HM TREASURY

# Financial Services Act 2012:

## summary of consultation responses on draft secondary legislation and Government response

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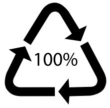

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# 1 Introduction

1.1 The Financial Services Act 2012 is a key piece of legislation which fundamentally reforms the regulation of financial services in the UK. The Act:

- makes the Bank of England responsible for financial stability;
- provides for focussed prudential and conduct of business regulators (the Prudential Regulation Authority or PRA, and the Financial Conduct Authority or FCA);
- creates a macro-prudential authority, the Financial Policy Committee (FPC), within the Bank of England;
- places the judgement of expert supervisors at the heart of regulation; and
- allows the inclusion of activities in respect of benchmarks as regulated activities and creates three criminal offences related to market manipulation.

1.2 The Act received Royal Assent on 19 December 2012 and the Government intends to lay the necessary secondary legislation imminently. The Government launched three consultations on the secondary legislation:

- Implementing the Wheatley Review: draft secondary legislation on the provisions relating to the manipulation of LIBOR;
- Financial Services Bill: the Financial Policy Committee's macro-prudential tools on the levers that the Bank of England's new Financial Policy Committee will have to address risks it identifies to financial stability; and
- A new approach to financial regulation: draft secondary legislation on the remaining secondary legislation related to the Act.

1.3 These consultations closed in December 2012, and the secondary legislation will be made in the coming months ahead of cut-over to the new regulatory regime, which the Government aims to have in place on 1 April 2013, subject to the Parliamentary timetable.

1.4 This document contains a summary of the responses received to each consultation, along with the Government's response to the issues raised.

# 2 A new approach to financial regulation: draft secondary legislation

2.1 The consultation document *A new approach to financial regulation: draft secondary legislation* was published in October 2012. The document invited comments on secondary legislation under the following provisions:

- Section 22A of the Financial Services and Markets Act 2000 ("FSMA"), as amended by the Act covering the allocation of responsibility for prudential regulation between the PRA and the FCA;
- Section 55C of FSMA as amended by the Act, setting out the threshold conditions that authorised persons must meet in order to become authorised;
- Section 50 of the Act, transferring regulation of mutual societies to the PRA and FCA;
- Section 192B of FSMA as amended by the Act regarding the scope of regulators' power of direction and information gathering rules over parent undertakings of authorised persons or recognised UK investment exchanges and, by virtue of Schedule 17A to FSMA as amended by the Act, recognised UK clearing houses;
- Section 213 of FSMA as amended by the Act on the allocation of responsibility for rule-making with regards to the FSCS between the FCA and PRA; and
- Section 234B of FSMA as amended by the Act on the power to designate bodies that can make super-complaints to the FCA about the impact of the market in the UK for financial services on the interests of consumers.

2.2 By the deadline of 24 December, HM Treasury received 15 responses from trade associations, banks and other financial institutions, and consumer representation groups.

## Threshold conditions Order

2.3 The threshold conditions (TCs), set out in Schedule 6 to FSMA, are the minimum requirements that firms need to meet in order to become authorised. Failure by an authorised person to continue to meet the TCs enables the regulator to take action in relation to the firm including where appropriate varying or cancelling the firm's permission.

2.4 The threshold conditions Order revises the existing TCs with a view to ensuring that they are a clear, relevant and unambiguous set of standards which regulated firms are required to meet and upon which the regulators will base their regulatory judgements; and reflect and support the regulators' objectives and priorities. The Order also specifies which TCs are relevant to the exercise of the functions of the FCA on the one hand, and the PRA on the other. The Government asked for views on the proposed division of TCs between the PRA and FCA, views on the new content of the TCs, and any other comments. Views were received about:

- the implications for consumers of the FCA TCs;
- the introduction of a new 'probity' requirement;
- the definition of 'adequate resources';

- the new 'effective supervision' TC;
- assessment of business models; and
- how the new threshold conditions will work in practice.

### FCA threshold conditions

2.5 Consumer groups generally welcomed the proposed FCA TCs, with some respondents highlighting in particular the recognition that deficiencies in a firm's business model can cause consumer detriment. One respondent argued that the FCA's TCs should include a specific requirement on firms "to ensure they treat every customer fairly".

2.6 The Government supports the principle of 'treating customers fairly' and has given the FCA significant new tools to help it deliver its consumer protection mandate. However, the concept of 'fairness' is too general to include in the TCs without exhaustive definition, and the Government believes that this is better dealt with elsewhere – for example in FCA rules.

### Inclusion of a new reference to "probity"

2.7 The TCs include a new requirement that those responsible for managing the affairs of a firm act with probity, in addition to having adequate skills and experience. This new requirement received some strong support. However one respondent considered that the concept of probity is subjective, and should be qualified by reference to the judgment of a reasonable consumer.

2.8 The Government does not consider that the concept of 'probity' is significantly more subjective than other criteria against which the regulator must take regulatory judgments; and therefore takes the view that the additional wording is unnecessary.

### Definition of "adequate resources"

2.9 One respondent was concerned that "resources" was too widely defined, to include everything from "financial resources, to internal systems, to skills, people and the effectiveness of management". The Government notes that this is true of the existing TCs; and that the new TCs are in fact more explicit as a statement of what is required of firms. The respondent also noted that the 'threshold condition codes' will have the force of law and queried whether this amounts to unlawful sub-delegation.

