

Part 1: The Changing Regulatory Landscape

Conolly Tunnard outlines the new regulatory structure being enacted by the Coalition Government.

In the lead-up to the General Election, George Osborne announced that if elected the new Government would scrap the FSA and return regulation to the Bank of England ("BoE"). This scenario has now come to pass and the financial services industry is entering a period of upheaval as the regulatory structure is amended.

Now that the fog of confusion is beginning to lift, the outline of the new structures is beginning to emerge and some of the details can be ascertained.

The structure

European regulatory structure

The new regulatory structure will be a complex one, and whilst the BoE will be the prime regulator in the UK, it must not be forgotten that the European regulatory structure is evolving also, with the creation of the European Systemic Risk Board (ESRB) and the European System of Financial Supervision (ESFS). The ESFS will

be split into the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA), and the European Securities and Markets Authority (ESMA). Whilst this alphabet soup of European regulators will no doubt have a considerable impact on the content and style of UK regulation, this will happen through the new UK regulators, and firms will not normally be regulated directly in their day-to-day activities by the European bodies. The European bodies will have powers of intervention through the UK regulators if member state regulators do not follow European regulator requirements. It can be expected that European regulators will be more interventionist with member state regulators than has been the case in the past. The diagram below sets out the proposed UK structure.

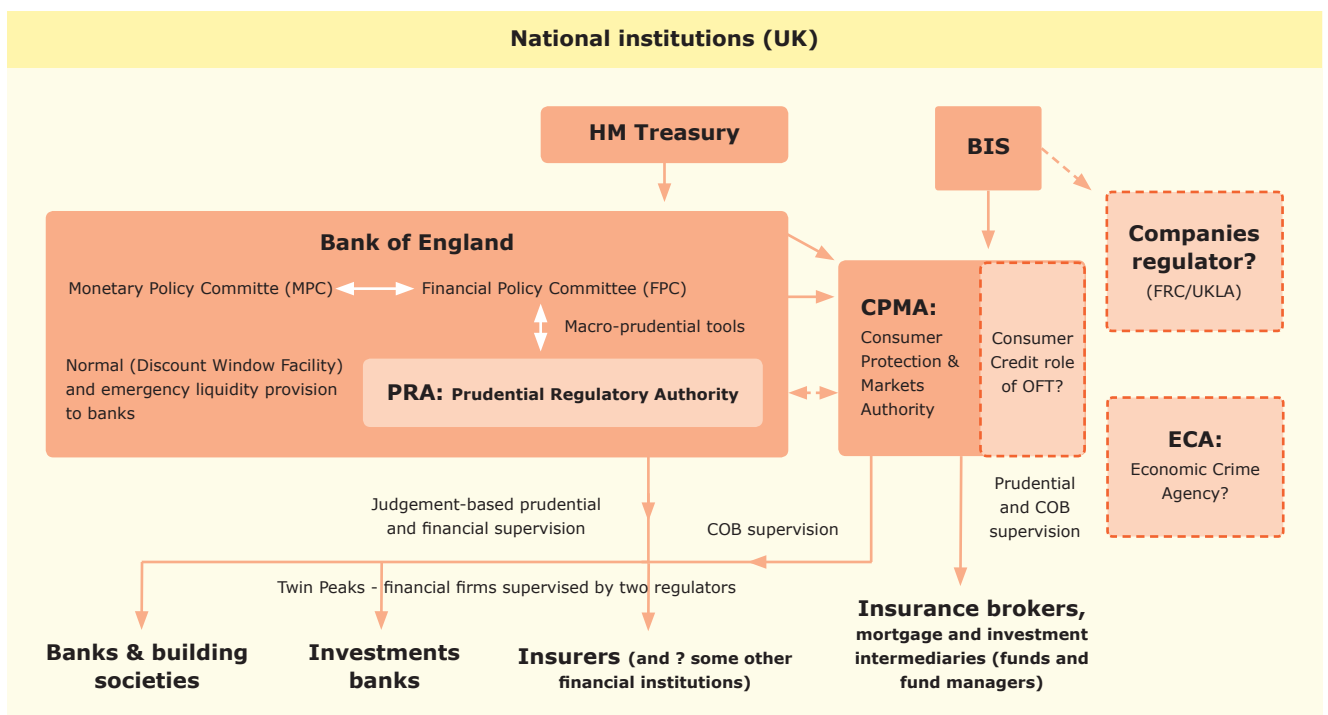
UK regulatory structure

UK firms will be directly regulated by the new UK regulatory structure that is emerging to replace the FSA, which will be scrapped. The key player in the UK system of financial services regulation will be the BoE.

Within the BoE a body called the Financial Policy Committee (FPC) will be set-up. The FPC will not directly regulate firms but its impact on the prudential regulation of firms will be huge. The FPC's duty will be to be in charge of macro prudential policy. It will have two main objectives:

1. Improving the overall resilience of the financial system by addressing aggregate risks and vulnerability across the system that have the potential to threaten stability; and
2. Enhancing macroeconomic stability by addressing cyclical imbalances through the financial system eg by dampening the credit cycle.

