

28 June 2010

With much fanfare, George Osborne announced the abolition of the Financial Services Authority ("FSA") in his maiden Mansion House speech as on 16 June 2010. In doing so, the new UK Coalition Government's Chancellor set out his 2012 vision for reforming the institutional framework for financial regulation in the UK. The "twin peaks" model of regulation is the name of the game. If the experience of implementing his last but one predecessor's vision of an unitary regulator is any guide, it will be a truly Olympian achievement with gold medals deserved by all concerned for its unwinding to have been implemented by the end of 2012. This ambitious implementation timetable also presupposes that no international or European regulatory developments will knock it off course. What is guaranteed is a period of uncertainty for every individual and institution involved in the UK's financial services industry whilst the scope of the new regulatory authorities and the detail of how they will work together in practice is resolved.

### The "macro" level

Central to the new Chancellor's thinking is that only independent central banks have the broad macro economic understanding, authority and knowledge required to make macro-prudential decisions in relation to the financial soundness and stability of the financial systems of their countries. To do so, these central banks must also be familiar with every aspect of the institutions that participate in those financial systems and which they may also have to support financially as lenders of last resort.

The Bank of England ('the **BoE**') is the outright winner in these reforms of the regulation of the UK's financial system. The BoE will assume control of macro-regulation and oversight of micro-prudential regulation in the UK. The much criticised tripartite regime of the BoE, HM Treasury and the FSA sharing responsibilities for the oversight of the UK's financial system is to be abolished. The FSA will also cease to exist in its current form. In the next financial crisis, it will be clear which institution was in charge of systemic risk. The BoE will have exclusive responsibility to watch for asset bubbles and other systemic threats and to take action to defuse them.

### Prudential regulation

A new prudential regulator (whose working title is the Prudential Regulatory Authority ('**PRA**')) is to be created as a subsidiary of the BoE to carry on the micro-prudential regulation of the UK's financial 2 institutions including banks, investment banks, building societies and insurance companies. Its Chief Executive will also be a deputy governor of the BoE. Hector Sants has agreed to stay on as the Chief Executive of the FSA to oversee the transition of its prudential regulatory responsibilities to the PRA which he will then head.

Mervyn King, the Governor of the BoE said in his reply to the Chancellor's Mansion House speech that prudential regulation would reflect "two different but complementary perspectives: a bottom-up perspective, focused on setting institution-specific capital requirements, and an overall perspective with a set of system-wide capital requirements that may vary over the economic cycle".

However, with no international or EU consensus currently in place for the type or role of prudential tools, any UK approach could be overtaken by the work being done by the Basel Committee or the European Commission's proposals for a more harmonised 'single EU rulebook' for regulatory capital.

### Conduct of business regulation

The concept of a single unitary regulator of the UK's financial services industry is to be ripped up with a definitive

move to the "twin peaks" model of regulation used in countries such as Australia and the Netherlands with separate regulatory authorities for prudential and conduct of business regulation.

A new Consumer Protection and Markets Authority (**'CPMA'**) is to be created to regulate the conduct of business of every authorised financial firm providing services to clients.

This brings with it the potential for conflict with Europe where the functions of the proposed European Supervisory Authorities are to be divided by industry sector (banking, insurance and securities), not by regulatory function. Furthermore, the separation of regulatory functions will require the potential for conflicts in cross over areas such as authorisation to be identified and resolved.

Nevertheless it was the Governor of the BoE's view that: "putting prudential regulation into the same organisation as the oversight of consumer protection and market conduct didn't work in practice. The two types of regulation require different skills and a different approach. Separating them - the so-called "twin peaks" model of financial regulation - is the right direction of reform".