2.10 The Government does not agree that the making of threshold condition codes amounts to unlawful sub-delegation: it is a well established principle that the regulator has a range of functions, including rule-making, which have legal consequences. The power to make threshold condition rules is expressly provided for in statute – see new section 137O of FSMA.

### New "effective supervision" TC

2.11 The Order introduces a new requirement that the firm must be capable of being supervised effectively by the regulator. This is in regard to all circumstances including the nature (and complexity) of its regulated activities, the complexity of its products, and the way in which its business is organised. One respondent stated that they "would not expect any assessment of the 'effective supervision' requirement to be dependent on the resource constraints of the regulator"; and a number of others expressed similar concerns.

2.12 The Government notes these concerns. However, on balance the Government believes that it is reasonable, and an important tool for effective regulation, to ensure that the regulator has means to require firms to have a business model that is comprehensible to the regulator, and to ensure that they co-operate with the regulator's reasonable requests.

### Assessment of business models

2.13 The Order provides for the FCA to be responsible for a new 'business model' TC, namely that the firm's strategy for doing business must be suitable for its regulated activities, having regard to the FCA's operational objectives. The PRA will also be assessing dual-regulated firms' business models (as part of its supervisory approach), however it does not need a specific business model TC of its own in order to do so, or to take action where it has concerns with a firm's business model.

2.14 One respondent recommended that it should be "made explicit that the FCA business model Threshold Condition should allow it to only intervene, in relation to business models and strategy, where the interests of UK consumers are at risk." The Government does not agree: the FCA's mandate goes significantly wider than consumer protection, and it would be inconsistent to limit the TC in the way suggested.

2.15 The respondent also argued that "the regulators should be required to coordinate their assessments to avoid inconsistent decisions". The Government agrees, and notes that this is already required by the general duty on the PRA and FCA to coordinate the exercise of their functions (section 3D of FSMA).

2.16 A number of respondents argued that there should be detail and guidance from both the PRA and the FCA about how they intend to judge compliance. The Government agrees that it will be important for the regulators to provide guidance to firms, whether this is general guidance (for example using the FCA's guidance power) or specific guidance to individual firms. However, it is not necessary to make reference to this in the threshold conditions order.

### How the new threshold conditions will work in practice

2.17 Some respondents expressed concern about how the TCs will be used as a supervisory tool. One respondent expressed a general concern that the changes to TCs give the regulators significant additional power "to escalate any non-trivial alleged regulatory failing (including matters involving a high degree of subjective judgment) into a TC issue, raising stakes for firms and giving rise to a degree of legal uncertainty". Another argued that a balance must be struck so that business growth and innovation are not hindered; and that there are "risks that interventions could be made without a thorough understanding of the firm's business".

2.18 The Government notes that part of the purpose of the changes to the TCs is to ensure that they can be used as an effective regulatory tool, and to that extent agrees with the comments that respondents have made. The Government also agrees that the regulators should be proportionate. This is given explicit recognition in the principles of regulation set out in section 3B of FSMA. However, it is also clear that in the past, regulation has not been as robust as it should have been. Part of the purpose of the Government's reforms is to give the regulators a mandate for a more intrusive and challenging approach. The Government wants to see a financial services industry which is well regulated, and is seen to be so: it is this that will ultimately build confidence in the financial system, which is in the interests of consumers and industry. The changes to the threshold conditions are an important part of the new framework.

## Section 22A Order

2.19 Section 9 of the Financial Services Act 2012 adds new section 22A to FSMA. Section 22A provides that the Treasury may specify by way of an Order which regulated activities are PRA-regulated activities. As well as regulating deposit-takers and insurers, the Government intends that the PRA will be able to designate certain investment firms for prudential regulation by the PRA where it determines that it is desirable, in light of the PRA's objective, for the PRA to regulate prudentially that firm.

2.20 Most consultation respondents did not comment in detail on the section 22A order. Some respondents stated their view that firms should be allowed sufficient time (for example, 12 months) to make any necessary adjustments to enable it to meet the PRA's requirements. One respondent argued that the power to immediately designate a firm "should only be exercised where the PRA considers that there is an imminent threat to its objectives that cannot be otherwise prevented".

2.21 The Government believes that the process set out in the Order is clear. Further detail is set out in the draft policy statement which is currently being consulted on by the Bank and FSA. Beyond that, the PRA is under a duty to have regard to the principle of proportionality in the exercise of its general functions, which applies to its approach to designation of firms under section 22A.

2.22 Lloyd's of London noted that the Order does not make secondary market activity a PRA-regulated activity, and expressed concern that this would have the unintended effect that Lloyd's would no longer have permission to carry on their secondary market activity.

2.23 The Government can confirm that Lloyd's will continue to have permission to carry on that activity by virtue of an Order to be made under section 119 of the Act (transitional provisions). Provided Lloyd's carries on one PRA-regulated activity, it will be prudentially supervised by the PRA in respect of all its regulated activities. The FCA will be responsible for conduct of business supervision of the secondary market activity. It is therefore unnecessary to refer specifically to secondary market activity in the Section 22A Order.