Its role, simply put, is to monitor the "big picture" of the financial system and identify emerging issues and develop corrective policies to head off economic problems before they take hold. The failure to monitor the big picture and develop strategies to deal with the emerging crisis are criticisms that have been levelled at the FSA in its failure to identify the emerging banking crisis. It is this failure that the FPC is designed to prevent.



The FPC is going to be created as a committee of the Court of Directors of the BoE, will be chaired by the Governor of the BoE, and will have a membership of 11, comprising six BoE executives and five members from outside the BoE.

The job of the FPC is to evolve policy to meet the objectives set out above, which will be put into effect at the firm level by two regulatory bodies.

One of the criticisms levelled at the FSA was that it had too much on its plate to be both a prudential regulator and a conduct of business regulator. It is largely for this reason that it has been decided that firms should be regulated by a "twin peaks" method of regulation with separate regulators for prudential regulation and conduct of business.

Prudential regulation will be the responsibility of the Prudential Regulation Authority (PRA) and conduct of business regulation will be the responsibility of the Consumer Protection and Markets Authority (CPMA).

The PRA will have the primary objective of promoting the stable and prudent operation of the financial system through the effective regulation of financial firms in a way which minimises disruption caused by firms that do fail. This is known as microeconomic regulation.

In simple terms its role will be to make sure firms do not take undue risks they are not properly capitalised for, and to enact the policy decisions made by the FPC at firm level. An example of this would be counter cyclical measures to dampen over-exuberance in the markets that can lead to economic crises.

The PRA will be responsible for the prudential regulation of banks and other deposit takers, broker-dealers (or investment banks), and insurers including friendly societies. About 2,000 firms will be regulated by the PRA.

The Deputy Governor of the BoE for prudential regulation will be the Chief Executive of the PRA, and the Deputy Governor for financial stability and the Chief Executive of the CPMA will sit on the PRA board.

The key functions of the PRA will include:

- exercising judgement about the safety and soundness of financial firms;

- making prudential rules for the firms it regulates;
- authorisation of firms to engage in regulated activities;
- supervision and enforcement of compliance with rules;
- approval of individuals performing certain controlled functions within a firm; and
- the raising of levies to fund PRA's activities.

The Consumer Protection and Markets Authority is the other peak of the "twin peaks" regulatory structure and will deal with conduct of business regulation for all firms and prudential regulation for those firms not regulated prudentially by the PRA. It has to be said that this covers the large majority of firms, so most firms regulated by the FSA will still only be regulated by the one regulator. The CPMA will regulate:

- the conduct of all firms - including all firms authorised and subject to prudential supervision by the PRA - in their dealings with ordinary retail consumers, taking a proactive approach as a strong customer champion; and
- dealings in wholesale financial markets including the conduct of all financial services firms in wholesale markets, firms providing market services (such as investment exchanges and providers of multilateral trading facilities), and market conduct more generally (including, through the use of the existing FSMA powers to impose penalties on persons for market abuse, ensuring the integrity of financial markets).

The CPMA will be governed by a board with a majority of non-Executives appointed by the Treasury. The Chief Executive of the PRA will sit ex-officio on the board of the CPMA.

The primary objective of the CPMA will be to ensure confidence in financial services and markets, with particular focus on protecting consumers and ensuring market integrity.

The CPMA will also have a relationship with the FOS and the FSCS in a similar manner to that which the FSA has with FOS and the FSCS at the moment.

The key powers and functions of the CPMA will be as follows:

- making the rules which govern the conduct of financial firms, in both

the retail and wholesale spheres, and prudential rules for firms not regulated by the PRA;

- the granting of permissions for all regulated activities classified as "non-prudential". It will be responsible for the authorisation of firms not regulated by the PRA and for providing permissions for conduct-based regulated activities undertaken by firms authorised by the PRA;
- supervision of compliance with conduct of business rules, and of the prudential activity that sits within its remit;
- a strong approach to enforcement to ensure credible deterrence; and
- the approval of individuals to perform conduct-related controlled functions within financial firms that are also prudentially regulated by the PRA, and approval of all controlled functions where firms are regulated by the CPMA only.

It will take up to two years to put the legislation and the above structures in place, but in the interim the FSA is being organised as a "shadow organisation" that reflects the above structure.

How OAC can help?

We can help you understand the best way of structuring your business to achieve the most effective response to the challenges of the new regulatory structure and also keep you updated as changes occur.

Download my other article "Part 2: The Changing Regulatory Landscape" at oacplc.com/publications/oac-topical-article-1010cc2.pdf.

Conolly Tunnard
+44 (0)20 7278 9500
conolly.tunnard@oacplc.com
oacplc.com/complianceconsulting

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OAC Actuaries and Consultants

Portsoken House Minories London EC3N 1LJ
www.oacplc.com enquiries@oacplc.com

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