A New Approach to Financial Regulation in the UK
More clarity but important details remain obscure

- As foreshadowed by the Chancellor in his Mansion House speech on 16 June, the FSA’s regulatory empire is to be divided up, principally between two new successor authorities – a Prudential Regulation Authority (PRA) and a Consumer Protection and Markets Authority (CPMA).

- The Treasury has now published more detailed proposals in a consultation document titled “A new approach to financial regulation: judgement, focus and stability”.

- The high-level premise of the policy appears sensible and intellectually justifiable – uniting “macro-” and “micro-” prudential regulation under the auspices of the Bank of England (the Bank) and having a strong and focused consumer protection and conduct of business regulator – but commentators had predicted that the pursuit of these two objectives would give rise to tensions. So it has proved.

- While the outline of the Government’s proposals is now coming more clearly into focus, numerous gaps, overlaps and ambiguities in the proposed new arrangements remain.

- This briefing paper comments on some of the potentially more significant and troubling of those issues. We have assumed a basic level of familiarity with the structural reforms proposed by the Treasury.

1. THE DIVISION OF RESPONSIBILITIES

Broadly, the policy proposals set out in the Treasury’s consultation involve both a vertical and horizontal division of the FSA’s existing responsibilities:

There will be a vertical division by reference to those regulated activities which policy-makers regard as giving rise to the greatest prudential and (in aggregate) systemic concerns:

- deposit taking;
- dealing in investments as principal (i.e. investment banking); and
- insurance.

Firms undertaking any of these activities will be authorised (by being given permissions) and supervised by the PRA. Firms undertaking other regulated activities, including fund managers, brokers, corporate finance advisers, specialist mortgage lenders, custodians and intermediaries, will be authorised and supervised by the CPMA.

PRA-regulated firms will need to be supervised by the CPMA in respect of conduct of business, resulting in their being authorised and supervised by both authorities.
The consultation document says:

“the basic principle regarding the scope of responsibilities of the PRA and CPMA is that each regulatory authority will be responsible for taking decisions – for example, on rule-making, authorisation, approval of individuals performing controlled functions, supervision and enforcement – in relation to the activities that it regulates.”

The horizontal division of the FSA’s existing responsibilities consists principally in:

- giving the PRA a right of veto over any action which might be taken by the CPMA which “could cause a firm-specific financial stability risk” (in other words, financial stability considerations will be paramount); and
- assigning to the CPMA all responsibility for conduct of business supervision, both in the retail and wholesale financial markets.

As the Government recognises:

“While this principle is very clear, putting it into practice will require a significant degree of cooperation and coordination by the authorities to ensure that they avoid duplicating efforts, or cutting across each other’s work.”

Understandably, the consultation document is short on details as to how in practice the significant challenge of these closely-related regimes operating in parallel will be made to work.

2. THE KEY ROLE OF THE FINANCIAL POLICY COMMITTEE

A key goal of the Government’s new policy is the alignment of macro-prudential financial regulation and monetary policy, while also smoothing the relationship between macro- and micro-prudential regulation. It is intended that this will be achieved by putting the Bank of England in charge of macro-prudential regulation and by locating the PRA, with responsibility for the day-to-day supervision of the (systemically important) banks, investment banks and insurers, under the governance of the Bank.

Central to the proposals on enhancing financial stability is the establishment of a new Financial Policy Committee (FPC) within the Bank with the power to identify imbalances, risks and vulnerabilities in the financial system, and to take decisive action to mitigate those risks to protect the wider economy. It is envisaged that the FPC will play a similar role at a domestic level to that of the European Systemic Risk Board for the EU and the IMF early warning function.

The FPC will have the objective of protecting financial stability and improving the resilience of the financial system by monitoring for threats and taking action where necessary to address vulnerabilities and imbalances (with internationally-agreed ‘macro-prudential tools’), and informing Parliament and the wider public of its analyses and actions.

The FPC will also be charged with overseeing at a general level the supervisory work of the PRA and CPMA to identify any implications for financial stability, keeping the regulatory perimeter under review, and ensuring that

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1 The content of the FPC’s macro-prudential toolkit is likely to depend on the outcome of negotiations within the EU and at Basel on new capital and prudential standards. Those tools are likely to include counter-cyclical capital buffers, limits on leverage (to be imposed at a generic rather than firm-specific level), forward-looking provisioning and higher collateral requirements during periods of unsustainable growth in lending.
the division of responsibilities between the two regulatory authorities remains appropriate. The FPC will be able to give ‘macro’ directions to each of the two authorities but will not be able to exert control to the extent of imposing prudential or conduct of business decisions in respect of individual firms. It is nevertheless clear that the Government intends for the FPC (and therefore the Bank) to play a proactive rather than a responsive role as overseer of the UK regulatory system. The FPC will also be able to make recommendations to the Bank’s Court of Directors and to the Treasury.

