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UK Government Proposals for Financial Regulatory Reform

The new UK coalition government has announced its plans for reforming the UK banking and wider financial regulatory system, including proposals to enhance the role of the Bank of England, to merge the agencies responsible for tackling economic crime and to introduce a banking levy.

The UK general election on 6 May 2010 resulted in an historic coalition government of the Conservative and Liberal Democrat parties. This has brought together members of two political parties that had previously held, and campaigned on the basis of, different policies on matters relating to financial regulation. On 20 May 2010 the new Government published its five-year policy paper, *The Coalition: our programme for government*, which outlined proposals (among other things) to reform what it calls the "broken banking system", in order to "build a new economy from the rubble of the old". The Queen's Speech on 25 May 2010 also highlighted certain aspects of the Government's economic and financial regulatory reform package.

The new Government considers that reforms are needed to promote responsible and sustainable banking, give greater powers to regulators to curb unsustainable lending practices, encourage competition in the banking sector, protect taxpayers from financial malpractice and help the public manage their own debts. It has been reported that some of these reforms will be placed before Parliament in a draft bill after the summer recess.

This client publication discusses the main proposals announced by the Government and considers further steps that could be taken to achieve intelligent reform.

Bank of England as Regulator

The Government has proposed that the Bank of England would be given control of macro-prudential regulation and oversight of micro-prudential regulation. This proposal addresses a perceived gap in supervision under the current regime: broadly speaking, the Bank of England currently has oversight of monetary and financial stability, and the Financial Services Authority (the "**FSA**") undertakes prudential and conduct of business regulation. Systemic risks to the financial sector as a whole did not explicitly come within the purview of either institution.

Proposals to move more FSA functions to the Bank of England, which the Conservatives had published in their election manifesto, appear to have been abandoned or postponed. However, it would appear that the Bank is to have a supervisory role over the FSA for micro-prudential regulation. This would appear sensible, although the details have yet to be revealed and implementation will be key.

As a general matter, our view is that now is not the time to do away with the FSA. The FSA was set up following the Barings Bank scandal in the 1990s, due to concerns over the quality of prudential supervision by the Bank of England and in order to consolidate various different regulators of different financial sectors. The hiving off of the Bank's regulatory functions to this new, more independent, body was regarded as a move that would enhance the supervision of the UK banking and financial sector. It would be an upheaval to transfer functions back to the Bank at this juncture, and for the Bank to assume a role in relation to parts of the market it has never before supervised, such as investment firms. A further re-designation of personnel to different institutions would be a major distraction when there are so many key proposals emanating from Europe with which the UK needs to engage. Any implication that the FSA is somehow lame is unhelpful in the context of these ongoing European discussions. The UK needs all of its officials to have maximum clout.

A key reason for the failure of the tripartite system of financial oversight in 2007 (contributing to the collapse of Northern Rock) was a failure by the relevant bodies to properly identify and monitor risks to the financial system as a whole. The Bank of England's focus on meeting the inflation target distracted it from monitoring other important variables that affect financial stability. The Bank is now to be given responsibility for systemic oversight. It is therefore desirable to give the Bank of England an additional oversight role in relation to the linked subject of prudential regulation.

Under EU legislation currently being discussed in Brussels, there may in the foreseeable future, be a new financial regulatory framework that aims to strengthen prudential supervision across the EU. Macro-prudential supervision would be the responsibility of a new European Systemic Risk Board that would, with the assistance of the European Central Bank, be tasked with giving early warning of any growing systemic risks and, where necessary, recommending action to deal with such risks. Micro-prudential supervision would be carried out by the European System of Financial Supervisors, made up of national supervisors, and by three European Supervisory Authorities for the banking, securities and insurance and occupational pensions sectors. In order for the new EU supervisory framework to work properly, the responsibilities of the Bank of England and the FSA would need to correspond with those of the new EU institutions and their counterparts in other member states. The precise roles of these new EU bodies will be key to the UK and the financial markets generally. As a general proposition we believe that financial regulation should be formulated and conducted in the location of the markets and in the language of the markets. Any detachment from the markets, in terms of location or language, inevitably heightens the risk of disjointed regulation.

