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The UK Government Proposes to Change the Architecture of the UK's Financial Regulatory System

The new UK coalition government has set out its plans for reforming the UK banking and wider financial regulatory system which will see the end of the Financial Services Authority in its current form. This client publication summarises the proposals and their implications.

The new UK coalition government has adopted the course previously advocated by the Conservative Party, the leading coalition party in the current government, prior to the recent general election in the UK. The Conservative Party long advocated the abolition of the Financial Services Authority (the "FSA") in its current form. It proposed that the FSA should be split, with its prudential regulatory function being overseen by the Bank of England (the "BoE") and its conduct of business function being hived off. Enforcement functions, currently spread across a number of UK agencies, would be consolidated.

The starting point for the proposed changes is the view of the new government that the existing tripartite system of financial regulation (involving the FSA, the BoE and HM Treasury) failed to identify, prevent or dampen macroeconomic developments and practices that led to the financial crisis, which resulted in the public sector having to bear the burden of increasing stability in the financial markets. The FSA has been criticised for concentrating on rule compliance at the expense of wider matters affecting systemic stability.

This client publication discusses the main proposals announced by the government. Further clarification of these proposals will emerge as the government pushes forward with its plans.

Strengthened Role for the Bank of England

The BoE will have control of both macro-prudential regulation, through the establishment of a Financial Policy Committee ("FPC"), and micro-prudential regulation, through the establishment of the Prudential Regulation Authority (the "PRA"). The PRA will be a subsidiary of the BoE and will be chaired by the Governor of the BoE. The BoE will continue to set interest rates through its Monetary Policy Committee.

The FPC will be given the power to address any macroeconomic and financial issues that could threaten financial stability. This clear remit is welcome given that it fills a previous gap in UK regulation, correctly identified by the government.

The PRA will be responsible for prudential regulation of the financial sector, including all UK banks, investment firms and insurers. The FPC will have the power to require the new PRA to implement its decisions by taking regulatory action with respect to all firms.

Mervyn King, Governor of the BoE, stated in his speech at Mansion House on 16 June 2010 that the BoE will "aim to avoid an overly legalistic culture" and that this will be an important aspect of the separation of prudential and conduct of business regulation. He anticipates that the BoE will exercise discretion when setting capital and liquidity ratios for individual banks. This will require changes to current legislation and rules. The interaction of these new capital-setting powers with the proposed Basel III Accord and revised EU Capital Requirements Directive has yet to be worked out.

Consumer Protection and Markets Authority

There will be a new body, the Consumer Protection and Markets Authority (the "CPMA"), which will take on the FSA's responsibility for consumer protection and conduct of business regulation. It will regulate the conduct of all firms, both retail and wholesale, including those prudentially regulated by the PRA. The CPMA will take on the FSA's responsibility for the Financial Ombudsman Service and the newly-created Consumer Financial Education Body, and will also have responsibility for the Financial Services Compensation Scheme. Mark Hoban MP, in his statement to Parliament on 17 June 2010, recognised the "need to ensure that this body [the CPMA] has a tougher, more proactive approach to regulating conduct...".

Until the government provides further detail it is unclear how it intends to deal with the overlap that exists between prudential and conduct regulation, although the CPMA is expected to work closely with the FPC and PRA.

Furthermore, it is also unclear at this stage which regulatory body will be responsible for supervising market infrastructure providers, such as clearing houses and exchanges, payment service providers and credit rating agencies. The name of the CPMA suggests that such organisations may fall within its remit. However, futures exchanges and clearing houses are of significant systemic importance, so BoE regulation for those sectors would be more logical.

Single Economic Crime Agency

There is to be a new, single economic crime agency (the "ECA"), which is intended to deal with serious economic crime. Economic crime currently falls within the remit of various different government departments and agencies. The details of the proposals for the ECA have yet to be revealed. There are already questions about the scope of the proposed agency's remit. Will it only deal with criminal matters or civil enforcement matters too? If civil enforcement falls within the scope of the new CPMA, as the regulator of conduct in firms, then issues need to be resolved as to when the CPMA should consider passing a matter on to the ECA for criminal enforcement. Concerns have been raised as to whether the CPMA would want to hand a matter over to the ECA, given that enforcement actions often arise from conduct of business failures.

The FSA has recently reinvigorated its enforcement arm and has made some progress in dealing with insider dealing, market abuse and regulatory failures. Recent improvements in terms of staff professionalism and a higher profile approach will need to be transitioned to the new regulatory bodies.

Separation of Retail & Investment Banking

The government has taken steps to set up an Independent Commission on Banking to report on the optimal structure of banking businesses. It has appointed Sir John Vickers as chair and has published the Commission's terms of reference. The Commission will make recommendations on structural measures to reform the banking system, including as to whether and how retail and investment banking can viably be separated, as well as related non-structural measures to promote stability and competition in banking.

It is interesting to note that before the coalition government was formed, the Conservatives and (particularly) the Liberal Democrats proposed a return to a Glass-Steagall-style separation of retail and investment banking. However, it is likely that the Commission's findings will be milder than those original proposals, reflecting the political reality that international coordination will be necessary in this area of regulation and that a unilateral approach would be disadvantageous for UK interests. The Commission is due to report in September 2011.

Commentary

There is still huge uncertainty about how the above proposals will be implemented. Clarification will no doubt emerge as the government fleshes out its plans over the next few months.

By passing the FSA's existing powers to separate prudential and consumer regulators, the government is changing the UK's regulatory model. It is splitting prudential from conduct of business regulation, which is a model often referred to as "twin peaks". Many have observed (including, most notably, Hector Sants, the Chief Executive Officer of the FSA and the future CEO of the PRA) that the structure of regulation is not the key to effective financial supervision and that "making good judgments" is the central issue.

Given the diverse financial regulatory structures in place around the world, it is noticeable that the effects of the global financial crisis were not neutralised in any first tier, sophisticated financial centres hosting meaningful amounts of international wholesale business. In addition, although it was widely cited throughout the election campaign that the previous Labour government's approach to financial regulation was defective, it is unclear as to whether the new model (assuming no change of staff) would have achieved any different outcome.

It is therefore questionable whether such radical reforms are necessary in the current economic climate given the amount of legislative and regulatory change being proposed at the international, European and national levels.

The government has promised that it will conduct a comprehensive consultation and publish a policy document for public consultation before the summer recess. These matters will also be subject to scrutiny and debate in Parliament. This process should lead to transparent and informed discussions among policy-makers and stakeholders as to the structure of financial regulation that would best promote growth, stability and consumer protection.

It remains to be seen how the new regulatory framework will sit within the proposed new EU supervisory and legislative framework, which tends to apply an integrated approach to prudential and conduct of business regulation. There is potential for an additional layer of regulatory complexity where it is unclear how regulatory obligations originating at EU level will be apportioned between the PRA and the CPMA.

The finer details of the government's proposals will need to illustrate that structural reforms to the financial regulatory landscape will not impose additional and unnecessary costs on the taxpayer. They will also need to illustrate how the changes will improve market conditions in the next couple of years. Also welcome would be assurances as to how the UK's strong influence on regulatory reform initiatives at the international and EU levels will be maintained, particularly during the transitional phase. In this regard, some comfort may be taken from the fact that the current CEO of the FSA, Hector Sants, is to become the CEO of the PRA to oversee the changes.

Overall, the government should be cautious about pushing these reforms through quickly. It has adopted an ambitious timeframe for implementation, stating that it will ensure that the primary legislation creating the new regulatory bodies is passed within two years. Past experience of UK regulatory reform suggests that this may be optimistic.

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