The chief executives of each of the PRA and CPMA will sit on the FPC, alongside the Governor of the Bank and a number of independent committee members. The two supervisory authorities will brief the FPC on significant risks prior to its regular meetings, and each will be required to consult the FPC before making rules that have material implications for financial stability.

The creation of the FPC, with wide powers of oversight and direction in relation to the day-to-day supervisory authorities, highlights a shift in policy and a dramatic change in the concentration of responsibilities for the UK regulatory regime. Never before has the Bank of England been in a position to exercise power and influence across so broad a plain.

The new arrangements, although internal to the corporate personality of the Bank, might nevertheless have the effect of importing some tensions and conflicts. What is striking about this new regulatory structure is the multiple layering of governance and oversight functions; FSA regulators, until now able to pursue their intrusive supervisory approach with relative independence from Government, will themselves now be required to accept a more direct and intrusive level of supervision. Ultimately, the FPC can force the hand of the PRA on the making of new rules (for example, on capital requirements). This may not always be a harmonious process.

Will the Bank have the right quantity and quality of resources, and a sufficiently nimble governance structure, to manage its many roles and responsibilities more effectively than its predecessors? And is the Bank culturally ready to execute the additional responsibilities assigned to it, ranging from the more familiar territory of macro-financial matters to the gritty frontline of micro-supervision? The recent announcement of the Treasury Select Committee’s inquiry into the proposals alludes to these concerns when it asks "what characteristics, experience and qualities should the Government look for when appointing external members of the FPC?". Wallflowers need not apply.

3. SEPARATING PRUDENTIAL AND CONDUCT OF BUSINESS REGULATION

The consultation document says that "prudential and conduct of business regulation require different approaches and cultures". What are the approaches and cultures which the Government is expecting of its new creations? The Government seeks to address this question broadly in three ways by:

- setting formal parameters for each authority;
- indicating the expected regulatory cultures; and
- attempting to deal with overlap through prescribing a "collegiate" approach.

The document is reasonably clear on the first two matters, but less successful when it deals with the considerable overlap (and potential for underlap) between the remits of the PRA and the CPMA, and how the two authorities can in practice be made to work cooperatively.
3.1 Formal parameters
Each regulator will have its own primary (statutory) objective:

The PRA’s primary objective will be to “promote the stable and prudent operation of the financial system through the effective regulation of financial firms in a way which minimises the disruption caused by any firms which do fail”.

The latter part of this objective points to the PRA focusing much of its regulatory effort on ensuring that firms have effective arrangements (for example, so-called ‘living wills’) for the eventuality of financial collapse. Curiously, the objective as proposed focuses on mitigating the consequences of a firm’s failure rather than reducing the likelihood that a firm will fail.

The CMPA’s primary objective will be to ensure “confidence in financial services and markets, with particular focus on protecting consumers and ensuring market integrity”.

In relation to consumer protection the Government says that it is considering expanding the statutory powers of the CPMA (i.e. beyond those applying to the FSA under the present regime). This might enable the CPMA, for example, to champion financial inclusion more actively with powers to force firms to open their doors to a wider range of clients.

In exercising their respective powers, each authority will have a range of secondary factors to which it must have regard, including the objectives of the other authority (to support effective coordination) and “principles of good regulation”. The consultation document suggests that these will not be the same for each authority and almost by definition, therefore, policy and cultural tensions will be hard-wired into the new architecture.

3.2 Competition and innovation
The consultation document proposes in particular that two existing principles to which the FSA must have regard when exercising its statutory functions should not survive as guiding principles for either of the new regulatory authorities, namely the requirements to promote competitiveness and to encourage innovation in financial services. The consultation document says:

“There is a strong argument that one of the reasons for regulatory failure leading up to the crisis was excessive concern for competitiveness leading to a generalised acceptance of a “light-touch” orthodoxy, and that the lack of sufficient consideration or understanding of the impact of complex new financial transactions and products was facilitated by the view that financial innovation should be supported at all costs.”