### **Consolidation of the prosecution of white collar crime**

A new Economic Crime Agency (**'ECA'**) is also to be created to consolidate the work of tackling serious economic crime that is currently dispersed across several Government departments and agencies. This appears to envisage the abolition of the Serious Fraud Office (**'SFO'**). It also raises perplexing questions about the division and transition of the existing powers of the FSA's Enforcement and Financial Crime Division (which was only consolidated last October) into the CPMA and the ECA as well as the ultimate destination of the Office of Fair Trading (**'OFT'**)'s current enforcement and prosecution powers. Whilst it is likely to result in the criminal prosecution powers of the SFO, the FSA, the OFT, the Fraud Prosecution Service and the Crown Prosecution Service Revenue and Customs Division being consolidated in this new agency, what will happen to the enforcement of parallel civil offences such as market abuse remains to be seen.

### **Timetable**

Having announced the bare bones of the new regulatory structure, the Chancellor left it to Mark Hoban, the Financial Secretary to set out the timetable and process for the transition to the new regime in his statement to the House of Commons the next day (17 June 2010).

He set out the first task to be creating the Financial Policy Committee (**'FPC'**) in the Bank of England. The FPC is to be responsible for looking across the UK's economy at the macroeconomic and financial issues that may threaten financial stability and to address the risks it identifies. It will be empowered to require the new PRA to implement its decisions by taking regulatory action with respect to all firms. As the Governor of the BoE has commented the evening before, the FPC's role is "to turn down the music when the dancing gets a little wild".

An interim FPC is to be set up by this autumn in advance of legislation. Ultimately its membership will consist of the Governor of the BoE as its Chairman with its members including the Deputy Governors for monetary policy and financial stability, the Chief Executive of the new PRA, the Chair of the new CPMA as well as external members and a Treasury representative.

Secondly, legislation will be required to create the new PRA as a subsidiary of the BoE. The PRA will also be chaired by the Governor of the BoE with Hector Sants as the new Deputy Governor for Prudential Regulation as its Chief Executive. Paul Tucker as the Deputy Governor for financial stability will also sit on the Board of the PRA.

Thirdly, the new CPMA will take on the FSA's responsibility for consumer protection and conduct of business regulation of retail and wholesale firms. The Financial Secretary has said the CPMA is to take "a tougher and more proactive approach to regulating conduct" with the primary objective of promoting

confidence in financial services and markets. This provides encouragement for the advocates of the FSA's policy of more intensive and intrusive supervision, though there is uncertainty about whether the scope of the CPMA will allow it to pursue a line of questioning about the business plan of a financial institution that includes its regulatory capital requirements. It also begs the question which Authority will be making which judgements about which judgements of the Board of that financial institution.

The CPMA will also assume the FSA's existing responsibility for the Financial Ombudsman Service (**'FOS'**) and oversee the newly created Consumer Financial Education Body (**'CFEB'**). The CPMA will also have responsibility for the Financial Services Compensation Scheme (**'FSCS'**) but given the important role the FSCS plays in financial crises, it is expected to work closely with the FPC and the PRA.

Before these new bodies including the ECA are set up in their permanent form, the Coalition Government intends to carry out a full and comprehensive consultation process with a detailed policy document to be published before the summer recess at the end of July.

### **The personal dimension**

At the time of going to press, there were little more substantive policy statements than the Chancellor's Mansion House speech and the Financial Secretary's House of Commons statement though there has been much speculation and commentary on what these reforms might mean. Whilst the structures might change, the staff who carry on the essential functions within those structures are likely to stay the same at least for the immediate future. It was a coup for the Chancellor to talk Hector Sants out of his pre-Election resignation announcement to oversee the transition at least of the prudential regulatory functions of the FSA to the PRA. At the FSA Enforcement Conference on 22 June 2010, he and the Margaret Cole were adamant that the FSA's more overtly aggressive enforcement policy against individuals and firms of credible deterrence must survive the transition to the new structures. However Ms Cole and her fellow senior Enforcement staff were evidently concerned that what they see as the strong momentum they have developed in their actions against firms and their senior management could be dissipated rather than maintained and enhanced by these reforms. The transitional arrangement for the enforcement activities of the FSA is probably the major unresolved issue of the new structures. Its resolution and the detail of the new authorisation and approval functions are likely to have the most impact on the individuals that work in the UK's financial services industry.