

UK Regulatory Restructuring and the Financial Services Bill

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**The Senate Room, Senate House,
University of London**

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Financial Services Bill

- Failure of Tripartite System (Bank, Treasury & FSA)
 - Failed to coordinate adequately in crisis, and ineffective pre-crisis
- Macro-prudential supervision
 - Micro-prudential supervision not adequately monitor and control systemic risks
- Twin peaks model of supervision - more focused
 - Prudential Regulatory Authority – safety and soundness
 - Financial Conduct Authority – protect consumers & investors, and trading infrastructure

Judgement-led supervision (forward-looking); not legalistic and backward-looking

Does Regulatory Structure Matter?

- No regulatory structure can guarantee against bank crises
- However, legislation should make provision for handling crises and resolving bank/investment firm failures
- But FSA was institutionally dominated by a conduct of business ethos, causing it to lose focus on prudential and financial stability issues
 - Europe: 3 European Supervisory Authorities & ESRB
 - Australia: Twin Peaks (APRA & securities regulator)
 - Canada: Central bank, bank supervisor, provincial securities regulators
 - USA: Fed, Financial Oversight Council and multiple regulators
 - Switzerland: FINMA and Swiss National Bank
 - Other single regulators: Germany/BaFin, Sweden, Japan, & South Korea

Successful regulation and supervision depends on

- **Culture**

- Rigorous challenge of bank risk models and governance
- Require banks/firms to explain why business models are safe before approved

- **Focus**

- Pro-active oversight of whole financial system
- Forward looking assessment of potential risks (not backward looking legalistic rules)
- Firms should address conflicts of interest and consumers' need for timely, accurate and intelligible information

- **Philosophy**

- **Macro-prudential systemic risks and controlling externalities**
- **Firms should act honestly, fairly and professionally in best interest of customers**
- **Exercise of supervisory judgement based on discretionary powers**

Legislation can influence culture, focus and philosophy

- Setting clear objectives
- Effectively allocates powers and responsibilities
- Establishes appropriate system of accountability of regulatory bodies to the Treasury and Parliament

The Financial Services Bill

- **Parliament** sets the legislative framework and holds the Government to account (for the regulatory framework) and holds the regulatory bodies to account (for performance of their functions) (important role of Treasury Select Committee)
- **The Chancellor of the Exchequer and the Treasury** are responsible for the regulatory framework and for all decisions involving public funds
- **Statutory Objectives:** Financial Stability plus the previous objectives under the Financial Services and Markets Act

UK 'Twin Peaks' Approach

- **Bank of England** - protecting and enhancing the stability of the UK financial system, working with other bodies (BoE, PRA, FCA & Treasury), special resolution regime; clearing & settlement; payment system
- **Financial Policy Committee (FPC) – macro-prudential oversight.** Identifying and monitoring systemic risks and taking action to remove or reduce them (including through directions and recommendations to the PRA and FCA) and devising macro-prudential tools
- **Prudential Regulatory Authority (PRA) (a 'subsidiary' of the Bank)** - prudentially regulating banks, insurers and complex investment firms; objective of safety and soundness of individual firms
- **Financial Conduct Authority (FCA)** - protecting and enhancing confidence in financial services and markets, including by protecting consumers and promoting competition; can use financial product banning orders; regulates exchanges/MTFs and consumer credit
- ***Treasury has adopted new MOU***

FPC - economic & political impact

- Authority of the FPC to adopt macro-prudential indicators and measures/controls (counter-cyclical capital, LTV, LTI ratios)
- FPC decision to take macro-prudential measures will infringe considerably on Government economic policy and have direct political impact
- Joint Committee proposed that Treasury have final say in deciding the FPC's remit.
- Treasury rejected this by allowing FPC to disagree with Treasury so long as it explains why

Judgment led supervisory model

‘Central to this supervisory model is the presumption that regulators cannot rely on the judgment of the firms they supervise, and must take their own view formed from their own analysis about significant issues which affect the safety and soundness of the firm. . . . Furthermore, where that judgment differs from the firm’s management, the regulator must act.’

Hector Sants, CEO of the UK Financial Services Authority

19 May 2011

Legal risks of discretionary supervision

- Judgmental led supervision – less reliance on legalistic rules and more supervisory discretion – ‘if a bank appears to the supervisor to be too complex, the supervisor should be able to make it become simpler’ not constrained by legal/regulatory rules
 - ❑ Legality,
 - ❑ Due process, and
 - ❑ Proportionality
- Do supervisory assessments and decisions for a firm to take action need to be grounded in existing conditions for authorisation?
- New sec 22A provides PRA power of prudential regulation cl 6

The FCA and competition

- Operational objectives: ‘promoting competition, efficiency and choice for the benefit of consumers’
- FSA proposed ‘promote effective competition for the benefit of consumers’
- FCA may make reference to OFT
- FCA-designated consumer groups can file ‘super complaints’
- Transfer consumer credit regulation from OFT to FCA

Accountability and governance

BoE/FPC

- FPC (11 members – 6 internal, 5 external, chaired by Governor). Committee of ‘Court’ (procedural oversight). MPC is committee of the Bank – also chaired by Governor
- FPC decides macro-prudential indicators and lays measures before Parliament as secondary legislation (affirmative procedure)
- Coordinating FPC with MPC. Enough to have Governor as chairman? Will the objectives/policies conflict? Inflation target v. Asset bubble. How to resolve it – a single committee?
- Governor’s term changed to 1 8-year term (TSC proposal)
- Enhanced role of ‘Court’, rejects notion of Board of Banking Supervision