But a distinction can be made between supporting innovation at all costs and the desirability of facilitating innovation in connection with regulated activities. Certainly the promotion of financial innovation could, and perhaps should, continue to be a principle of good regulation (to avoid the opposite extreme of regulation that emasculated markets), but accepting that if the PRA or CPMA concludes that a particular innovation is harmful, then financial stability and consumer protection should prevail.

The case for removing the global competitiveness principle is weaker. The FSA is required to have regard to the international character of financial services and markets and the desirability of maintaining the competitive position of the United Kingdom. Neither the Turner Review, nor other analyses of the financial crisis, suggest that the international character of financial services or the competitiveness of the UK industry was a material cause of the crisis, or that a less internationally focused, or less competitive, UK industry would have contributed to financial stability.
It is unclear whether the Government is proposing removing the existing principle of facilitating competition between those who are subject to regulation. However, if this is the case, then it is suggested that this would be undesirable. Competition between firms improves efficiency and thereby contributes to economic growth. There is no evidence that less competition would have reduced the costs or consequences of the crisis.

3.3 Regulatory cultures

Although both the PRA and the CPMA are presented as tough regulators (for what else could be expected?), the emphasis in each case is slightly different.

In the case of the PRA, the new cultural aspiration is “judgement led prudential regulation”. In effect, this seems to mean that the PRA will seek to be well informed about the risks in at least the major firms it regulates and, as a result, will make individual judgements about the prudential requirements which should apply.

The intention is clearly that the PRA should take a credible and appropriately intrusive approach to prudential supervision, in marked distinction to what has been perceived as the sometimes ‘box-ticking’ approach adopted by the FSA, at least prior to the financial crisis. According to the consultation document, there will be two further consequences of the PRA’s regulation being led by “judgement”:

- a rigorous enforcement division within the PRA: “credible and effective supervisory and enforcement powers” are necessary for the PRA properly to inform itself of prudential risks; and
- a reduction and simplification of the FSA’s existing prudential rules and guidance: the consultation document acknowledges that this process will be constrained by the need for compliance with European law and the need for “transparent regulation and legal certainty”.

The Bank is not traditionally an institution that has operated in a heavily rules-based regulatory environment and, however judgemental, outcomes-focused or principles-based the Bank might aspire to be in its supervisory capacity, it is clear that the ‘Governor’s eyebrow’ approach to supervision cannot return in its original form; the Bank will have to implement EU prudential rules in a transparent and consistent way. A new supervisory culture will therefore need to be developed within the Bank which combines the desirable features of judgement-based regulation with an ability to interpret and apply rules transparently and consistently. This may not be easy unless the Bank can retain and draw effectively on the accumulated skills and knowledge of current FSA staff.

The suggested reduction and simplification of the FSA’s rules and guidance may, as a general matter, be welcomed. However, as already mentioned, in many cases the detailed requirements of those rules implement EU Directives, which will therefore continue to be required. Going forward, the extent to which rules and guidance will be derived from EU law is likely to increase, with a corresponding decline in the ability of the PRA to adopt super-equivalent requirements. A reduction of specific rules and guidance will also need to be weighed against the advantages in providing greater clarity to firms; prudential requirements are generally less capable than conduct of business norms of being reduced to broad principles. Capital and liquidity are clearly areas where leaving firms to set their own requirements, based on high level principles, is unlikely to promote financial stability.

It is intended that the CPMA will continue the FSA’s current approach to regulation, especially in relation to retail business:

“the CPMA will build on the progress recently made by the FSA towards a more interventionist and pre-emptive approach to retail conduct regulations… [The FSA’s recent] initiatives recognise and respond to some of the distinctive characteristics of retail product complexity and asymmetry of information between consumers and producers. This will necessarily be backed by a strong approach to enforcement to ensure credible deterrence.”
Despite the Government’s intention that the CPMA be a “strong consumer champion in pursuit of a single objective”, it will need to be able to focus on more than simply protecting consumers. The CPMA will, for example, also have responsibility for the regulation of market conduct (including inter-professional wholesale business) in which consumer protection may not be quite so relevant, or at least should not be the sole or primary objective.

It is to be hoped that the Government’s desire to embed the culture of consumer protection in a more dedicated regulatory authority does not lead the CPMA to lose focus on other critical aspects of its regulatory functions, including prudential issues (albeit not in relation to banks, broker-dealers and insurers), and the clean and efficient functioning of markets, retail and wholesale.