## Mutuals Order

2.24 The FSA currently has a range of functions under the body of legislation which governs the establishment and operation of mutual societies. The Mutuals Order divides these functions between the PRA and the FCA and inserts co-ordination mechanisms similar to those in the Financial Services Act.

2.25 Some respondents made general comments welcoming the Government's commitment to supporting the mutuals sector. One respondent suggested that the Government should undertake a general review of the system of registration and regulation, arguing that the current position in which firms can state that they are 'registered' by the FSA without being 'regulated' by the FSA was confusing for consumers and could lead to consumer detriment.

2.26 The Government notes these concerns; however, they are not issues that can be dealt with through the Mutuals Order.

2.27 In the consultation document, the Government asked for views on the high-level approach taken to splitting the 'mutuals functions' between the PRA and the FCA; the requirements on the PRA and FCA to coordinate and consult each other; the proposal to apply the PRA's objective to its functions, while not applying the FCA's objective to its functions. The Government also asked for any comments on amendments to specific pieces of mutuals legislation.

### Division of responsibilities

2.28 Most respondents did not comment on the division of responsibilities for mutuals legislation; however those who did supported the Government's general approach. One respondent noted that the FCA is being given the administrative functions relating to mutuals, and make the general point that it is important to ensure that the FCA is not seen as a "'soft target' to which awkward or process-driven tasks can be easily handed off".

2.29 The Government agrees. As stated in the consultation document, the division of responsibilities is simply intended to follow the general division of responsibilities under the Act,

and the provisions should not be taken to imply that the FCA has general responsibility for process-based regulatory tasks.

2.30 One respondent argued that the PRA should assume responsibility for monitoring the funding sources of a society, and that therefore sections 6A, 6B and 8 should be assigned to the PRA.

2.31 While the Government agrees that the PRA will have an interest in this issue, the FCA will have wider responsibilities for gathering data on funding sources. From a practical point of view, it is therefore more efficient to allow the FCA to undertake this role, and provide information to the PRA as necessary under the general duty to coordinate.

### Requirements to coordinate and consult

2.32 Most respondents did not comment on the division of responsibilities for mutuals legislation; however those who did comment supported the Government's general approach. One respondent argued that the PRA should not be required to consult the FCA regarding confirmation of a merger, because such decisions are taken "against exhaustive criteria" in section 95(4) of the Building Societies Act 1986 "that do not allow for the introduction of extraneous considerations or other discretions"; and similarly that the PRA should not be required to consult the FCA before requiring additional information during the course of an emergency merger, because consultation would "add no value but introduce delay".

2.33 The Government agrees that the conditions in section 95(4) are exhaustive. However, there may be limited circumstances where the FCA comes into possession of information relevant to the statutory criteria after the approval of the transfer statement. On balance, it is therefore preferable to retain the consultation requirement. The consultation requirement refers only to the PRA's assessment of the statutory criteria – it does not imply that extraneous factors may be taken into account in determining whether a merger should be approved.

### Application of the PRA's objective

2.34 In general, respondents supported or did not object to the proposal to apply the PRA's objectives to its functions. There was a range of views about the proposal not to apply the FCA's objective. Some respondents agreed with the position. Others argued that the FCA's objective should be applied, for example one respondent disagreed with the description of the registration function as 'administrative'.

2.35 The Government continues to believe that where the regulator has significant discretion about how to perform a particular function, it is advantageous to apply the objectives. On this basis, it is right to apply the PRA's objectives and not the FCA's. The PRA's functions under the legislation involve a substantial amount of discretion, and it is appropriate that when carrying out a function such as directing the merger of two building societies, the PRA should be held to account for whether its actions promote its objectives. The FCA, on the other hand, will have little or no discretion in exercising the majority of its functions, as they are mostly administrative in nature, so in the legal sense there is little to which the FCA objectives could be applied. The Government therefore intends to proceed with the proposal not to apply the FCA's objectives.

## Guidance for bodies seeking designation as super-complainants

2.36 The fact that designated consumer bodies will be able to make super-complaints to the FCA was welcomed, as was the general alignment of new the process for designating such organisations with the existing approach taken by the Department for Business, Innovation and Skills.

2.37 A range of opinions was expressed on the issue of what bodies should be able to make super-complaints. On the one hand, there was some concern that allowing organisations with a trading arm or representing small and medium sized enterprises (SMEs) to make super-complaints would allow for mis-use of the system, and allow it to be captured by commercial

interests. Other respondents argued that bodies representing the interests of SMEs should be allowed to make super-complaints, but that this needed to be balanced carefully with supporting consumer protections.

2.38 A number of respondents discussed the requirement for consumer bodies to be able to "demonstrate that they are able to deal with any competition and economic issues involved in super-complaint cases, whether through in-house experience or using external advice". This requirement received some support, but some respondents felt this might either preclude smaller organisations which would not have the resources to fulfil this criterion, or limit the type of super-complaints that would be valid to those around competition, when other problems may also give rise to consumer detriment.

2.39 Some respondents asked the Government to consider measures to reduce potential administrative burdens on bodies which applied to be designated to make super-complaints to both the FCA and Office of Fair Trading. One respondent suggested that HM Treasury should seek comments on applications from bodies to become super-complainants, when they are posted on its website.

2.40 The Government will carefully consider the responses before finalising the criteria and guidance for bodies seeking designation as super-complainants. Finalised criteria will be published in advance of the FCA coming into operation on 1 April.

