draft technical standards which do not imply policy choices through the ESAs, and must act independently and objectively in developing such standards.

4 Consistent with such obligations, the UK authorities will coordinate the positions they take in international groups and international negotiations on all major issues where there is a shared interest with another authority. Where not all the UK authorities are represented in international organisations and at international bodies, the UK authorities that are represented shall, in a timely manner, consult with and keep the other UK authorities informed in relation to any matter of common interest.

[1] The PRA ia an operationally independent subsidiary of the Bank of England.

[2] In some specific organisations, representatives are required to act in accordance with explicit objectives. For example, in the ESAs, members of the Board of Supervisors are required to act independently and objectively in the sole interest of the Union as a whole when performing their duties. In these cases, the UK representatives will coordinate and consult with the other relevant UK authorities to ensure the UK is an effective participant in these fora.

5 The principles set out in this Memorandum of Understanding should apply to the management of mutual interests between UK authorities and other independent domestic bodies, including but not necessarily limited to the Pensions Regulator (tPR), Takeover Panel, and the Financial Reporting Council (FRC). The UK authorities and other bodies may under their own authority agree separate bilateral Memorandums of Understanding covering coordination of international activity if required.

6 This Memorandum of Understanding applies in relation to discussions and negotiations in relation to financial services issues in international organisations and international bodies at which the UK authorities are represented. These include, but are not limited to, the bodies listed at Annex A.

International Coordination Committee

7 As provided for by section [62] of the Financial Services Act [2012], this document establishes an International Coordination Committee (hereafter referred to as 'the Committee') that shall be responsible for ensuring the UK authorities act in accordance with the principles set out in the document.

8 The Committee shall be comprised of officials from the UK authorities and shall be chaired by the representative of HMT. The Committee may invite representatives of other bodies to attend its meetings.

9 The Committee shall meet once a quarter or more often as necessary.

10 The Committee will be accountable to the Chancellor and shall provide him or her with a copy of its meeting minutes and any other material that he or she requests.

Principles

11 The UK authorities will coordinate their international engagements in accordance with the principles of openness, cooperation and coherence. In order to comply with these principles the UK authorities, at all levels of negotiation, should:

a keep the other relevant UK authorities informed in relation to matters that impinge on their respective responsibilities;

b where possible, consult with any other relevant UK authority and work towards an agreed position in good time before engagement with the international organisation or bodies;

c subject to the regulations or practices of the international organisation or body involved, share relevant information and documentation with any other relevant UK authorities;

d facilitate, in accordance with the regulations of the international organisation or body, the attendance of any other relevant UK authority at any relevant meeting or sub-committee where appropriate;

e consider the opinions of the other relevant UK authorities when deciding their own position;

f agree consistent objectives with other relevant UK authorities in relation to matters of common interest, in accordance with the relevant authorities' own objectives; and

g act consistently with international laws and regulations.

12 Where issues, on which there is no agreed UK position, arise during the course of an international meeting without advance notice, the represented authority will take into account the interests and objectives of the other parties to the best of their abilities. The represented authority will communicate the nature of the discussion and any outcome to the other relevant authorities as soon as possible.

Review of this document

13 This document shall be reviewed by the relevant UK authorities at least annually or more often as necessary to ensure that the contents remain appropriate and that the list of international bodies at Annex A remains current.

Annex A: International Bodies

Body	UK Representative(s) (voting)	Other interested parties may include[3]
EU Council, including EU Financial Services Committee	HMT	PRA, FCA
European Banking Authority (EBA)	PRA	FCA, Bank
European Securities and Markets Authority (ESMA)	FCA	Bank, FRC
European Insurance and Occupational Pensions Authority (EIOPA)	PRA	tPR, FCA
European Systemic Risk Board (ESRB)	BoE	PRA, FCA
Financial Stability Board (FSB)	HMT, BoE, PRA/FCA	
Basel Committee on Banking Supervision (BCBS)	BoE	PRA
Bank of International Settlements (BIS)	BoE	
International Organisation of Securities Commissions (IOSCO)	FCA	Bank
G20 leaders' meetings	Prime Minister	
G20 Sherpa meetings	Cabinet Office	
G20 Finance Ministers' meetings	HMT	
G20 Central Bank Governors' meetings	BoE	
International Monetary Fund (IMF)	HMT, BoE	PRA, FCA
International Association of Insurance Supervisors (IAIS)	PRA	FCA
Joint Forum	PRA, FCA	Bank
Organisation for Economic Cooperation and Development (OECD)	HMT	Bank

[3] Across the range of International Bodies, other interested parties may also include organisations such as: the Financial Services Compensation Scheme (FSCS), Financial Ombudsman Service (FOS), Financial Reporting Council (FRC) and Takeover Panel. In some international bodies, there is also scope for flexibility in sub-committee or working group participation. It may also be possible for additional interests to be represented through observer status at various levels in some international fora.

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ISBN 978-0-10-182682-2