3.4 Coordination between the PRA and the CPMA – the emergence of a Coalition Authority?

Having, as a policy matter, put the FSA asunder the consultation document accepts that extensive cooperation between the PRA and the CPMA will be necessary in many areas where the design of the new regime gives rise to overlap and, potentially, conflict (something the new regime is of course intended to avoid).

As both regulators will have responsibilities in the same areas of supervision, for example, over the senior management of firms holding permissions from both the PRA and the CPMA, cooperation will be unavoidable. There is no clean divide between conduct of business issues and prudential matters – the same set of facts or behaviour may give rise to concerns under both headings. Further, as mentioned above, the CPMA will be responsible for the prudential supervision of non-PRA regulated firms, and most if not all of the most substantial financial services groups operating in the UK can expect to have at least one group member supervised by each of the two new regulatory authorities. It is not yet clear how consolidated supervision of UK financial services groups will operate in practice, as relevant EU Directives require consolidated supervision of such groups whether or not their activities fall within the remit of the PRA. Potentially, substantial UK financial services groups or sub-groups face group-wide supervision by both authorities.

The consultation document acknowledges that prudential and conduct of business regulation has given rise to “in-built tensions between different objectives” under the current unified system; but one can scarcely avoid the conclusion that the necessity in many matters to have a combined regulatory approach between the PRA and the CPMA may well perpetuate these tensions.

The consultation document envisages formal processes to facilitate coordination between the two authorities, including:

- a statutory requirement that each authority will have regard to the objectives of the other (although in the case of the PRA this applies only so long as there is no conflict with the PRA’s statutory objective: in that sense financial stability overrides consumer protection);

- cross-membership of the boards of the authorities, ensuring each authority is kept up-to-date with the policy deliberations of the other. The CEO of the PRA will sit ex officio on the CPMA Board and vice versa;

- statutory memoranda of understanding, setting out the mechanics of day-to-day cooperation and coordination on more strategic long-term thinking;

- formal collegiate mechanisms to support joint working on the supervision of firms subject to regulation by both the CPMA and the PRA. It is stated that where groups contain firms supervised by both the PRA and CPMA, it will be important for the PRA to have confidence that activities elsewhere in the group do not impact on the safety and soundness of the entities it supervises;
• statutory "information gateways" between the PRA and the CPMA to allow an appropriate flow of information where necessary; and

• mutual consultation on proposed new rules.

The more complex the necessary inter-relationship between the PRA and the CPMA becomes, the more it might be suggested that the case is weakened for abandoning the concept of a single regulator. In any event, it is at the edges of cooperation – or the lack of it – that the new regime will be most tested. It will be here that firms may feel the greatest regulatory burden as they get to grips with the requirements of two regulators, not necessarily always pulling in the same direction. We expect this to be a particular risk in the insurance sector, in which firms are heavily regulated from both a prudential and a conduct of business perspective.

According to the Government’s proposals the CPMA will be required to consult with the PRA on any firm-specific action it intends to take which could have an adverse impact on the stability and soundness of the firm. Where any decision could cause a firm-specific financial stability risk the PRA will have the power to override the decisions of the CPMA. While confirming the status of the PRA as the ‘senior’ regulatory body, this could have the strange consequence that, for example, a systemically important firm could, potentially, escape the appropriate penalty for a major conduct of business wrongdoing if the PRA fears that enforcement action could put financial stability at risk.

A further uncertainty concerns approvals for changes in control of authorised firms. The existing regime and thresholds for regulatory approval (derived from the EU Acquisitions Directive) will need to be retained. But it is unclear whether the PRA and CPMA will apply separate approval regimes, or whether the CPMA will be responsible for all approvals in relation to UK authorised firms. In any event, cooperation will be required between the two authorities to ensure that all relevant issues (prudential and otherwise) can be taken into account.

3.5 Limited accountability for the PRA?
Three matters are of potential concern to regulated firms:

• The Government is considering whether the PRA’s rule-making function should continue to be subject to statutory processes, including consultation and the duty to carry out a detailed cost-benefit analysis. These statutory processes will apply to the CPMA. A weakening of either requirement could result in a deterioration in the quality of regulatory requirements in the UK and result in rules being made without regard to all relevant considerations.