## Parent undertakings Order

2.41 Respondents were supportive of the draft Order specifying the financial institutions that are subject to the powers over parent undertakings in Part 12A of FSMA (as amended by the Act).

## FSCS Order

2.42 There were few comments on the draft FSCS Order. Those respondents that did comment agreed that the Order, as drafted, would achieve the stated policy aim of dividing responsibility for compensation rulemaking between the PRA and FCA. One respondent argued that the split rulemaking arrangement was not ideal, and that the Government should ensure that the PRA seeks input from consumer groups when fulfilling its responsibilities for the FSCS.

2.43 Two respondents raised concerns about how the FSCS will be funded in future, particularly around potential cross-subsidy of the FCA retail pool by classes that the PRA will make compensation rules for.

2.44 The Government believes that the regulators are best placed to determine how the FSCS should be funded and that these considerations should not be restricted by secondary legislation. The PRA and FCA will be required to coordinate in fulfilling their roles in relation to the FSCS, including when making decisions on how it should be funded.

## Impact assessment

2.45 One respondent called for specific costings for new IT systems, and two highlighted the need for the costs of the new system to be proportionate.

2.46 Both the FCA and the PRA will be required to carry out cost benefit analysis and to consult before making changes to their rules. Future regulatory provision will be subject, therefore, to the appropriate processes for ensuring that new regulatory burdens are controlled and justified by the regulatory outcomes they are expected to generate.

2.47 The PRA and FCA will also come under the remit of the National Audit Office, which will act as a further safeguard on the regulators to take a proportionate and efficient approach.

## Other

2.48 The following issues were raised by respondents, which were not related to specific consultation questions:

- the need to ensure a smooth transition to the new regime, with regulators sharing clear guidance to firms; and
- the importance for effective coordination between the PRA and FCA, to ensure a level playing field between the FCA and dual regulated firms.

2.49 The FSA and Bank of England have published approach documents on how the PRA and FCA will carry out their roles as new regulators.

2.50 The Financial Services Act places a statutory duty on the PRA and FCA to coordinate the exercise of their functions. This will be supported by:

- a requirement for the coordination MOU 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 duty to coordinate their actions over the year.

# 3 Financial Services Bill: the Financial Policy Committee's macro-prudential tools

3.1 The Government's consultation paper *The Financial Services Bill: the Financial Policy Committee's macro-prudential tools* was published on 18 September 2012. The consultation period closed on 11 December 2012 and seventeen responses were received. Set out below are the key themes emerging from these responses and summaries of the responses to the consultation questions.

## Further information from the Financial Policy Committee

3.2 Many respondents stated the importance of the Financial Policy Committee (FPC) acting in a clear and transparent fashion. It was felt that the FPC should ensure that the rationale for its decisions is clearly explained and communicated. Some respondents also requested that the FPC provide more information about how its direction making powers would work in practice and in what situations it intends to use the tools.

3.3 The Government believes that the FPC must explain its direction making powers and decisions clearly. The Bank of England Act 1998, as amended by the Financial Services Act 2012, requires the FPC to publish explanations of its decisions to use its powers of recommendation and direction, and requires the Bank to publish a policy statement for its powers of direction. The Bank has published a draft of the policy statement on its website.

## Effectiveness of macro-prudential tools

3.4 Respondents agreed that macro-prudential regulation is necessary, but there was a variety of views as to which tools would be most effective for reducing systemic risks. Many responses suggested that there could be practical issues regarding the implementation of the proposed tools that would need to be considered to ensure that they are applied consistently across firms with differing business models or approaches to estimating risk.

3.5 The Government and the FPC will keep the performance of the Committee's tools under review. Macro-prudential policy is a relatively novel area and the FPC and the regulators will increase their knowledge as macro-prudential policies are implemented.

## International coordination

3.6 Respondents stressed the importance of international coordination to avoid placing UK firms at a competitive disadvantage, both in Europe and more widely, particularly with other bodies with macro-prudential functions. Many respondents believed that because of the complex and often international nature of macro-prudential risks unilateral action to address these risks would be less effective than a coordinated response.

3.7 The Government agrees that macro-prudential policy will be most effective when it is coordinated internationally. The Government expects that influencing macro-prudential policy in Europe and internationally will be an important element of the FPC's and the wider Bank's role.

## Resolvability

3.8 A number of responses recommended that the FPC give specific consideration as to how to improve the 'resolvability' of complex financial institutions, as being able to resolve such firms without contagion effects would have significant financial stability benefits.

3.9 The Government agrees that the resolvability of complex financial institutions is an important issue, and notes that the Financial Services (Banking Reform) Bill is designed to improve the resilience and resolvability of UK banks. The UK has committed, along with the other G20 and EU countries, to implement the FSB's Key Attributes for Effective Resolution Regimes. These require the introduction of resolution regimes for financial institutions and infrastructures – of any type, so including investment firms and financial holding companies but also potentially other types of financial institutions – which have the potential for having a systemic impact on failure.

## Application of macro-prudential tools to insurers

3.10 Respondents from the insurance sector noted that the FPC's proposed direction powers would not apply to them under the scope set out in the draft statutory instrument. These respondents believed that this was appropriate given the relatively small amount of systemic risk that the insurance sector gives rise to and that the proposed tools are geared towards banks and other credit providers.