Single Authority to Tackle Economic Crime

It is proposed that a single agency will tackle serious economic crime. Such work is currently done by three agencies: the FSA, the Serious Fraud Office and the Office of Fair Trading. These functions would be merged.

This development is to be welcomed in simplifying administration and increasing consistency in this area. It should also reduce government expenditure.

The Government should consider other possible similar efficiencies in financial regulation. For example, the Office of Fair Trading's role as a consumer lending regulator looks increasingly anachronistic and would be better transferred to the FSA.

Banking Levy

The Government aims to introduce a banking levy, including seeking international agreement on the implementation of the levy. Various forms of levy are under discussion. Some are compensatory (for recent events) and may have a moral logic to them, although one should not forget that many governments have made (or may well make) profits from the near compulsory acquisition of stakes in stricken financial institutions. Others are prospective and revenue-raising which are more questionable as a conceptual matter. The European Commission recently proposed the establishment of *ex ante* national resolution funds, funded by a levy on banks, to facilitate the resolution of failing banks.

A burden of higher taxes on the financial sector may well deter entry by investors into the sector, and thus run counter to the Government's twin goals of ensuring the flow of credit to the economy and encouraging greater competition in banking.

Bonuses

The Government means to present proposals that will tackle unacceptable bonuses in the financial services sector, ensuring the reduction of risk.

Under the Financial Services Act 2010, HM Treasury has already been given powers to make regulations requiring the preparation by banks and investment firms of executive remuneration reports. The Act also mandates the FSA to make rules requiring banks and investment firms to prepare and act in accordance with remuneration policies that are consistent with the effective management of risk and the Financial Stability Board's Implementation Standards.[1] Such FSA rules may prohibit remuneration in a specified way and make void any part of an agreement which contravenes the prohibition. The FSA had already made rules requiring bonus policies to be consistent with prudent risk management, including guidance on long-term locking-up of bonuses (as opposed to cash payments), prior to these formal powers being introduced. The FSA has stated that it intends to consult further on remuneration before the end of June 2010 in light of its new statutory powers and obligations.

Free National Financial Advice Service

The Government wants to create a free national financial advice service, funded in full from a new social responsibility levy on the financial services sector. The Government has not yet said how it intends to ensure that the cost of this service does not ultimately end up with taxpayers.

Separation of Retail & Investment Banking

The Government proposes establishing an independent commission to investigate how retail and investment banking can viably be separated. The commission would be tasked with reporting on its findings within one year.

The Conservatives and (particularly) the Liberal Democrats had previously proposed a return to Glass-Steagall separation of retail vs. investment banking. However, this commitment seems to have been watered down, probably reflecting the political reality that international coordination would be necessary in this area of regulation and the need to follow the lead of the US and other international developments on this issue.

Other Proposals

There are proposals to "encourage diversity in financial services", promote mutuals (e.g., building societies – essentially, banks owned by depositors) and create a more competitive banking industry.

The government intends to develop proposals to ensure the flow of credit to viable SMEs, including a loan guarantee scheme and net lending targets for the nationalised banks.

These commitments are somewhat vague and may not result in any legislation. It is difficult to see how the financial sector can deliver the flows of credit that are necessary for the economy to avoid a double-dip recession at a time when financial institutions face higher taxes, more stringent regulations and higher capital requirements.

[1] The Financial Stability Board coordinates, at an international level, the work of national financial authorities and international standard setting bodies. The Implementation Standards prioritise certain areas of the Board's Principles for Sound Compensation Practices that require rapid progress and implementation by firms and authorities.

Commentary

The details of these proposals are to be fleshed out by the Government over the course of this Parliamentary session. These matters will all be subject to scrutiny and debate in the House of Commons and House of Lords. The coalition Government is operating with a narrow majority and includes politicians with sometimes opposing views on many issues, both between the two political parties that make up the coalition and within those political parties themselves. As a result, some of these proposals are likely to be changed as they pass through Parliament into law. For instance, there are recent reports that ministers may be reconsidering the possibility of abolishing the FSA and transferring its powers to the Bank of England. Clearly much of the Government's thinking is still in development, given the similarly evolving state of international regulatory initiatives, particularly in the US and EU.

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