• The consultation document suggests that the existing accountability mechanisms applicable to the FSA’s rule-making function may not be retained for the PRA. These include:
  – a duty to establish consultative panels (currently, a consumer and a practitioner panel);
  – a duty to maintain a complaints mechanism; and
  – a power to commission reviews and inquiries in respect of the FSA’s performance.

The Government has proposed retaining these accountability mechanisms for the CPMA but no reasons have been given in the consultation document for abandoning the requirement for the PRA to have a complaints mechanism.

• The consultation document makes no reference to the possibility of appeals being brought from decisions of the PRA to the Upper Tribunal. This contrasts with the position of the CPMA whose decisions are stated to be subject to appeal.
It is unclear whether this omission is accidental. However, an attempt to insulate the PRA from judicial scrutiny is likely to contravene the EU’s Single Market Directives, which insist on the right for a regulated firm to apply to the courts if dissatisfied with a regulator’s decision. Given its limitations, it is unlikely that judicial review would satisfy EU requirements. Clarification that decisions of the PRA may be appealed to the Upper Tribunal would be welcome.

In all three of these areas it appears possible that the PRA may be subject to a lower standard of accountability and scrutiny than the CPMA. The reasons for this are not clear, and although prudential judgments involve difficult decisions, often with limited information and in the absence of clear counterfactual situations, this does not appear to be a sufficient reason for stepping back from the safeguards currently applicable to the FSA, which faces the same constraints in respect of its prudential and conduct-related decision-making.

In any event, the reasons for different treatment need to be articulated and tested as part of the public consultation process on the new regulatory regime.

4. MARKETS AND INFRASTRUCTURE

The division of regulatory responsibilities continues in the proposals for market and infrastructure regulation. Responsibilities will be divided between the CPMA and the Bank (not the PRA).

The CPMA will be responsible for all market conduct regulation, whether retail or wholesale. The Bank will be tasked with overseeing systemically important settlement and clearing systems.

An “operationally distinct division” of the CPMA will take on responsibility for all market conduct regulation (wholesale and retail), and so will likely retain the existing market monitoring and market abuse teams from within the FSA. But a point which the consultation document does not articulate clearly, perhaps because the point is not clear, is whether market conduct can be regarded as operationally distinct from conduct of business. For example, front running is a conduct of business concern (i.e. customer abuse), but is also a species of market abuse.

On the one hand the consultation document distinguishes between wholesale and retail market conduct issues; on the other hand the document also says that as between wholesale and retail issues the “underlying issues and the key legal concepts are ultimately the same”.

The idea of forming a distinct market conduct division with a broad overview of retail and wholesale market functionality (which are clearly related) seems at first to be undeniably logical. But quite how operationally distinct the market conduct division can be, given the significant overlaps and dependencies between market and conduct of business regulation, remains to be worked through. As is now becoming apparent, attempts to excise discrete elements of the existing unified regulatory regime can leave jagged edges behind.

4.1 Exchanges, central counterparties and settlement systems

The consultation document distinguishes between exchanges and other trading platforms and those market infrastructure providers that are capable of having a more systemic impact, such as settlement systems and central counterparties (CCPs).

Exchanges and other trading platforms, being inextricably linked with the dealing-related services they provide, will be the responsibility of the market conduct division of the CPMA, whereas CCPs and settlement systems will be overseen by the Bank, alongside its existing payment system oversight responsibilities.
CCPs are set to become increasingly important in the management of OTC derivatives risks and there is certainly some logic in assigning responsibility for these systemically significant functions to specialised prudential regulators, although it is not clear why the PRA is disqualified from this job.

One consequence of this division of responsibilities is that it may be necessary for an organisation to seek authorisation from both the CPMA (for example, as an exchange) and the Bank (for example, where that exchange operates its own CCP). This further highlights the potential complexities for firms, and groups, in dealing with, and building constructive relationships with, multiple regulatory authorities.

4.2 UKLA
The Government has said that it makes sense for the UKLA’s public markets function to be brought together with other regulatory functions relating to “companies and corporate information” under the auspices of the Department for Business, Innovation and Skills.

While noting the “synergies that exist between the UKLA and other markets functions” the consultation document floats the idea of a merger of the UKLA with the Financial Reporting Council (FRC), thus establishing a “powerful companies regulator”.

The UKLA has operated as a relatively discrete sub-function within the FSA and there has been no suggestion that the FSA’s stewardship of the UK’s listing authority function was flawed. Some may feel that a merger of the UKLA and FRC is unnecessary structural engineering, but in fairness this appears to be one of the more open questions posed by the consultation document.