3.11 The Government agrees that the insurance sector poses a relatively small amount of systemic risk and would require the FPC to meet the criteria set out in paragraph 4.48 of the consultation before extending the scope of the FPC's power of direction to the insurance sector.

## The Countercyclical Capital Buffer

3.12 Respondents were supportive of the FPC having responsibility for setting the rate of the Countercyclical Capital Buffer (CCB) in the UK. Respondents felt that the FPC's macro-prudential focus will mean that it would be best placed to make decisions regarding the level of the CCB.

3.13 Some respondents felt that market participants would appreciate guidance from the FPC regarding how the CCB would work and how it would be used in practice. In particular, some responses stated that the FPC should make clear what would trigger a change in the level of the CCB.

3.14 A number of respondents highlighted the importance of using the CCB in a symmetrical way. They felt that the tool would be most effective if the level of the CCB was drawn down following a turn in the cycle. Some respondents worried that the FPC may be reluctant to lower the level of the CCB in an environment characterised by risk-averse behaviour by financial firms, but that lowering the level of the CCB would be important to help maintain credit supply.

3.15 Some respondents had concerns that giving the FPC control of the CCB before 2016 would 'front run' the agreed Basel III timetable for implementation of the CCB. Many of these respondents were concerned that without international reciprocity arrangements, the CCB could be subject to leakages, creating a disadvantage for UK firms.

3.16 A small number of respondents felt that, given the current position of the UK in the credit cycle, the FPC would have little reason to raise the level of the CCB before 2016.

3.17 One respondent suggested that the FPC and the Treasury have joint responsibility for the setting the level of the CCB until 2019 when, under the Basel III timeline, the CCB and the relevant reciprocity agreements will be fully implemented.

3.18 The Government believes that the FPC is the appropriate body to be responsible for setting the rate of the CCB. The Government notes that the Bank of England has published a draft policy statement that provides more information on how the FPC intends to use the CCB and what indicators will be used by the committee to inform its decisions.

## Sectoral capital requirements

3.19 The majority of respondents supported the FPC having a direction power over sectoral capital requirements because of the more targeted nature of the tool relative to the CCB. Respondents welcomed the interim FPC's stated intention to avoid an "overly activist, fine-tuning approach", but some noted that the FPC still risked being perceived as applying an "industrial policy" via the application of sectoral capital requirements.

3.20 Many respondents stated that more information was needed on how the FPC will use sectoral capital requirements in practice. For example, some responses asked how the FPC would ensure that requirements were implemented consistently across firms using different approaches to risk weighting (i.e. betweens firms using the standardised approach from Basel and firms using their own risk modelling approach).

3.21 Respondents' views on granular sectoral capital requirements were mixed: some respondents agreed that the ability to apply granular requirements would be useful for mitigating housing market bubbles, but others were concerned by the possible unintended consequences arising from applying granular requirements. One respondent highlighted in particular that macro-prudential capital requirements on residential property would be likely to have a greater impact on mutuals as they are required by law to have a large proportion of their assets as residential loans.

3.22 There were a variety of views as to how macro-prudential sectoral capital requirements should be integrated with the existing micro-prudential framework. A small number of responses made suggestions as to how sectoral capital requirements should be applied, with some advocating the use of consultation by the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA). This call for transparency was continued by another response that suggested that the FPC publish guidance on how it intended to impose sectoral capital requirements.

3.23 One response put forward the suggestion of using Pillar II discussions between the regulators and firms to adjust the Basel II scaling factor for the identified asset class. This respondent felt that this approach was superior to adjusting risk weights directly as they felt this could create distortions.

3.24 The Government notes that the Bank of England has published a draft policy statement that provides more information about how the FPC will use sectoral capital requirements (both granular and broader requirements) and the indicators that will inform its decisions. The regulators will seek to implement directions from the FPC in an effective and proportionate manner, consulting with industry where required.

## Leverage ratio

3.25 Generally, respondents supported the use of a leverage ratio cap as a backstop measure in support of other tools, but support for a time-varying leverage ratio was limited to a small number of responses. Supportive responses highlighted the role of leverage expansion in the last financial crisis, with one response stating that a leverage ratio would be the FPC's most important tool.

3.26 Respondents stated that a leverage ratio was a relatively blunt tool and expressed concerns about how it would be applied fairly across different business models. Respondents stated that a leverage ratio would have a greater impact on firms with low-risk business models than firms

with high-risk business models. If a leverage ratio was introduced, many respondents advocated a tiered approach that would be sensitive to different business models, to compensate for this.

3.27 One response stated that leverage is a key element of credit creation, and was therefore too important to be placed in the hands of a "technocratic" committee. They advocated the Government setting a target for leverage in the system, in a similar fashion to the inflation target for the Monetary Policy Committee, which the FPC would have to meet using its other tools.

3.28 The Government's intention remains to provide the FPC with a time-varying leverage ratio, but no earlier than 2018 and subject to a review in 2017 to assess progress on international standards.

## Scope of the FPC's direction power

3.29 The majority of responses did see a case for expansion of the scope of the FPC's direction powers, but advocated the Government taking a cautious approach when considering any expansion beyond the current position. Respondents felt that the conditions set out in paragraph 4.48 for expanding the scope of the FPC's tools were sensible. Many respondents felt that the scope set out in the consultation document was an appropriate starting point for the FPC's tools.