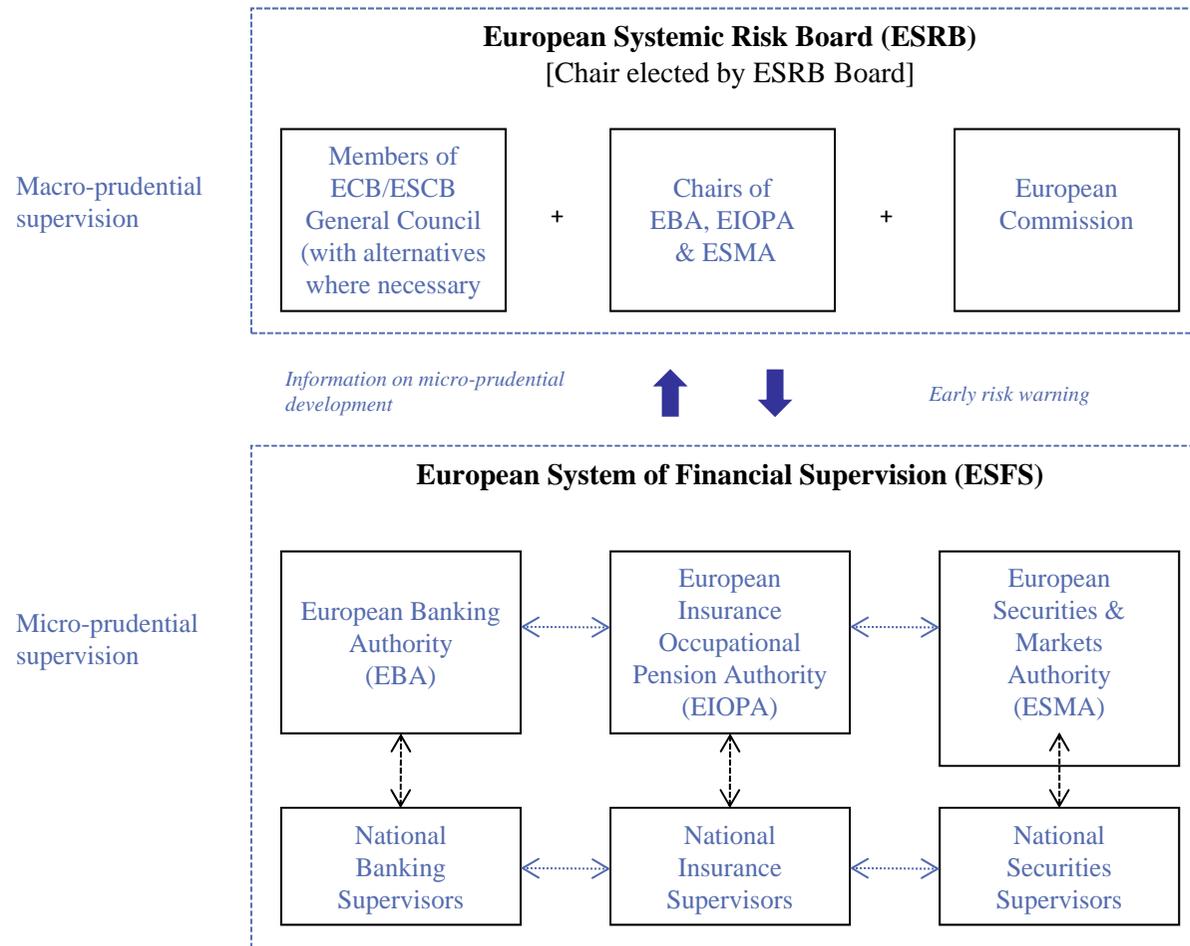
Accountability of PRA & FCA

- Single complaints commissioner
- Insurance industry: rejected proposal to have at least 1 person on PRA Board with insurance expertise
- Upper Tribunal scope of review – no more *de novo* review. In certain cases, refer contested decisions back to the regulators, rather than substituting its own opinion
- PRA & FCA required to submit a report to Treasury if a significant regulatory failure occurs.
- Joint Committee recommended that sec. 348 FSMA amended to allow regulator to disclose information – under Treasury review
- PRA has a duty to publish consultation arrangements and report annually on its consultation activities. In contrast, FCA has practitioner panels

Independent Commission on Banking

- Government committed to primary and secondary legislation for ring-fence by end of this Parliament (May 2015)
- Note: Mervyn King's evidence that Parliament should define in legislation the ring-fence; not FPC/PRA.
- Government proposes to define ring-fence in primary & secondary legislation. Joint Cmt recommended against primary legislation
- Government agrees with ICB timetable that regulatory capital (non ring-fence) requirements be completed by early 2019, in line with Basel III

Challenge of EU financial supervision



European regulatory challenge

Problems with Europe

How will UK regulatory institutions interacting with European Supervisory Authorities

Capital Requirements Directive IV – Maximum harmonisation of capital requirements and Solvency II. But Commission has agreed to higher capital under ICB proposals

Do ESAs' regulatory and technical implementation standards constrain UK macro-prudential regulatory discretion – UK wants top-down discretion, while EBA/Commission favours bottom-up approach

Conclusion

- Pre-crisis UK regulatory framework failed to assess and control systemic risk and too deferential to bank risk management and governance
- UK institutional structure not really the cause of the crisis – but the culture, focus and philosophy of regulation was the problem
- New ‘Twin Peaks’ institutional structure and macro-prudential regulation – and role of judgment led supervision
- Accountability and governance of Bank/FPC/PRA? And coordination with MPC?
- Coordination with European Supervisory Authorities and implementation of EU financial legislation