5. CRISIS MANAGEMENT
It is proposed that the Bank, both directly and through the agency of the PRA, will be given enhanced powers to deal with financial crises. This is an area in which the previous Government had recently legislated, but which the current Government believes requires further enhancement.

The Bank will continue to have powers to provide emergency liquidity funding, but in a well-trailed departure from the Tripartite arrangements, now perceived to have been discredited, the Bank will have overall responsibility for coordinating resolution action when it next becomes necessary. The Treasury must be consulted if resolution action would involve the use of public funds.

As described in section 2 above, it is intended that the FPC should use the new macro-prudential toolkit to respond to systemic threats to financial stability, with the objective of avoiding the need for crisis management at the level of individual firms. If these measures are not successful, however, the Special Resolution Regime (SRR) may need to be invoked.

In addition to its responsibilities for supervising individual firms, the PRA will also be responsible for requiring “management action” from individual firms that run into difficulties (for example, requiring the firm to issue new equity) and ultimately for triggering the SRR for failing institutions.

The existing Special Resolution Unit within the Bank will have responsibility for contingency planning prior to the SRR being triggered and for coordinating measures subsequently deployed under the SRR.
The logic of locating these important crisis management functions in one place is not easily faulted, at least in theory, but concerns can be identified arising out of the Bank's multiple roles. By way of example, how long will the PRA wish to wait before pulling the SRR trigger, and thus implicitly acknowledge a failure of its micro-prudential supervision of the firm concerned? If the Bank, as lender of last resort, finds itself in the position of prolonging the life of an ailing institution, will it be open to the challenge that it had acted to protect the interests of its subsidiary, the PRA?

As the consultation document acknowledges, "[i]t is important to ensure that appropriate safeguards are in place to ensure that conflicts do not arise between the Bank's role as lead resolution authority and the Bank's new responsibilities in relation to the PRA".

A solution proposed in the consultation document is to ensure that contingency planning and resolution operations are managed distinctly from the PRA's prudential supervisory operations and will fall within the remit of the Deputy Governor for Financial Stability and not the Deputy Governor for Prudential Regulation. But this surely begins to undermine the rationale for co-locating those related functions. In any event, it may further be doubted whether the operational separation of those potentially competing responsibilities can realistically be maintained through the senior ranks of the Bank's governance structure, and ultimately to the level of the Governor, in the heat of the next financial crisis.

Another comment in the consultation document could have troubling consequences. The Government suggests that the existing power of the FSA to modify at its own initiative an individual firm's permission to carry on regulated activities could be expanded, and that the trigger points for the PRA and the SRR might be modified "to ensure intervention is possible before a breach of threshold conditions". Any movement towards giving greater discretion to the PRA to initiate interventions in the financial sector could potentially have significant consequences for the ability of UK institutions to raise new capital at a time when regulatory authorities are seeking to encourage, and in some cases to require, banks and insurers to do just that. It will therefore be critically important to ensure that there is clarity as to the circumstances in which such interventions may take place.

One further change contemplated in the consultation document is to give the new authorities supervisory powers over certain unregulated companies, such as holding companies, in circumstances where a regulated firm is failing. If implemented, this would mark a significant extension to the scope of the UK regulatory jurisdiction. The FSA (and its predecessor bodies) has not sought to supervise unregulated companies directly; any attempt to do so could raise difficult questions as to the nature and extent of those new powers, particularly in cases where unregulated holding companies are incorporated outside of the UK.

6. IMPLEMENTATION

The Government intends to publish a further consultation document, together with draft legislation, in early 2011. A Bill will be introduced into Parliament in mid-2011 and should be enacted by 2012. However, given the scale of the changes envisaged, it has been proposed that the FSA will restructure itself on a non-statutory basis in advance of the legislation coming into force.

Thus the FSA will introduce a ‘shadow’ internal structure allocating staff and responsibilities in anticipation of the creation of the two new authorities in the first quarter of 2011. A new operating model will be developed to address issues such as structure, resources and risk-based supervisory frameworks for the PRA and CPMA. In Autumn 2010 the Government will establish an interim FPC to carry out preparatory work on the macro-prudential toolkit and to undertake, so far as practical, a macro-prudential role (although without the statutory powers that the new legislation will in due course need to confer).
The last Government needed four and a half years to establish the FSMA-based regime, so this is clearly a challenging timetable for implementation and both short-term and longer-term costs are likely to be significant. According to the impact assessment published with the consultation document the cost of developing and bringing in the necessary legislation, and implementing the reforms, is expected to be of the order of £50 million spread over three years. The Government does not estimate there to be any significant transitional or ongoing costs to firms regulated solely by the CPMA, although it accepts that firms and groups supervised by both the PRA and the CPMA are likely to incur some additional costs.