3.30 Respondents in favour of expanding the scope of the FPC's direction powers felt that this would improve the effectiveness of the tools by helping to minimise leakages.

3.31 The representatives of the insurance sector that responded to the consultation noted that the FPC's direction powers did not extend to insurers and felt that this was appropriate as the tools outlined in the consultation document were more suited to the banking sector. They argued that FPC and the Government would need to give careful consideration as to what tools could be applied to insurers before expanding the FPC's toolkit in this direction. Some respondents from this sector stated that the FPC would benefit from a member of the committee having insurance experience and expertise, especially if the Committee was to seek to expand its toolkit to insurers.

3.32 Respondents were broadly divided between two points of view on the exemption for small investment firms: that small investment firms should not be exempted as small firms can create systemic risks if unsustainable behaviour is exhibited by a large number of firms; and that Limited Licence Investment Firms (LLIFs) should be exempted as their activities are not systemically important.

3.33 Those respondents that did put forward a definition either suggested an exemption based on number of employees, coupled with a balance sheet size condition, or that LLIFs alone should be exempted.

3.34 The Government believes that the scope of the FPC's direction power as set out in the consultation is an appropriate starting point for the FPC, but remains open to the possibility of expanding this scope in future. Before the Government would consider expanding the scope of the direction power, the FPC would need to provide evidence that:

- there are potential risks in those sectors that need to be addressed;
- the tools would work effectively in those sectors; and
- the tools would not create material unintended consequences or costs in excess of the benefits that the tools would be expected to deliver if implemented in those sectors.

3.35 The Government has decided to exclude investment firms that are not regulated by the PRA from the FPC's SCR power. This will capture the systemically important firms while ensuring that

smaller firms are not subject to disproportionate requirements. The CRR/D4 will provide for small investment firms to be excluded from CCB requirement, although this legislation is not yet final.

## Procedural requirements

3.36 The majority of responses recognised that there could be situations in which it would be desirable to forgo procedural requirements in order to secure a rapid implementation of a measure, but that this would only be acceptable in extraordinary circumstances and that post hoc accountability mechanisms should be in place. Respondents were almost unanimous in their desire for procedural requirements to always apply in normal circumstances. It was felt that the procedural requirements would help reduce regulatory uncertainty and that engagement with the industry would help ensure that the tools were applied effectively.

3.37 The Government agrees that procedural requirements should be followed where possible, given the novel nature of the FPC's direction powers. The Government notes that the FPC will be required to produce explanations and Cost Benefit Analysis (CBA) for its decisions. In the light of these accountability mechanisms, the Government intends to remove the requirement for the regulators to also produce a CBA when adjusting the level of sectoral capital requirements up or down. However, the requirement to consult and respond to representations will still apply.

## Other macro-prudential tools

3.38 Many respondents refrained from offering a definitive view on a liquidity requirements tool, stating that it is difficult to come to a conclusion when international standards are not in place. Those that did offer an opinion were generally supportive of the FPC having a liquidity requirements tool once international standards are in place. Those that supported the FPC having this tool cited the importance of liquidity in the last crisis and to the general health and viability of firms. Those that did not support the FPC having this tool argued that liquidity was best determined at the micro-prudential level

3.39 Respondents were also reticent to offer a firm opinion on margining requirements in the absence of international standards in this area. Respondents highlighted that requirements imposed by the FPC could be difficult to apply and easy to avoid, and that coordinated action would be necessary to ensure that this tool would be effective.

3.40 Some respondents felt that this tool would be unnecessary or inappropriate. One response felt that the creation and increased use of central counterparties and the proposed international standards in this area would be sufficient to mitigate any risks from margining practices. Some responses felt that margining requirements should reflect the risk of individual transactions and that market participants would be best placed to judge this.

3.41 Respondents' views on maximum loan to value/loan to income (LTV/LTI) ratios were mixed. The majority of responses were finely balanced, acknowledging that LTV/LTI caps could have financial stability benefits, but also noting that this would be a blunt tool that could prevent credit worthy borrowers from accessing credit.

3.42 Respondents noted that an LTV/LTI cap would be easy to implement and would have clear signally effects, but that restrictions could drive high LTV/LTI lending into the shadow banking sector.

3.43 A small number of responses advocated the FPC having a direction power to set maximum LTV/LTI ratios, arguing that this would provide the FPC with a more balanced toolkit.

3.44 The Government thanks respondents for their views on these potential tools. The Government will consider these tools further if and when the FPC recommends they should be added to the measures that fall under its power of direction.

## Disclosure recommendations

3.45 The majority of respondents felt that the FPC's recommendation power would be sufficient to implement disclosure policies and that the FPC should not be given a direction power in this area. These responses highlighted the need for the FPC to consider the burden it will place on the industry when asking firms to disclose information.

3.46 The Government is minded to agree with respondents that the FPC's recommendation power will be sufficient to implement disclosure policies.

## The draft statutory instrument

3.47 Very few respondents had comments on the draft statutory instrument included in the consultation document. It was felt by one respondent that the statutory instrument should include references to "reduced own funds" and "reduced level of risk" in order to allow the FPC to lower capital requirements.