It remains to be seen whether these estimates prove accurate. Intuitively, establishing and operating two regulators with overlapping authorisation and supervision regimes will be more expensive than operating only one. It is unclear if the £50 million estimate covers the cost of new premises for the PRA together with separate IT systems and support services for the new authorities, if required.

It is possible that the new judgements-based approach to supervision of the PRA will require additional technically-skilled staff beyond those recruited by the FSA as part of its Supervisory Enhancement Programme and existing FSA staff will need to be trained on the new regulatory regime.

There will be a significant challenge for firms who will need to understand and comply with the new regime, and get to grips with the new supervisory culture as it develops. These challenges are likely to be greatest for firms subject to regulation by both bodies (which includes a significant number of smaller firms such as building societies and credit unions). The Government contends that the shake-up will reduce the frequency and severity of future financial crises although, understandably, the Impact Assessment recognises that “[i]t is impossible to quantify the benefits of the proceed option in a realistic way”. Some commentators will inevitably question whether the costs of establishing the new regime offer value for money in these more straitened economic times.

7. EARLIER QUESTIONS REVISITED

In our commentary on the Chancellor’s June announcement (All Change: the End of the Line for the FSA2, June 2010) we posed some ‘Open Questions’. We return to those original questions here to see how far they have been answered by the more detailed consultation document.

Will there be a single rule book or multiple rule books?
Each regulator will have its own rule book. Firms which straddle both sides of the vertical division will have to deal with two regulators and two rule books both in respect of obtaining relevant permissions and in the ongoing supervision of firms and individuals within firms. The potential for “unnecessary discrepancies and overlaps” is not insignificant; something which the original formation of the FSA as a single statutory regulator was intended to avoid.

Nevertheless, by operation of the horizontal division of responsibilities described in section 1, all regulated firms will be subject to the single conduct of business rule book of the CPMA (although this horizontal distinction may not always easily be made as noted in the following paragraphs).

2 Searchable at www.slaughterandmay.com
What will happen to FSA rules that are not clearly prudential or conduct of business?
The FSA’s Principles for Businesses will presumably be retained in more or less their existing form, but will be
applied by both regulatory authorities in both vertical and horizontal planes. The question remains, which of the
two authorities will be responsible for, and for enforcing, the Principles? If both, but separately, will those two
regimes develop in exactly the same way, bearing in mind the differing statutory objectives of the two authorities?

As already noted, responsibilities for supervision will be divided vertically, and many multi-service firms will
be subject to supervision by both the PRA and the CPMA. The problems of marrying the different approaches
and standards of the two authorities are potentially considerable, and could well be expected to increase the
complexity and costs of operating a fully-compliant organisation. The consultation document, while recognising
these problems, suggests only that it may be necessary to form a “college” of supervisors for multi-service firms.

The FSA’s recent work on consumer protection has identified firms’ cultures as a key driver of their behaviour
towards customers, and has established that such cultures are largely set by the attitudes of senior management.
In other words, the FSA has begun to expand conduct of business regulation into a top-down view of a firm’s
organisation as a whole. But this approach to conduct of business regulation clearly trespasses on matters which
are the domain of prudential supervision (to be carried out by both authorities), such as the rules which govern
senior management arrangements, systems and controls, and the requirements that apply to approved persons. It
may prove difficult to continue the FSA’s current approach in relation to large multi-service firms without a more
overt pooling of supervisory effort and expertise between the CPMA and PRA, which might undermine the case for
separate regulators.

Will there be a single approach to authorisation?
The answer seems to be “No”. Each regulator will be responsible for issuing permissions for the regulated activities
allocated to it in the vertical division.

The consultation document asks whether an integrated model (for example, giving one authority responsibility
for authorisation and removal of permissions) would be preferable. Superimposing a single authorisation gateway
might facilitate a more efficient authorisation process under the new regime and for that reason is appealing. But a
joint process would be likely to give rise to further tensions.