3.48 The Government believes that the references to "reduced own funds" and "reduced level of risk" are not necessary in order for the FPC to reduce or reverse requirements it imposes.

# 4 Implementing the Wheatley Review: draft secondary legislation

4.1 In September 2012, the final report of the Wheatley Review of LIBOR[1] made recommendations to Government and market participants to reform the London Inter-Bank Offered Rate (LIBOR). Subsequently, the Government included provisions in the Financial Services Act 2012 to allow the regulation of activities relating to benchmarks, as well as the creation of a criminal offence related to the manipulation of benchmarks. In turn, the Government published a consultation paper – *Implementing the Wheatley Review: draft secondary legislation* – which sought views from the public on two draft Statutory Instruments (Sis), which implement these recommendations. Specifically:

- the first draft SI – which amends the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (the "RAO") – specified that the activities of providing information to, and the administering of, a specified benchmark were regulated activities. Initially, the benchmark specified will be LIBOR; and
- the second draft SI – the new "Misleading Statements and Impressions" Order – specified the relevant activities, investments and benchmarks, for the purpose of criminal offences in Part 7 of the Financial Services Act 2012 (2the ACT2). Initially, the only benchmark to come within scope will be LIBOR.

4.2 The consultation paper also sought views on the extension of the regulation of benchmark activities, and the list of benchmarks for which the criminal offence applies, beyond LIBOR as the initial benchmark; for example to include benchmarks relating to energy or commodity markets.

4.3 In preparing these Orders, the Treasury also benefitted from the consultation conducted by the Wheatley Review, which began in August 2012. Indeed, a number of responses to the Treasury consultation stated that they had no further comments to those provided in response to the Wheatley Review.

4.4 By the deadline, HM Treasury received 14 responses to this consultation from trade associations, banks, regulated investment exchanges, energy firms, financial index providers and commodity price reporting agencies.

## Impact assessment

4.5 There was a difference of views on the impact assessment provided by HM Treasury: some respondents believed the costs to LIBOR contributing firms and the administrator appeared to be high and primarily one-off; others suggested that the costs were too low.

[1] www.hm-treasury.gov.uk/wheatley_review.htm

## Amendments to the Regulated Activities Order

4.6 The Order amends the RAO to specify that the activities of providing information to, and the administering of, a specified benchmark were regulated activities. The specified benchmark is LIBOR.

### Definitions of the activities

4.7 Respondents made comments relating to the drafting of the activities to become regulated. In particular, respondents queried whether the activity "administering the arrangements for determining a specified benchmark" sufficiently covered the governance aspects of administering a benchmark as well as operational aspects, as envisioned by the Wheatley Review.

4.8 The Government believes that the activity as outlined captures all aspects intended to be caught by the Wheatley Review – both operational and governance aspects. Indeed, the FSA have interpreted the activity as covering both operational and governance aspects and have published a consultation on draft rules accordingly.[2]

4.9 One response noted that users of benchmarks should not be subject to the same rules and requirements as benchmark administrators and submitters.

4.10 The Government notes that there are no such obligations contained in these Orders.

4.11 The draft Order also extended the definition of 'consumer', as defined in FSMA, to allow the FSA's consumer protection objective to include consumers whose "rights, interests or obligations are affected by the level of a regulated benchmark". Two responses were concerned that this definition appeared broad.

4.12 The Government is confident that this definition is appropriate and consistent with the existing definitions of consumer contained in FSMA, as amended by the Financial Services Act 2012.

### Exclusion provisions

4.13 Respondents also made comments on the two exclusion provisions in the draft Order. Two respondents noted that their interpretation of the exclusion for providing information based solely on factual information was that benchmarks based solely on transaction-data would not be captured by the regulation. It was queried whether this exclusion should extend to benchmark administrators who collect transaction-data for the purpose of the determination of a benchmark.

4.14 The Government notes that these exclusions do not affect which benchmarks are able to be regulated as the definition of benchmark, as outlined in FSMA as amended by the Financial Services Act 2012, is not affected. Moreover, in principle, the Government would not necessarily want to exclude administrators of benchmarks compiled by transaction-data.

4.15 Respondents also noted the link between the two activities – i.e. that the activity of providing information requires that the information be provided to a person who has permission to administer a specified benchmark – and consequently queried the provision that excludes the FCA from being considered as carrying on the regulated activity if it administers the benchmark. Respondents pointed out that under such a scenario, the link between the activities is broken.

4.16 The Government agrees with this point and has amended the exclusion provision in the Order to confirm that a person still carries on the regulated activity of providing information to a specified benchmark even if the FCA administers the benchmark.

[2] www.fsa.gov.uk/static/pubs/cp/cp12-36.pdf

### Definition of regulated benchmark

4.17 Some respondents questioned whether the definition of the regulated benchmark – i.e. LIBOR – should be more explicit: for example, to include all the LIBOR currencies and maturities, or to explicitly state that LIBOR can be administered by anybody. One respondent suggested that the definition could be expanded to include the definitions widely used in commercial contracts (i.e. the rate published on the Reuters screen).

4.18 The definition as drafted allows for the full suite of published currencies and maturities as well as different administrative bodies. The Government believe that legislation need not reflect contractual definitions. Commercial contracts are subject to a very different drafting style and approach when compared to legislation. In addition, there is no consistency in the definitions used in commercial contracts in this area. The use of any particular definition could lead to uncertainty about which rate is captured.

### Transitional provisions

4.19 The Order provides that contributing banks will be deemed to have a Part 4A permission to carry on the activity of providing information to LIBOR upon the commencement of the Order. Respondents either welcomed or did not comment on the proposed approach to transition for the LIBOR contributing banks.

4.20 However, two respondents cautioned of the costs arising from the transition of the administrator of LIBOR, given that the expected timeline for the process to seek a successor body extends beyond the commencement of these Orders. In this scenario, the incumbents and the successor body would face duplicated costs. It was suggested by two respondents that the commencement of the activity of administering a benchmark be delayed until the successor administrator is able to carry out the activity.

4.21 The Government believes that it is not appropriate to delay the commencement of the amendment to the RAO and that it is right for the incumbent administrators to become authorised to carry on those activities without the need to apply for authorisation. Any staggered commencement would mean that only contributing banks would be regulated, while the administrator is not, which we do not believe is appropriate. This would also be problematic for the link between the two regulated activities in the Order.

4.22 However, the Government notes the concerns of respondents and has revised the transitional provisions, to facilitate a smoother transition for both the incumbent and future administrators. The provisions are now drafted as follows: the incumbent administrators are deemed to have a Part 4A permission, called an "interim permission", upon the commencement of the Order. This interim permission then continues until a successor LIBOR administrator has had an application for the relevant authorisation granted by the FCA.

## Misleading statements and Impressions Order

4.23 This Order specifies the relevant activities, investments and benchmarks, for the purposes of criminal offences in Part 7 of the Act. Initially, the benchmark to come within scope will be LIBOR. The agreement and investments specified replicate those contained in the Financial Services and Markets Act 2000 (Misleading Statements and Practices) Order 2001 which was made under section 397 of FSMA which is repealed by the Act.

4.24 Respondents made no particular comments relating to the content of the proposed "misleading statements" Order. However, some relevant comments relate to the definition of LIBOR, as discussed in relation to the Regulated Activities, above.

4.25 The section below contains further discussion on this topic.

## Other benchmarks

4.26 Chapter 4 of the consultation document sought views on the extension of the regulation of benchmark activities and the list of benchmarks for which the criminal offence applies, beyond LIBOR as the initial benchmark; for example to include benchmarks relating to energy or commodity markets.

4.27 Of those that made comment, all respondents cautioned against the immediate extension of the scope of regulation and the criminal offence beyond LIBOR. Most argued that it was vital for an international consensus and framework to be developed under the auspices of the International Organisation for Securities Commissions (IOSCO), the Financial Stability Board (FSB) and the European Commission. A typical response provided was that "international co-ordination on any future extensions of scope is vital, given the international nature of financial services; particularly the work on-going by the EU, IOSCO and the FSB".

4.28 Some cautioned of the large diversity and variety of benchmarks – both in content and methodologically – that are compiled across the financial services industry. Consequently, there were calls for a specific taxonomy to be created at an international level to help define the categories of benchmarks which ought to be captured by regulation; in particular, an agreed definition of "systemic" benchmarks would be welcome.

4.29 One respondent also suggested that, given that benchmark oversight is a novel area of regulation, any extension to that oversight should follow once the regulatory authorities have better experience of regulating benchmarks.

4.30 Three respondents also noted that there was a range of non-regulatory options that could be explored before official regulation was considered: including, effective competition between benchmark providers – which allows users to review the suitability of a particular benchmark – as well as self-regulatory initiatives such as industry-led Codes of Conduct. Moreover, two commodity price reporting agencies outlined that IOSCO had recently published a set of general principles for price reporting agencies designed to enhance the integrity and credibility of commodity benchmarks, which the G20 had welcomed in a communiqué.

4.31 A small number of respondents suggested that the offence of making false or misleading statements or impressions to specified benchmarks should be extended to benchmarks beyond LIBOR. However, those respondents also urged for an internationally-consistent and robust method of determining which benchmarks should be brought within scope. It was suggested that sanctions should extend to all benchmarks, but also noted that this issue was being taken forward in the European Commission's Market Abuse Regulation (MAR) and the Criminal Sanctions-Market Abuse Directive (CS-MAD).

4.32 Specifically regarding benchmarks in the energy market, a respondent noted that the European Union Regulation for Wholesale Energy Market Integrity and Transparency (REMIT), coordinated by the Agency for the Cooperation of Energy Regulators (ACER), would create a comprehensive framework for the monitoring of wholesale energy markets in the EU and prohibiting market abuse.

4.33 Implementation of the recommendation of the Wheatley Review to bring LIBOR within the scope of statutory regulation is a priority for the Government. Therefore, at this stage, the Government has only specified LIBOR in these Orders. In the meantime, the Government and the Financial Services Authority are actively engaging in the relevant international fora and considers that international consensus does not support the specification of additional benchmarks at present. IOSCO have recently published a consultation seeking views on, among other things,

the appropriate scope of regulation for benchmarks. However, further benchmarks can be brought within the scope of regulation relatively quickly by way of an Order from the Treasury, if it became clear that to do so would bridge a gap in regulatory or enforcement powers.

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This document can be found in full on our website: http://www.hm-treasury.gov.uk

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