If the PRA was tasked with this responsibility then the PRA would be responsible for giving authorisation to firms
that it would not supervise, and whose activities may give rise to few if any systemic prudential concerns. It may be
questioned whether the PRA could perform this task effectively.

If the CPMA was responsible for authorisation then similar difficulties would arise for firms subject to prudential
regulation by the PRA. It may be doubted whether a body established with the objective of being a consumer
champion is well placed to determine whether a new bank or insurance company should be authorised. Moreover,
to do so effectively the CPMA would need to have within it a specialist unit skilled in the prudential regulation of
such firms, thereby duplicating the work of the PRA.

So it appears that a dual regime for both authorisation and supervision is inevitable, although it would be welcome
if the legislation made clear that:

• a person authorised by the CPMA will not commit an authorisation offence if he engages in an activity subject
to authorisation by the PRA (but could be subject to disciplinary proceedings by the PRA or the CPMA for
having done so);
• contravention of an authorisation requirement will not affect the enforceability of a contract by a third party against the firm responsible for such contravention; and

• a person authorised only by the CPMA will be able to enforce a contract against a third party where such a contract relates to an activity regulated by the PRA.

Injunctions and similar remedies should be available to deal with the situation of a CPMA-regulated firm engaging repeatedly in activities for which authorisation is required from the PRA.

Who will be responsible for enforcement?
So far as breach of supervisory requirements is concerned, the *vertical division* means that there will need to be two separate enforcement regimes. However, under the *horizontal division*, the CPMA will be responsible for enforcing conduct of business requirements and for policing the financial markets (except in relation to listing and disclosure requirements, for which we shall look to the UKLA or its successor).

It will inevitably be the case that the same set of facts may raise both conduct of business and prudential concerns. The consequent burden on the investigated firm of dual enforcement processes, and the potential for confusion and overlap between two sets of investigating regulators, are likely to be heavy and great, respectively.

There is an argument for looking at the formation of a single unified enforcement authority, but this again may be regarded as counter-cultural in the context of a proposal to pursue both vertical and horizontal divisions of regulatory responsibilities.

What will happen to the punishment of market abuse?
The market abuse regime will be allocated to the CPMA’s market conduct division. It remains to be seen how this enforcement regime will interact with the criminal powers of the proposed new Economic Crime Agency (*ECA*), but this further complicated interaction is to be consulted on separately. Coordination with the ECA will certainly be required if the latter agency assumes responsibility for prosecuting insider dealing and market manipulation.

How will the new regulators coordinate their action internationally?
The CPMA will be the UK’s lead regulator so far as representation at the European Securities and Markets Authority (*ESMA*) is concerned. The PRA will represent the UK at the European Banking Authority (*EBA*) and the European Insurance and Occupational Pensions Authority (*EIOPA*).

How will single market passporting be made to operate effectively?
This is not addressed in the consultation document, but presumably outward passports will be administered according to the *vertical division*, with the PRA issuing notifications in respect of banks, investment banks and insurers and the CPMA doing the same for other financial firms. It would be an unfortunate consequence if firms subject to regulation by both the PRA and CPMA were required to apply for two separate passports. However, inwardly passporting EEA firms, which are subject to home state prudential regulation, will presumably come under the UK jurisdiction of the CPMA alone.
8. CONCLUDING REMARKS

It is too early to pass judgement on the proposals for a new regulatory regime. As the consultation document indicates, the proposals are open to adjustment and refinement before the necessary legislation is brought forward.

Putting the Bank at the heart of prudential regulation and financial stability is a sensible and justifiable policy move. But, at the same time, the proposals are likely to give rise to significant difficulties in both implementation and application and, given the complex new structure of regulatory authorities and responsibilities, will require intensive cooperation to deliver the desired improvements in regulation.

In particular:

- The vertical and horizontal divisions of responsibilities between the PRA and the CPMA give rise to risks of tension and conflict and (for firms) the possibility of over-regulation.

- The need for colleges of regulatory authorities for more complex firms undermines the case for abandoning a single unified regulatory model.

- In the light of the previous comment, it may be asked whether the benefits of what will be a considerable upheaval will ultimately outweigh the costs, financial and otherwise.

Nevertheless, the course which has been embarked upon is now unlikely to change direction radically. At this stage it must be hoped that the potential problems, including those issues identified in this paper, will be resolved through a constructive consultation process, and that the new regime which finally emerges can be implemented with the minimum of disruption for regulated firms.